BETTER MARKETS

SEC REPORT

FEBRUARY 1, 2023

The Securities And Exchange Commission: Regulation And Enforcement In 2022

Major Progress But More Work To Do

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INTRODUCTION

THE SEC'S MISSION AND WHY IT MATTERS

In this report, we examine the progress of the Securities and Exchange Commission (SEC or Commission) over the past year on two fronts, regulation and enforcement. We review the agency's many positive steps to make the securities markets fairer and more transparent for investors, and we also identify areas, in both regulation and enforcement, where the SEC must do more to fulfill its statutory duty and serve the American public.

Why do these issues matter, not only to policymakers and experts in financial regulation but also to virtually every American? Because the SEC is critical to maintaining the integrity, stability, and vitality of our securities markets, and those markets are critical to a thriving economy. The securities markets contribute to economic prosperity by providing capital to innumerable companies of all types and sizes. Capital essentially means funding, which is critical for any business—small, medium, or large—to start up and expand. As companies grow, they create goods, services, and innovative technologies. These activities generate more and better jobs that in turn create wealth and raise standards of living. In short, we depend on a financial system that supports the productive economy, and at the core of that financial system are the securities markets.

The SEC exists to regulate and police those markets so that they work as intended. For example, if people are going to invest their hard-earned money, they must be able to rely on promoters' promises. That requires investors to have trust, faith, and confidence in the representations and disclosures that induced them to invest and in the markets where their securities are later valued and traded. That's why the SEC prioritizes investor protection and, for example, requires companies to disclose complete and accurate information about investment opportunities. That's also why the SEC serves as the federal cop on the securities beat. It is the main line of defense against the financial firms and individuals who commit fraud and other forms of abuse that victimize investors.

Consider the threats to investors in the securities markets. Sometimes they take the form of classic violations of law, from false disclosures and fraudulent Ponzi schemes to market manipulation and theft of investors' money. In other cases, the threats are more subtle but no less damaging, as when predatory high-frequency trading firms use computer algorithms to take individually small but collectively massive amounts of money out of Americans' pockets. Or consider the financial advisers who recommend investments that pay themselves generously in fees and commissions but saddle their unsuspecting clients with poor returns or even catastrophic losses from high-risk investments.

If the SEC fails to write strong rules to address illegal and predatory behavior—and to fix structural flaws in the markets—then investors, markets, and the capital formation process suffer a long list of harms. Investors are more likely to fall victim to fraud, to trade in risky products based on manipulative digital

engagement prompts, to receive bad investment advice from advisers with conflicts of interest, to pay more for their trades than they should, and to struggle with important investment decisions without the information they need on the financial risks surrounding climate change and other trends that affect a company's financial returns. Gaps in securities regulation can also increase the threat of major market stresses, runs, and instability, contributing to a financial crisis or even a crash.

When enforcement lags, these injuries are compounded. If securities frauds are not identified and shut down, the number of victims continues to grow and investor losses mount. If enforcement actions are not brought, investors often have little hope of recovering their money through disgorgement of the scammer's ill-gotten gains. And if wrongdoers face light penalties, more are emboldened to break the law and those who are unfit to lead companies or work in the industry remain on the playing field, capable of doing further damage.

Weak regulation and enforcement threaten a deeper harm by eroding investors' confidence in the fairness of the markets and the ability of regulators to protect them. That means fewer people will put their money at risk and fewer companies will have the capital they need to start up, grow, and create jobs. Thus, inadequate regulation and weak enforcement threaten not just the financial system, but the entire economy and the jobs and living standards of all Main Street Americans, even those who never invest in the securities markets. The U.S. securities markets are the broadest, deepest, and most liquid capital markets in the world. Their success is due largely to the extensive regulatory framework that governs them and the SEC's work in implementing and enforcing that framework, which underpins a thriving financial system and economy.

All of this is why the SEC is such an important regulatory agency and why those who care about the success of our markets and our entire financial system and economy should be aware of the SEC's achievements as well as the areas where it can improve.

HIGHLIGHTS OF THIS REPORT AND OVERVIEW OF FINDINGS

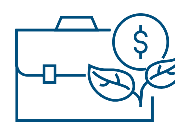
This report looks at six major aspects of the securities markets that the SEC is responsible for regulating, including:

INVESTOR PROTECTION

MARKET STRUCTURE

FINANCIAL STABILITY

CAPITAL FORMATION



ENVIRONMENTAL, SOCIAL, & GOVERNANCE FACTORS

PRIVATE FUNDS

It describes the important progress the agency has made and also where it needs to do more in each area. We then review the SEC's accomplishments in the realm of enforcement, along with approaches that the agency should pursue more aggressively to enhance accountability and more effectively punish and deter bad actors. We don't attempt to cover all aspects of the SEC's regulatory or enforcement work or some of its other important programs such as examinations. Our goal is to highlight some of its most important regulatory and enforcement priorities, accomplishments, and gaps.[1]

[1] Those interested in more detail can turn to many resources, but the first stop should be the Better Markets website, www.bettermarkets.org. There readers can find an entire archive of our advocacy on the SEC and the other financial regulators, including comment letters, reports on many aspects of financial regulation, and press releases and other resources. In addition, the SEC's website, www.sec.gov, offers useful information on many topics, including all proposed and final rules as well as fact sheets and enforcement releases.

REGULATION HIGHLIGHTS

1. INVESTOR PROTECTION

The SEC is using its existing authority under the securities laws to combat the unregistered and fraudulent **crypto offerings** that have proliferated over the past several years. Meanwhile, some firms are using new **digital engagement practices** (DEPs) and gamification techniques to induce trading habits that are not in investors' best interest, and the SEC plans new rules targeting those abuses. The SEC recently rolled back rule provisions adopted under the prior administration that hampered the ability of **proxy advisory firms** to provide their clients with timely and independent advice on issues of corporate governance requiring informed shareholder votes. **Mandatory arbitration** has plagued investors for years, forcing them into secretive, unfair, and often expensive forums that provide little relief when they have been victimized by firms. The SEC should exercise the explicit authority it received in the Dodd-Frank Act to ban or limit the use of mandatory pre-dispute arbitration clauses. Advisers continue to give conflicted advice to their clients to generate fees and commissions, and although the SEC has issued helpful guidance and begun to enforce **Regulation "Best Interest,"** it must strengthen the rule itself.

2. MARKET STRUCTURE

The way orders for **securities trades are handled and routed** makes an enormous difference to investors, and the SEC has proposed an ambitious set of rules to make the process fairer and more transparent. They include a new best execution standard, an order competition requirement, smaller trading increments, and enhanced disclosures about how well orders are executed. In addition, to reduce risk, the SEC has proposed to **shorten the "settlement cycle,"** the time period between a trade and the settlement of that trade through the actual exchange of money and securities.

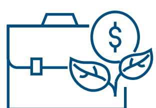
3. FINANCIAL STABILITY

Executive compensation practices that incentivized high-risk financial activities helped set the stage for the 2008 financial crisis. The SEC has recently finalized two important rules, one that will reveal the relationship between **executive compensation and financial performance** and one that will require companies to recover or **claw back incentive-based compensation** that was erroneously awarded, as shown by accounting restatements. The huge market in U.S. **Treasury securities** is a potential source of dangerous financial instability, and the SEC is pursuing new rules to enhance the oversight of trading platforms specializing in government securities, require high-frequency trading firms that trade extensively in government securities to register as dealers, and require more trading in U.S. Treasuries to be conducted through a central clearing agency. The SEC has proposed new liquidity requirements to help make **money market funds** more resilient in times of market stress, although they fall short of the measures needed to fortify these bank-like products, including capital buffers and pricing for all MMFs that accurately reflects the changes in share value (the floating NAV). Finally, the SEC must do more to address the conflicts of interest that dominate the major **credit rating agencies**, which have a history of inflating ratings to attract and retain lucrative ratings business from companies seeking to raise capital. The SEC should establish an independent assignment system for structured products, as required under Dodd-Frank; make clear that the ratings agencies are liable for misleading ratings; and reveal the names of the firms shown to have violated the law in the annual examination reports compiled by the SEC.

4. CAPITAL FORMATION

The **private offering markets** have overtaken the more transparent "initial public offering" process for raising capital. The SEC plans to help restore balance by increasing transparency in the required filings associated with private offerings (the Form D), updating the accredited investor definition to ensure only wealthier investors assume the heightened risks in private offerings, and expanding the universe of companies that must file regular reports with the SEC (via a change to the definition of shareholder "of record"). The SEC has moved aggressively to combat abuses in offerings by **special purpose acquisition companies (SPACs)** through rule proposals and targeted enforcement.

5. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS



Environmental, social, and governance (ESG) factors are of increasing interest to investors as they decide where to put their money at risk. The SEC is responding with two rules aimed at ensuring that investment fund strategies match **fund names** and enhancing **disclosures** surrounding ESG funds. The SEC has also proposed a wide-ranging rule to require enhanced and standardized corporate **disclosures regarding climate change** risks. To help address racial economic inequality, the SEC has issued FAQs to promote diversity in the asset management field, and it plans to propose a rule requiring disclosures about **corporate board diversity**. To mitigate risk, promote fairness, and enhance corporate transparency, the SEC has proposed rules to strengthen the reporting obligation when the **5% ownership threshold** in a company is reached and to reveal more information about **share buybacks**, often used to enhance executive compensation rather than benefit the company or its workforce.

6. PRIVATE FUNDS

Private investment funds pose stability risks and investor protection concerns. The SEC has appropriately proposed rules to enhance the quantity, quality, and timeliness of private fund reporting on the **Form PF**, and it has proposed a rule that will require more comprehensive **disclosures to investors**, audits, fairness opinions for certain transactions, and bans on preferential treatment of investors.

ENFORCEMENT HIGHLIGHTS

The SEC amassed an impressive record of enforcement, with an increase in the number of cases and monetary sanctions totaling $6.4 billion in fiscal year 2022. However, it must be more aggressive if the tide of securities law violations is to be stemmed. The SEC must routinely hold **individuals** accountable, not only their corporate entities; impose **fines** large enough in relation to a defendant's assets or net worth to effectively deter misconduct; and impose more robust **non-monetary sanctions** to reform behavior and protect the public. The SEC continues to use the **whistleblower program** to good advantage, and it wisely finalized two rules to make clear it will consider the dollar amount of an award only to increase, not decrease, the award, and further to clarify that it is prepared to make awards even if an award could be made under another agency's whistleblower program. Finally, as noted above, the SEC is actively pursuing **crypto violators** under the securities laws, and a compilation of significant cases is set forth in the Appendix.

THE CHALLENGES FACING THE SEC

Anyone reviewing or evaluating the SEC's record must also consider its challenges. The traditional formulation of the SEC's three-part mission is this: (1) protect investors; (2) maintain fair, orderly, and efficient markets; and (3) facilitate capital formation.[2] It's a huge responsibility. The SEC oversees a $100-trillion capital market, representing 38 percent of the capital markets worldwide. It oversees the initial offering of securities, secondary trading in the markets, and all of the market participants who make it work, including brokers, advisers, and exchanges.[3] In short, the job of the SEC is more complicated than policing a disclosure regime and bringing enforcement actions to stamp out fraud.

The agency faces many challenges, including these:

- The **industry participants** in the securities markets include thousands of firms and individuals, such as broker-dealers, investment advisers, and exchanges.
- The financial services industry offers a huge variety of **securities products and services**, including stocks, bonds, mutual funds, ETFs, digital platforms, and computer-based robo advice, all with different features and pricing structures. And policing the explosion in cryptocurrency offerings, accompanied by rampant fraud and abuse, has posed a huge challenge for the SEC, particularly in the enforcement arena.
- The **technologies** used in the securities markets are constantly evolving, such as the computer algorithms that high-frequency trading firms use to jump ahead of other investors and pocket near-certain profits.
- The **fraudsters and predators** are ever-present, devising new ways to rob investors, manipulate the markets, and line their pockets.
- The **numerous laws** governing the securities markets are complex, comprised of four major statutes and a voluminous collection of rules that have grown to meet the challenges arising in the markets.
- The industry's **resistance to regulation** is constant, as members of the industry, in concert with their associations, lobbyists, law firms, and allies on the Hill, besiege the SEC during the rule-writing phase and then ask courts to strike down the rules they have failed to derail or weaken to their satisfaction.

Adding to all of these challenges is the SEC's chronic lack of adequate resources. The SEC's budget is meager given its enormous responsibilities and compared to the wealth and resources of the financial services industry it oversees. Over the past decade, the scope and breadth of SEC's responsibilities have increased dramatically, while the agency's funding has failed to keep pace. The SEC is charged with overseeing vast swaths of our $100 trillion capital markets, including 24 national securities exchanges, 99 alternative trading systems, ten credit rating agencies (NRSROs), seven registered clearing agencies, five SROs, 29,000 issuers, 15,000 registered investment advisers, and 16,000 investment companies. In addition, the SEC is responsible for addressing issues in the markets as they arise, which over the past few years in particular were numerous and complex. They included market disruptions in our U.S.

[2] Dennis Kelleher, *The Agenda for New SEC Chairman Gary Gensler*, Better Mkts. (May 17, 2021), https://bettermarkets.org/newsroom/agenda-new-sec-chairman-gary-gensler/.

[3] *See generally* John C. Doerfer, *The Federal Securities Act of 1933*, 18 Marq. L. Rev. 147 (1934) (outlining the historical context surrounding the Securities Act of 1933 and observing the role of the historic 1929 crash in giving rise to the legislation).

Treasuries markets in 2020, the rise and fall of special purpose acquisition companies, the rapid surge in cryptocurrencies, the meme-stock volatility in 2021, the rise of digital engagement practices, the fall of Archegos, investor demands for greater climate risk disclosure, and evolving cybersecurity risks.

Despite the seemingly overwhelming responsibilities of the agency, and its resource challenges, the SEC has performed admirably, especially considering that staffing levels of the Agency are at or below 2016 levels.[4] But to continue overseeing a growing and ever-more complex market, and to address numerous longstanding problems—some of which are described in this Report—the SEC must have more resources at its disposal. And they can be provided without putting added pressure on the federal budget: Through securities transaction, registration, and other fees, the SEC generated over $2.4 billion in revenues for the government during the last fiscal year.[5] Yet the agency remains subject to the Congressional appropriations process, one that continues to withhold sufficient resources for an agency that oversees a market critical to the economy and the American people.[6]

Over time, the SEC's priorities in meeting all of these challenges have shifted, sometimes with the agency's leadership and sometimes with the novel and pressing demands of the rapidly growing and evolving markets. Under Chair Gensler, the agency has declared its commitment to a number of key priorities, in both rulemaking and enforcement.[7] Although the Commission is under significant resource constraints, it is clear that Chair Gensler is serious about reinvigorating an agency that suffered from misguided priorities under the previous administration.[8] Over the past year, the agency has made laudable progress in both regulation and enforcement in the securities markets. However, as we show below, there are a number of important reforms that still require the SEC's focused attention.

[4] *See Oversight of the U.S. Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 117th Cong. (2022) (testimony of Gary Gensler, Chair, Sec. & Exch. Comm'n) ("Last year, the agency had 4 percent fewer staff than it did in 2016."), https://www.sec.gov/news/testimony/gensler-testimony-housing-urban-affairs-091522.

[5] Sec. & Exch. Comm'n, Fiscal Year 2022: Agency Financial Report 30 tbl. 1.4 (2022) (listing $2,436 million in total earned revenue for fiscal year 2022), https://www.sec.gov/files/sec-2022-agency-financial-report.pdf.

[6] Congress has approved a roughly 9.5 percent increase in funding for the SEC over FY2022 levels. While this represents a helpful increase, it does not match the amount the SEC actually needs to fulfill its regulatory and enforcement responsibilities.

[7] *See, e.g.*, Gary Gensler, Chair, Sec. & Exch. Comm'n, Remarks at the Securities Enforcement Forum (Nov. 4, 2021), https://www.sec.gov/news/speech/gensler-securities-enforcement-forum-20211104; Gurbir Grewal, Director, Div. of Enf't, Sec. & Exch. Comm'n, Remarks at SEC Speaks 2021 (Oct. 13, 2021), https://www.sec.gov/news/speech/grewal-sec-speaks-101321; Gurbir Grewal, Director, Div. of Enf't, Sec. & Exch. Comm'n, Remarks at PLI Broker/Dealer Regulation and Enforcement 2021 (Oct. 6, 2021), https://www.sec.gov/news/speech/grewal-pli-broker-dealer-regulation-and-enforcement-100621; *see also Oversight of the SEC's Division of Enforcement: Hearing Before the H. Comm. on Fin*. Servs. Subcomm. on Inv. Prot., Entrepreneurship, and Cap. Mkts., 117th Cong. (2022) (testimony of Gurbir Grewal, Director, Sec. & Exch. Comm'n Div. of Enf't), https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922.

[8] *See generally* Ephrat Livni, *Gary Gensler Reflects on His First Year as S.E.C. Chair*, N.Y. Times (Apr. 16, 2022), https://www.nytimes.com/2022/04/16/business/dealbook/gary-gensler-sec.html; Matthew Goldstein, *Manic Markets, Imploding Funds: Wall Street's New Top Cop Has a Full Plate*, N.Y. Times (Apr. 21, 2021), https://www.nytimes.com/2021/04/21/business/economy/gensler-wall-street-sec.html; Leslie Picker, *Donald Trump Nominates Wall Street Lawyer to Head S.E.C.*, N.Y. Times (Jan. 4, 2017), https://www.nytimes.com/2017/01/04/business/dealbook/donald-trump-sec-jay-clayton.html.

EXECUTIVE SUMMARY

REGULATION

1. INVESTOR PROTECTION

Investor protection is the SEC's top priority, and it is a full-time, around-the-clock challenge for the agency. Over the past year, the SEC has been especially effective at recognizing some new threats to investors and taking steps to address them. Examples include its strong response to the explosion—and implosion—of the cryptocurrency markets and its planned rulemaking to address the harmful use of digital engagement practices. The SEC has also taken positive steps to ensure that investors have access to independent and timely advice about how they should exercise their proxy voting rights. In addition, as discussed elsewhere in this Report, the SEC is pursuing a number of reforms in other areas, including market structure, capital formation, and private funds, that will better protect investors. At the same time, we identify two threats to investors that the SEC should more proactively address, including mandatory arbitration and conflicts of interest among financial advisers.

- As discussed further below, the SEC has been clear-eyed about the cryptocurrency markets and is appropriately asserting its authority over crypto offerings as securities. And it is gamely pursuing enforcement actions against firms that offer cryptocurrency investments that fail to comply with the securities laws, although it should ramp up its enforcement effort against platforms and exchanges that persist in their refusal to register.
- Digital engagement practices are cleverly designed interfaces, often on mobile apps, intended not only to make investing easier but also in many cases to induce more trading and therefore higher profits for brokers, turning a blind eye to what's best for the investor. The SEC has rightly recognized the need to address this trend and it plans a rulemaking on these emerging practices, as reflected in its Fall 2022 Regulatory Flexibility Agenda (Fall Agenda).[9]
- Although sometimes underappreciated, proxy voting is a vitally important feature of our capital markets. It enables investors to elect the leaders of the companies they own and help steer corporate policy. These are especially important rights given the emergence of the ESG movement and investor interest in directing their investment dollars to enterprises sensitive to the financial risks that climate change and racial injustice pose to companies. Here, the SEC has rightly rolled back rules adopted under the prior administration that hampered the ability of proxy advisory firms to render timely and truly independent analyses of corporate practices and policies that affect investors.

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[9] *See* Off. Of Info. & Regul. Affs., Fall 2022 Unified Agenda Of Regulatory And Deregulatory Actions, https://www.reginfo.gov/public/do/eAgendaMain (select "Securities and Exchange Commission" in the "Select Agency" drop-down menu and click "Submit") (last visited Jan. 6, 2023).

- Mandatory pre-dispute arbitration agreements have long prevented investors victimized by financial firms from seeking justice in court, forcing them to engage in a secretive, unfair, industry-run forum that rarely affords meaningful recovery for the damages suffered. Although the SEC received explicit authority in the Dodd-Frank Act to ban or limit pre-dispute mandatory arbitration clauses in client account agreements, the SEC has done nothing to implement that authority. The SEC must act on this authority for the benefit of investors and to more effectively deter fraud and abuse by the financial services industry.
- The SEC must also do more to fight the corrosive and costly impact of conflicted investment advice. Regulation "Best Interest," adopted in 2019, was a terrible disappointment, failing to capitalize on clear Congressional authorization in the Dodd-Frank Act to establish a strong and uniform fiduciary standard for all firms who offer advice about securities investments to their retail clients. Recent SEC attempts to compensate for the weak rule through guidance and enforcement are unquestionably helpful, but they are unlikely to solve the problem,[10] and investors deserve better in the form of a true fiduciary duty rule.

2. MARKET STRUCTURE

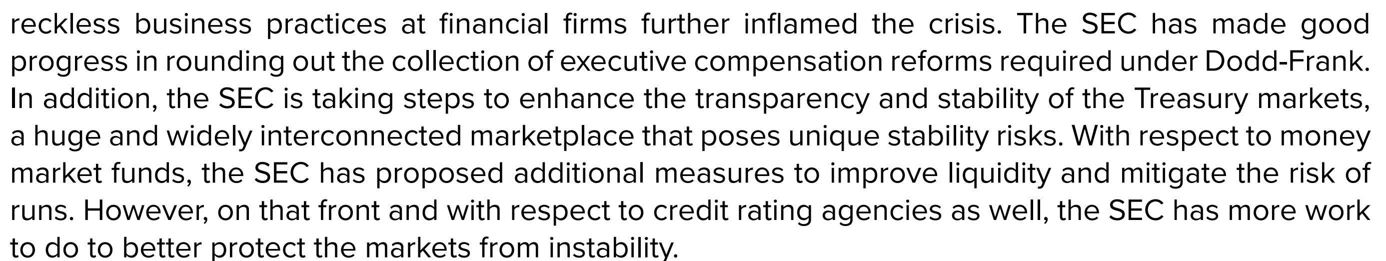
Although technical and often overlooked, the way that securities trades are routed and executed can make a huge difference to investors. The SEC is pursuing a number of reforms to make the mechanics of the markets fairer to investors and more transparent to markets and the SEC.

- On December 14, 2022, the SEC proposed a set of four reforms aimed at improving the prices that investors receive on their orders. Currently, retail investors' orders are often routed not to exchanges but to obscure firms known as wholesalers that, with advanced computer technology, can generate huge profits by trading against those orders while leaving investors with worse prices than they could have gotten in a competitive market. The recently proposed reforms seek to address this problem by 1) establishing a new "best execution" requirement; 2) requiring at least some types of orders to be exposed to competition in fair and open auctions before they can be executed internally; 3) expanding the monthly reporting on execution quality that firms must make; and 4) reducing the minimum pricing increment at which stocks may be quoted and trade, so that buyers and sellers can get better prices on their trades. Although promising, these proposals are lengthy and complex, and they raise some concerns about their likely effectiveness. Evaluating their impact will take some time.
- In a related vein, the SEC has proposed reducing the settlement cycle for securities trades to T+1 from T+2, thus requiring trades to settle within one, not two, days after the trade date. This will reduce the risks and costs associated with the current delay in finalizing the exchange of money and securities according to the terms of a trade.

3. FINANCIAL STABILITY

While the banking system draws more attention when it comes to ensuring the stability of our financial system and preventing financial crises, the securities markets can also trigger or exacerbate extreme financial stress and instability. Recall that abuses in the market for mortgage-backed securities, including grossly inflated credit ratings assigned to them, were the principal fuel for the 2008 financial crisis. And executive compensation policies that incentivized

[10] *See generally* Complaint, *SEC v. W. Int'l Sec., Inc.*, No. 2:22-cv-4119 (C.D. Cal. June 15, 2022), ECF No. 1.



reckless business practices at financial firms further inflamed the crisis. The SEC has made good progress in rounding out the collection of executive compensation reforms required under Dodd-Frank. In addition, the SEC is taking steps to enhance the transparency and stability of the Treasury markets, a huge and widely interconnected marketplace that poses unique stability risks. With respect to money market funds, the SEC has proposed additional measures to improve liquidity and mitigate the risk of runs. However, on that front and with respect to credit rating agencies as well, the SEC has more work to do to better protect the markets from instability.

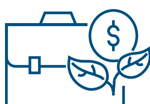
- Major contributors to the financial crisis were misaligned incentives generally, and executive compensation policies in particular, at many financial institutions. Those policies motivated corporate leaders to engage in high-risk activities for short-term profit and lucrative bonuses. The Dodd-Frank Act required the SEC to issue a variety of reforms to address the problem, and with the recent adoption of two final rules, the agency is coming close to implementing all of those reforms. In August 2022, the SEC finalized its pay versus performance rule, which will shine a light on the relationship between executive compensation and the company's financial performance, increasing transparency as a tool for combatting inflated and reckless compensation packages. And in October 2022, the SEC finalized its clawback rule, which ensures that when a company is required to issue an accounting restatement, broadly defined, it must recover incentive-based compensation paid to current or former executives over the prior three years, in excess of what they were entitled to under the restated financials. This important rule will deter accounting manipulation and benefit companies and shareholders who should not have to pay erroneously awarded compensation.
- The SEC is also pursuing important reforms in the U.S. Treasury markets, driven largely by concerns that those markets are prone to dangerous instability in times of stress. It has proposed rules that will require trading platforms that specialize in the trading of government securities to comply with additional requirements under what's known as Reg ATS. It has also proposed rules to ensure that principal trading firms (generally, high-frequency trading firms) that trade extensively in Treasuries must register as government securities dealers subject to reporting and other requirements, and that more trading in U.S. Treasuries is conducted through a central clearing agency.
- Money market funds (MMFs) displayed nearly catastrophic instability and exposure to investor runs not only during the 2008 financial crisis but also during the March 2020 market chaos triggered by the Covid pandemic. For years, the SEC has moved too cautiously and incrementally to solve the problem. Its latest round of proposals, issued in December 2021, will help by strengthening liquidity and reporting requirements and rolling back the redemption fees and gates adopted under the prior administration, which are believed to intensify rather than dampen run risk. However, they fall short by failing to require all MMFs to float the pricing of their net asset values, instead maintaining the fiction of a fixed NAV for retail MMFs. And they fail to require MMFs to establish capital buffers, which are necessary to minimize run risk and prevent fund collapse without taxpayer bailouts.
- The SEC also has more to do with respect to oversight of the credit rating agencies. Conflicts of interest inherent in the issuer-pay model of compensation persist, and the credit rating agencies are still unjustifiably insulated from liability for their ratings. The SEC can and should 1) fulfill the mandate of Section 939F of the Dodd-Frank Act by establishing an assignment system for initial ratings on complex structured products to help mitigate the conflicts of interest arising from the issuer pay model; 2) take steps to clarify that credit rating agencies are subject to liability under Section 11 of the Securities Act of 1933; and 3) increase transparency by specifically naming credit rating agencies when describing compliance violations in the annual examination reports required by Dodd-Frank.

4. CAPITAL FORMATION

Capital is the lifeblood of the U.S. economy, and the securities markets are crucial to ensuring that capital is allocated to businesses seeking to start up, grow, and provide the goods and services that the American people want and need. Exactly how capital is raised from investors can make a huge difference in terms of the amount and quality of information they receive in the process. Here, the SEC is planning a number of positive reforms, and it has already succeeded in limiting the harm done by special purpose acquisition companies or "SPACs," an opaque capital raising vehicle that has resulted in significant financial losses for investors.

- The backbone of the capital raising engine has long been the IPO or initial public offering, which helps ensure that investors get complete and accurate information about the companies asking for their investment dollars. But for several decades, the IPO has been overshadowed by a growing and complex array of exemptions from the IPO requirements that reduce transparency and investor protections. This trend is not good for investors, who face greater risks from these so-called private or limited offerings. The SEC plans to address part of the problem, as its Fall Agenda reflects items apparently aimed at improving the Form D, which currently provides minimal information about a private offering; updating the accredited investor definition that defines the class of investors who supposedly have the wealth and sophistication to invest in private offerings; and broadening the registration and reporting obligations of companies via amendments to the definition of shareholder "of record."
- On a related front, and to its credit, the SEC has made significant progress curbing abuses in the world of SPACs, a recently popular capital raising vehicle that evaded a number of investor protection requirements. Through increased enforcement and proposed rules, it has significantly curbed the use of the SPAC model and better protected investors.

5. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS



ESG considerations are having an increasingly profound impact on the capital markets because investors understand how these factors can influence the near and long-term profitability—even viability—of companies. Investors thus need full, accurate, and comparable material information about the impact of the ESG factors on investment managers and companies. The SEC has made significant progress on this front.

- In April 2022, the SEC proposed a sweeping climate disclosure rule to require enhanced and standardized disclosures of the risks that companies are facing from climate changes and the measures those companies are taking to address those risks. Although facing strong opposition, the proposal represents an important and worthwhile reform that responds to investor demands for information from issuers about the impact of climate change on their operations.
- In June 2022, the SEC proposed two rules to establish a standard ESG disclosure framework and better regulate the use of terms such as "ESG" and "Sustainable" in investment company names. Specifically, the SEC's proposed ESG rule would establish a standardized ESG disclosure framework that would create more reliable, consistent, and comparable disclosures for ESG funds based on the extent to which a fund considers ESG factors in its investment selection and issuer engagement processes. The other rule would combat the misleading use of fund labels, known as greenwashing, by ensuring that funds follow investment strategies suggested in fund names.

- In the fight against racial economic inequality, the SEC has taken some limited steps, with more anticipated in 2023. Last year, SEC staff implemented one of the SEC's Asset Management Advisory Committee's recommendations by issuing an FAQ relating to investment adviser consideration of diversity, equity, and inclusion factors.[11] This FAQ was an important step to clarify that diversity, equity, and inclusion are appropriate factors for investment advisers to consider when selecting other advisers to manage client assets, consistent with the client's investment objectives. And the Fall Agenda indicates that the Commission plans to propose rules requiring disclosures about the diversity of board members and nominees. These actions are welcome measures designed to help inform investors about the racial and gender composition of the governing bodies of publicly traded companies so those investors can make more informed investment decisions, and ultimately help address racial and gender economic inequality.
- With respect to corporate governance, the SEC issued a proposal in March to strengthen the beneficial ownership reporting rule to prevent opportunistic trading and to increase market stability by shortening the deadline for reporting once the 5% ownership threshold is reached. The proposal would also expand the scope of the rule to include derivatives. In February, the SEC proposed a rule to improve the quality, quantity, and timeliness of information regarding an issuer's repurchase of its own shares, otherwise known as "stock buybacks." These transactions are often used by executives to boost share prices and increase the value of their compensation, while diverting capital so it cannot be used to benefit the company or its workforce.
- Finally, the Fall Agenda indicates that the SEC will be considering "rule amendments to enhance registrant disclosures regarding human capital management," with the potential to increase transparency into the way companies treat and deploy their workforce, information that will benefit investors.

6. PRIVATE FUNDS

Long operating in the shadows and largely for the benefit of only wealthy investors, private funds nevertheless are important players in the capital markets, representing trillions of dollars under management and extensive interconnectedness with the financial system. The Dodd-Frank Act enhanced oversight in this sector by requiring private fund advisers to register and file reports via the Form PF. The SEC has correctly determined that it is time to strengthen some of the rules applicable to private funds.

- First, after nearly ten years' experience reviewing and assessing Form PF submissions by private fund advisers, the SEC has proposed two rulemakings within the past year designed to (1) increase the frequency of reporting in times of market stress; and (2) enhance and modernize the quantity and quality of data being reported.

[11] *See* Sec. & Exch. Comm'n, Staff Faq Relating To Investment Adviser Consideration Of Dei Factors (Oct. 13, 2022), https://www.sec.gov/tm/staff-faq-relating-investment-adviser-consideration-dei-factors.

ENFORCEMENT

1. THE INGREDIENTS FOR STRONGER ENFORCEMENT

The SEC's Division of Enforcement continues to work hard bringing actions against those who violate the securities laws. And the results were impressive for the past fiscal year. For example, the SEC announced that it had recovered $6.4 billion in monetary sanctions, a substantial increase over the $4 billion recovered during the prior fiscal year. However, the numbers do not tell the whole story. To be truly effective at punishing and deterring securities fraud and abuse, the SEC's enforcement program must more regularly incorporate other elements.

- First and most importantly, the individuals responsible for violations of law must be held accountable, in addition to the corporate entities for whom they work. The fact is that behind every violation by a broker, bank, or advisory firm, there stands one or more responsible individuals. Each must be personally punished with fines, restitution, disgorgement, claw backs, and industry bars in virtually every case. In addition, the executives, supervisors, and compliance and risk personnel who are responsible for ensuring that systems and controls are in place to prevent, detect, and remediate violations must also be held accountable to the full extent of the law. Holding individuals accountable must become the rule, not the exception, if violations of law in the financial markets are ever to be effectively deterred.
- Monetary sanctions must be high enough, relative to a defendant's balance sheet or personal financial status, to serve as real deterrent. Otherwise, fines and penalties represent merely a cost of doing business. Such weak sanctions not only reward past lawbreaking but also incentivize—guarantee, in fact—future lawbreaking.
- Non-monetary sanctions are powerful enforcement tools, and they should be imposed routinely. Fines alone are usually not sufficient; they should often be accompanied by admissions of liability, conduct-based remedies, and bars and disqualifications.

2. THE WHISTLEBLOWER PROGRAM

The whistleblower program continues to prove invaluable to the SEC's enforcement program. Every year the agency makes substantial awards for information provided by corporate insiders who blow the whistle on lawbreaking. This information is uniquely helpful in bringing enforcement actions against those who commit the often difficult-to-detect-and-prove violations of the securities laws. In August 2022, the SEC adopted two enhancements to its whistleblower rules.

- The first rule change made clear the Commission's authority and intention to pay out whistleblower awards even if the awards could otherwise be paid under another federal agency's whistleblowing program.
- The second rule affirmed the Commission's authority to consider the dollar amount of a potential award for the limited purpose of increasing an award but not to lower an award. As Chair Gensler put it, "[t]hese amendments . . . would help ensure that whistleblowers are both incentivized and appropriately rewarded for their efforts in reporting potential violations of the law to the Commission."
- Nevertheless, the Commission should consider further improvements, including a reassessment of its guidance restricting the types of independent analysis for which whistleblowers can get credit.

3. CRYPTOCURRENCIES AND DIGITAL ASSETS

An increasingly important aspect of the SEC's enforcement program is the battle the agency is waging against crypto firms and exchanges that offer or trade unregistered securities in the form of tokens and other digital investments. The SEC has made clear that most crypto offerings are securities, usually in the form of investment contracts, and it has rightly called upon the industry to register their crypto offerings and exchanges with the SEC.

- The SEC is bringing a significant number of cases and is having notable successes, including the action involving a digital asset company called LBRY, against which the agency secured a judgment in federal court for selling unregistered securities.
- In some cases, including the enforcement action against Ripple, the industry is engaged in a scorched earth litigation strategy to defeat the SEC's legal theories: The case was filed in December 2020, and Ripple has spent more than $100 million in attorneys' fees in just two years. The court's decision will undoubtedly be appealed, but it will hopefully help settle the status of many crypto investment offerings and confirm the SEC's jurisdiction over them.
- The attached appendix highlights the SEC's major actions involving cryptocurrencies, a list that is bound to grow unless the industry decides to abandon its lawless practices and seeks to comply fully with all applicable laws and rules—as all legitimate businesses must.[12]

[12] *See Fact Sheet Setting the Record Straight on Crypto, FTX, Sam Bankman-Fried, Jamie Dimon, the SEC and CFTC, and the Revolving Door*, BETTER MKTS. (Nov. 13, 2022), https://bettermarkets.org/newsroom/fact-sheet-setting-the-record-straight-on-crypto-ftx-sam-bank man-fried-jamie-dimon-the-sec-and-cftc-and-the-revolving-door/.

ANALYSIS

REGULATION

1. INVESTOR PROTECTION

Cryptocurrencies, digital engagement practices, proxy voting reform, mandatory arbitration, and Regulation "Best Interest."

Investor protection is at the heart of the SEC's congressional mandate. It is mentioned in the Exchange Act more than 200 times, and it is the first order of business among the SEC's tripartite mission—to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Ultimately, investor protection is not only essential to prevent harm to investors but also key to preserving investor confidence, and investor confidence in fair markets is necessary for the success of the securities markets. Regardless of the many innovations and technological advances that have developed in society and in our capital markets since our foundational securities laws were first implemented nearly 90 years ago, the protection of investors has always served as a guiding light for the SEC in regulating markets and market participants, and it must continue to do so.

A. CRYPTOCURRENCIES: The SEC must continue applying the securities laws and taking enforcement action against the scourge of unregistered cryptocurrency offerings.

Cryptocurrencies—or digital currencies—rapidly evolved from an obscure, fringe investment to an in-vogue asset pitched to Main Street households, capturing headlines and luring in millions of new investors. The dramatic fall in the value of crypto assets this Summer and Fall and the even more dramatic recent collapse of many firms, most recently FTX, have inflicted massive damage on investors and exposed the ugly truths about the crypto markets. The lure of crypto is based on nothing of underlying value; widespread appeal stems from the so-far empty promise of financial innovation coupled with the promise of quick, easy, and extraordinary profits. Political contributions combined with the power and influence of former public officials passing through the revolving door and into the industry rapidly expanded the crypto market and gave it a veneer of legitimacy.

The holy grail of the industry has been and remains new legislation that would help establish cryptocurrency as a *bona fide* financial market sector while at the same time ensuring the industry would be subject to minimal, light touch regulation. Fortunately, the rush to establish a new regulatory framework for crypto has lost some of its momentum in light of the recent chaos and collapse in the crypto market, but that legislative push will undoubtedly resume in earnest. So far, at least, regulators and policy makers have refrained from integrating the crypto markets into the mainstream banking and financial system, thus preventing the recent collapse in this market from triggering a widespread crisis.

To its credit, the SEC has been a clear-eyed regulator with respect to crypto. Chairman Gensler has repeatedly stated that the vast majority of crypto tokens are securities[13] and that securities in any form, no matter how novel on their face, should be subject to the same robust regulation under the securities laws to protect investors and the integrity and stability of our markets.[14] He has emphasized that for now, at least, cryptocurrencies are used primarily for speculative investment purposes; that the asset class is akin to the "wild west" and "rife" with fraud; and that investor protection in this area is clearly inadequate. In keeping with the view that the SEC already has the legal tools it needs to police many if not most cryptocurrencies, the Fall Agenda shows no signs of a crypto-related rulemaking.

All of which means that the SEC expects those offering crypto securities, and the platforms trading them, to comply with the registration, disclosure, and anti-fraud provisions of the securities laws. The SEC has acted accordingly, bringing dozens of crypto-related cases in court and administratively. Those actions are largely predicated on the claim that crypto offerings are unregistered securities in the form of investment contracts, defined under Supreme Court precedent as instruments through which a person invests money in a common enterprise with the expectation of profits to be derived from the entrepreneurial or managerial efforts of others. The SEC has also brought several cases against cryptocurrency companies[15] and promoters[16] for traditional violations of securities laws such as insider trading and disclosure failures. Additionally, in June 2022 the SEC denied the Grayscale Bitcoin Trust's proposed rule change to list and trade the shares of the Trust in the form of a publicly-traded ETF.[17] The SEC decision was based in part on the many examples of fraud and manipulation in the spot bitcoin market. In Appendix A, we briefly review the major enforcement actions that the SEC has taken with a connection to cryptocurrencies.

Moving forward, the SEC should be more aggressive in bringing enforcement actions against companies acting as unregistered exchanges that offer trading in cryptocurrency investments. And it should continue to resist attempts to weaken the SEC's authority over crypto investments in the form of proposed legislation that would give another regulator (such as the smaller, underfunded, and less experienced CFTC) primary regulatory jurisdiction over this market.

[13] *See* Gary Gensler, Chair, Sec. & Exch. Comm'n, Remarks Before The Practising Law Institute's SEC Speaks in 2022 (Sept. 8, 2022) ("Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities."), https://www.sec.gov/news/speech/gensler-sec-speaks-090822; Gary Gensler, Chair, Sec. & Exch. Comm'n, Remarks Before the Aspen Security Forum (Aug. 3, 2021) ("[M]any of these tokens are offered and sold as securities.....These products are subject to the securities laws and must work within our securities regime."), https://www.sec.gov/news/speech/gensler-aspen-security-forum-2021-08-03; Gary Gensler, Chair, Sec. & Exch. Comm'n, Interview with CNBC, (Jan. 10, 2022) ("[I]f they call themselves a token, they are still probably, possibly a security."); Gary Gensler, Chair, Sec. & Exch. Comm'n, Prepared Remarks of Gary Gensler on Crypto Markets, Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022) ("The [BlockFi] settlement made clear that crypto markets must comply with time-tested securities laws."), https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422.

[14] Chairman Gensler has also noted that the five largest platforms that facilitate the purchasing and selling of those securities make up 99 percent of all such trading and likely facilitate the trading of more than 100 digital asset tokens. *See id.*

[15] *See, e.g.*, Sec. & Exch. Comm'n, Sec Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action (July 21, 2022), https://www.sec.gov/news/press-release/2022-127.

[16] *See, e.g.*, Sec. & Exch. Comm'n, Sec Charges Kim Kardashian for Unlawfully Touting Crypto Security (Oct. 3, 2022), https://www.sec.gov/news/press-release/2022-183.

[17] *See generally* Order Disapproving a Proposed Rule Change to List and Trade Shares of Grayscale Bitcoin Trust, 87 Fed. Reg. 40,299 (July 6, 2022).

B. DIGITAL ENGAGEMENT PRACTICES AND GAMIFICATION: The SEC should move forward with its intended regulation of platforms that represent investor exploitation more than democratization of finance.

Brokerage firms that cater to individual investors are increasingly deploying DEPs to engage with and encourage their customers to trade securities.[18] According to the SEC, DEPs include "behavioral prompts, differential marketing, game-like features (commonly referred to as 'gamification') and other design elements or features designed to engage with retail investors on digital platforms."[19]

In August 2021, the SEC announced it would seek information and public comment on the use of DEPs by financial entities offering mobile investment apps and robo-advisers, to better understand current market practices and assess the need for further regulation. DEPs include the creation of online trading platforms and mobile apps that appeal to an increasing number of retail investors, especially young investors.[20] As Better Markets argued in a comment letter to the SEC,[21] while these platforms and apps may make trading easier and more accessible, they often include features intentionally designed to entice investors, manipulate their behavior, and maximize their trading activity, often in risky products that investors do not understand.

The reality is that the some of the dominant platforms and apps are designed simply to maximize broker revenue regardless of the damage done to investors. They manipulate investors by bombarding them with constant prompts and rewards for trading, urging them to trade and often luring them into complex and risky products including options and margin accounts. Brokers can sell that retail trading volume to other firms—"payment for order flow"—and reap huge profits. This is not about democratizing finance, as some have claimed; it's about exploiting retail investors for profit.[22]

A distinctive feature of these platforms, and one that can be especially harmful to investors, is the "gamification" of investing. This strategy involves the design and deployment of addictive, game-like features for the purpose of triggering more trading, more often, and more thoughtlessly. As we explain in our comment letter, that type of trading actually leads to suboptimal results and disproportionately high trading losses.

DEPs came under public scrutiny in the aftermath of the frenzied trading of GameStop, AMC, and other so called "meme-stocks" in early 2021. Better Markets has been at the forefront of educating regulators, legislators, policymakers, and the media about the dangers some DEPs, including gamification tactics, pose to retail investors and the stability of the capital markets.[23] On March 17, 2021, Better Markets'

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[18] *See* Dennis M. Kelleher et al., *Securities—Democratizing Equity Markets with and Without Exploitation: Robinhood, Gamestop, Hedge Funds, Gamification, High Frequency Trading, and More*, 44 W. New Eng. L. Rev. 51 (2022).

[19] Sec. & Exch. Comm'n, Sec Requests Information and Comment on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology (Aug. 27, 2021), https://www.sec.gov/news/press-release/2021-167.

[20] *See, e.g.*, Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes with Devastating Results*, N.Y. Times (July 8, 2020), https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html.

[21] *Better Markets Files Comment Letter with SEC on Digital Engagement Practices*, Better Mkts. (Oct. 4, 2021), https://bettermarkets.org/impact/better-markets-files-comment-letter-with-sec-on-digital-engagem ent-practices/.

[22] *See Fact Sheet: A Real Robin Hood on Wall Street: Democratizing Equity Markets Without Exploitation*, Better Mkts. (July 29, 2022), https://bettermarkets.org/analysis/fact-sheet-a-real-robin-hood-on-wall-street-democratizing-equit y-markets-without-exploitation/.

[23] *See* Kelleher et al., *supra* note 18.

Dennis Kelleher testified before the House Financial Services Committee and emphasized how trading is being gamified to increase volume and maximize profits for online trading platforms.[24]

In our October 2021 comment letter to the SEC,[25] Better Markets commended the SEC for closely examining such engagement methods and gathering valuable information from all stakeholders as it will help the Commission better understand the uses and abuses associated with this technology and take steps to better protect investors. While these technologies have the potential to help make trading more accessible to a younger and more diverse population of investors, they also pose serious threats. The "democratization" of finance that involves the use of DEPs to manipulate and exploit retail investors comes at too high a price.

Our comment letter also argued that the SEC can and should apply existing rules, including Regulation "Best Interest," to help curb the powerful conflicts of interest that drive these platforms, since DEPs often amount to *de facto* recommendations that trigger application of the best interest standard. And we urged the SEC to consider any new rules that may be necessary to make sure that these platforms serve rather than exploit investors. As Chair Gensler has rightly said, harnessing new technologies while protecting investors means bringing those innovations within a strong regulatory framework.

That is what the SEC must now do. In a promising sign, the SEC's Fall Agenda indicates that the SEC plans to move forward with rule proposals to address the threats posed by DEPs, both as to brokers and investment advisers.[26]

C. PROXY VOTING REFORM: The SEC has wisely rolled back anti-investor rules adopted under the agency's prior leadership.

In November 2021, the SEC proposed a rule, "Proxy Voting Advice," which sought to rescind an earlier rule from the prior administration that restricted the availability of independent and timely advice for shareholders who want analysis that can help them exercise their proxy voting rights. In July 2022, the SEC took the important step of finalizing the Proxy Voting Advice rule.[27]

Proxy advisors provide vast numbers of shareholders with independent advice and analysis that is untainted or spun by the inherently biased management of a company. It is no surprise that corporate management finds proxy advisory firms to be a thorn in their side. Silencing proxy advisory firms had been on the wish-list of many corporate executives and their trade association and lobbying organizations for years. Unfortunately, prior SEC leadership during the Trump administration sided with corporate interests instead of investors.

The SEC's prior rule imposed burdensome and time-consuming new requirements on the proxy advisory firms before they could continue relying on various exemptions from a comprehensive set of information and filing requirements generally applicable to the proxy process. The prior rule required proxy advisory firms to (1) make their advice available to the companies subject to their advice at or before the time that they made the advice available to the proxy advisory firm's clients and (2) provide their clients with a mechanism by which they could reasonably be expected to become aware of any

[24] *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part II: Before the H. Comm. on Financial Services*, 117th Cong. (2021) (testimony of Dennis M. Kelleher, Pres. & CEO, Better Mkts.), https://bettermarkets.org/sites/default/files/Kelleher%20HFSC%20Testimony%20GameStop%20 Hearing%203-17-2021%20FINAL%20%282%29.pdf.

[25] *See Better Markets Files Comment Letter with SEC on Digital Engagement Practices*, *supra* note 21.

[26] *See* Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions, *supra* note 9.

[27] *See* Proxy Voting Advice, 87 Fed. Reg. 43,168, 43,168 (July. 19, 2022).

written statements responding to the proxy advisory firm's proxy voting advice from companies that were the subject of the advice. These provisions in the Trump-era rule were contrary to the public interest and received staunch opposition from all but corporate management and their allies.

The 2022 Final Rule rescinded these conditions, removing the unnecessary shackles from proxy advisory firms. As we noted in our comment letter,[28] the SEC's 2022 rule is a victory for investors and their ability to receive independent and timely advice about upcoming proxy votes that elect corporate leaders and shape corporate policy. The SEC is to be commended for taking this important corrective action.

D. MANDATORY ARBITRATION: It's past time for the SEC to use its explicit authority to ban pre-dispute mandatory arbitration clauses.

Forced arbitration clauses that companies tuck into their fine-print agreements have been the bane of investors and consumers for decades. Pre-dispute mandatory arbitration clauses limit or abolish the rights of investors and consumers to seek relief in court when they have been exploited by companies through fraud or unfair practices. These clauses force defrauded investors and other consumers into secret, unfair, and biased arbitrations. Those proceedings are generally run by an industry self-regulatory organization that consistently favors the industry, offer relatively few procedural safeguards, and in some cases charge exorbitant forum fees. Investors and consumers rarely obtain meaningful recovery, and under the Federal Arbitration Act (FAA), which governs arbitration, the losing party has virtually no right of appeal.

Mandatory arbitration clauses are now commonplace in a wide range of consumer agreements with companies. In the securities industry, they became firmly entrenched following a series of Supreme Court decisions ratifying their use. In a pair of decisions dating back to 1987 and 1989, the Court made clear that disputes arising under the 1934 Exchange Act and the 1933 Securities Act can be forced into arbitration.[29] In so doing, the Court swept aside explicit provisions in those statues voiding any "condition, stipulation, or provision" purporting to waive compliance with those laws or any rules thereunder.[30] Since then, the Court has steadily expanded the scope of mandatory arbitration in securities cases and other areas, allowing it to extinguish class actions and class arbitrations; stretching it beyond contract disputes to statutory and other types of claims; and expanding its preemptive effect on state law.[31] As Justice O'Connor declared decades ago: "The Court has abandoned all pretense of ascertaining congressional intent with respect to the [FAA], building instead, case by case, an edifice of its own creation."[32]

The flaws in the typical arbitration system are abundant. It has simply failed to fulfill its promised role as a fair, expedient, and inexpensive method of resolving disputes. On the contrary, through the common

[28] Stephen Hall & Jason Grimes, *Comment Letter: Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, Better Mkts. (Dec. 27, 2021), https://bettermarkets.org/wp-content/uploads/2022/04/Better-Markets-Comment-Letter-on-Proxy-Voting-Advice-12-27-2021.pdf; *see also SEC's Rollback Of Trump-Era Requirements Will Make It Easier for Investors to Receive Independent Advice on Proxy Votes*, Better Mkts. (July 13, 2022), https://bettermarkets.org/newsroom/secs-rollback-of-trump-era-requirements-will-make-it-easier-for-investors-to-receive-independent-advice-on-proxy-votes/.

[29] *See generally Rodriquez de Quijas v. Shearson/American Express Inc.*, 490 U.S. 477 (1989); *Shearson/Am. Exp., Inc. v. McMahon*, 482 U.S. 220 (1987).

[30] 15 U.S.C. § 77n; 15 U.S.C. § 78cc(a).

[31] *See* Imre S. Szalai, *The Supreme Court's Arbitration Docket*, Am. Const. Soc'y (last visited Jan. 7, 2023), https://www.acslaw.org/analysis/acs-supreme-court-review/the-supreme-courts-arbitration-docket.

[32] *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 283 (1995) (O'Connor, J., concurring).

use of fine-print contracts, it is sprung on unsuspecting investors (who lack the bargaining power to contest such clauses even if they are aware of them). It is unfairly skewed toward large firms, as panels tend to favor industry. And even a "win" for the investor typically means a monetary award that falls well short of her actual harms and attorneys' fees. Some forms of damages available in court may be precluded in arbitration. The process also suffers from a lack of transparency. Typically, there's limited discovery, so it's hard for consumers to pry key evidence loose from the firms. Furthermore, there is no publicly issued award explaining the outcome to serve as a guide for other investors and a deterrent against further abuses.

The arbitration process also deprives investors of a meaningful right of appeal. In court, if the judge gets the facts or law wrong, an appeal is available to challenge the ruling. However, under the FAA, arbitrations may only be overturned in the rare case where an investor can show, for example, that corruption, misconduct, or a material "miscalculation of figures" occurred. By contrast, mistakes of law—even egregious ones—are not among the enumerated grounds for appealing an arbitration award. Finally, arbitration does not actually provide investors with the often-touted benefit of an "inexpensive" forum for dispute resolution. Firms are invariably represented by seasoned attorneys, forcing investors to retain their own experienced counsel and incur substantial expense.[33]

The Dodd-Frank Act gave the SEC explicit authority to ban or limit the use of mandatory arbitration clauses. Clearly concerned about the widespread use of mandatory arbitration in financial agreements, Congress included a provision in the Dodd-Frank Act, Section 921, which gave the SEC the authority to prohibit the use of forced arbitration by broker-dealers when it is "in the public interest and for the protection of investors."[34] Such a prohibition would strengthen investors' remedies by allowing them to enforce their rights under our securities laws in open court.

Despite the clear statutory mandate in Dodd-Frank, and despite the continued spread of mandatory pre-dispute arbitration,[35] the SEC has failed to implement—or even propose—a rule restricting arbitration under any administration. The time is long overdue for the SEC to end corporations' ability to deny injured customers the right to their day in court by forcing them into secret, biased, and unfair arbitration proceedings.[36] It is undoubtedly in the public interest and in furtherance of investor protection for the SEC to exercise the authority granted to it by Dodd-Frank to curtail mandatory arbitration.[37] The SEC can and must do better.

E. REGULATION "BEST INTEREST": The SEC's weak 2019 rule must be strengthened, as guidance and enforcement will not adequately protect investors from adviser conflicts of interest.

For decades, financial advisers have allowed powerful conflicts of interest to influence their advice, motivating them to recommend investments that put large fees and commissions in their own pockets

[33] *See The Dirty Dozen: Why Mandatory Arbitration Is Unfair*, Better Mkts. (Oct. 11, 2017), https://bettermarkets.org/newsroom/dirty-dozen-why-mandatory-arbitration-unfair-0/.

[34] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 921, 124 Stat. 1376, 1841 (2010). Section 921 of the Dodd-Frank Act amends § 15 of the Securities Exchange Act of 1934 (15 U.S.C. § 78o) and § 205 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b–5).

[35] *See* Jessica Silver-Greenberg & Robert Gebeloff, *Arbitration Everywhere, Stacking the Deck of Justice*, N.Y. Times (Oct. 31, 2015), https://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-dec k-of-justice.html.

[36] *Forced Arbitration: Taking Away Your Rights and Your Money*, Better Mkts. (June 11, 2019), https://bettermarkets.org/newsroom/forced-arbitration-taking-away-your-rights-and-your-money/.

[37] *See Consumer and Investor Groups Urge SEC to Restrict Forced Arbitration in Investor Contracts*, Pub. Citizen (May 2, 2013), https://www.citizen.org/news/consumer-and-investor-groups-urge-sec-to-restrict-forced-arbitratio n-in-investor-contracts/.

while saddling their clients with overpriced, underperforming, and often high-risk products. This practice has cost investors billions of dollars every year. To address this problem, the Dodd-Frank Act gave the SEC explicit authority to adopt a rule imposing a uniform fiduciary duty on all financial advisers.

However, in an indefensible cave-in to the industry, the SEC declined to exercise that authority and instead issued a vague and weak rule in July of 2019,[38] which required compliance by mid-2020.[39] The rule establishes a new "best interest" standard for advisers, relying largely on a duty to disclose conflicts of interest, not prevent them from influencing investment recommendations. As we explained in our comment letter, Regulation Best Interest falls far short of a genuine, uniform fiduciary duty.[40] Such a duty would require brokers and all advisers to always act in the best interest of their customers without regard to the financial or other interest of the broker, dealer, or investment adviser, something "Reg BI" does not do.[41] As a result of this cardinal failure by the SEC, the problem it was supposed to solve persists: Many advisers continue to recommend investments that enrich them at the expense of their clients.

Recent evidence bears this out. In November 2021, NASAA announced the results of a nationwide survey conducted by state securities regulators that assesses broker-dealer policies and practices following implementation of Reg BI.[42] It shows that a full year after the rule's compliance deadline of June 30, 2020, little had changed when it comes to the powerful influence that adviser conflicts of interest exert on investment advice. It concludes that Reg BI firms have steadily increased their participation in complex, costly, and risky products; they continue to rely on financial incentives that Reg BI was intended to curb; and they still place their financial interests ahead of their retail customers in violation of the rule's chief directive. These findings are consistent with FINRA's own exam results, which identify a wide range of compliance failures under Reg BI.[43]

Nevertheless, for the time being at least, the SEC remains focused on fortifying Reg BI through guidance and enforcement, not rule amendments. The SEC's Fall Agenda confirms the absence of a planned rulemaking.[44] In the words of Chairman Gensler, the SEC intends to get the most out of the rule "as written."

That process has begun. On March 30, 2022, the SEC issued a staff bulletin elaborating on the standards that apply to advisers under Reg BI and the Investment Advisers Act.[45] It contains some helpful guidance,

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[38] *See generally* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019).

[39] *See id.* at 33,400.

[40] *See* Dennis Kelleher et al., *Comment Letter: Proposed Rule, Regulation Best Interest* at 1–2, BETTER MKTS. (Aug. 7, 2018), https://bettermarkets.org/wp-content/uploads/2021/07/Better-Markets-Comment-Letter-Reg-BI-8- 7-18-Final.pdf; *see also* Stephen Hall, *2 Threats Facing Today's Investors—And the Regulatory Response*, NAPFA ADVISOR, https://www.naylornetwork.com/napf-nwl/articles/index.asp?aid=743560&issueID=94952.

[41] *See* Tara Sigel Bernard, *Financial Brokers Must Now Act in Your 'Best Interest.' What Does That Mean?*, N.Y. TIMES (July 16, 2020) ("Notably, the rule does not say that best interest means that a broker must place the customer's interests ahead of the broker's, which is what most people would think a best-interest regulation would include…… That still allows brokers or their firms to consider their own pockets when making recommendations…… "), https://www.nytimes.com/2020/07/16/your-money/fiduciary-duty-investments-best-interest.html.

[42] *See generally* N. AM. SEC. ADM'R ASS'N, REPORT AND FINDINGS OF NASAA'S REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE: NATIONAL EXAMINATION INITIATIVE PHASE II(A) (2021), https://www.nasaa.org/wp-content/uploads/2021/11/NASAA-Reg-BI-Phase-II-A-Report-Novemb er-2021_FINAL.pdf.

[43] *See* FIN. INDUS. REGUL. AUTH., 2022 REPORT ON FINRA'S EXAMINATION AND RISK MONITORING PROGRAM 26–27 (2022), https://www.finra.org/sites/default/files/2022-02/2022-report-finras-examination-risk-monitoring- program.pdf.

[44] *See* FALL 2022 UNIFIED AGENDA OF REGULATORY AND DEREGULATORY ACTIONS, *supra* note 9.

[45] *See* SEC. & EXCH. COMM'N, SEC STAFF BULLETIN: STANDARDS OF CONDUCT FOR BROKER-DEALERS AND INVESTMENT ADVISERS

reaffirming that advisers must consider reasonably available alternatives; must always consider cost as a factor when making an account recommendation; and must consider whether a rollover itself, as well as the new account being recommended, are in the client's best interest. On August 3, 2022, the SEC issued another staff bulletin to clarify the rule's requirements on identifying and addressing advisor conflicts of interest.[46] It emphasizes that compliance must "not be merely a 'check-the-box' exercise, but a robust, ongoing process." We hope and expect that the SEC will be issuing more guidance to put more meat on the bones of Reg BI, and Chairman Gensler has signaled as much.[47]

We've also seen progress on the enforcement front. Although it took the SEC two years to act, the agency has now filed its first case under Reg BI.[48] In *SEC v. Western International Securities, Inc.*, the SEC alleges that the defendants, including a broker-dealer and five individual registered representatives, sold over $13 million in high-risk, unrated, and illiquid bonds to retirees and other investors who had only moderate risk tolerances.[49] It specifically claims that the defendants recommended the bonds without having a reasonable basis to believe the bonds were in their customers' best interest, in violation of the explicit requirements in Reg BI. Here too, while we applaud the SEC's action, we hope to see more cases in the coming days, as compliance with Reg BI is plainly inadequate.

Ultimately, we doubt that the SEC can adequately protect investors from adviser conflicts of interest through guidance coupled with enforcement. If those doubts prove well-founded, then the SEC must return to the drawing board and rewrite Reg BI. The misleadingly labeled "Regulation Best Interest" must become an actual fiduciary duty that requires advisers—regardless of title—to put their customers' best interests first.[50]

2. MARKET STRUCTURE

Order execution and the settlement cycle.

Market structure governs the way securities trading is conducted, from the receipt and routing of customer orders to the execution, clearance, and settlement of each trade. The $100-trillion U.S. capital markets have grown steadily in both size and complexity. Long gone are the days of stock traders on the floor of exchanges executing orders with open outcry, hand gestures, and paper confirmations. Technology, along with increasing fragmentation in the structure of the market, have created opportunities for some predatory market participants, including brokers, high-frequency trading firms, and others, to take advantage of retail traders. They use high-speed computers, payment for order flow offered by wholesalers, maker-taker fee structures at exchanges, and preferential data access, all of which create conflicts of interest between brokers and their clients. The results are inferior execution prices for investors but huge profits for the firms.

Market fragmentation has become so intense that the SEC is now charged with attempting to monitor and regulate trading activity across 24 securities exchanges, 99 alternative trading systems, and seven

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CONFLICTS OF INTEREST (Mar. 30, 2022), https://www.sec.gov/tm/iabd-staff-bulletin.

[46] *Id.*

[47] *See* Gary Gensler, Chair, Sec. & Exch. Comm'n, "Investor Protection in a Digital Age," Remarks Before the 2022 NASAA Spring Meeting & Public Policy Symposium (May 17, 2022), https://www.sec.gov/news/speech/gensler-remarks-nasaa-spring-meeting-051722.

[48] Roger E. Barton & James E. Heavey, *Regulation Best Interest sees its first enforcement action*, REUTERS (July 15, 2022) ("The staff is considering additional bulletins that would further provide their views on each of these three points."), https://www.reuters.com/legal/legalindustry/regulation-best-interest-sees-its-first-enforcement-act ion-2022-07-15/.

[49] *See* Complaint, *SEC v. W. Int'l Sec., Inc.*, No. 2:22-cv-4119 (C.D. Cal. June 15, 2022), ECF No. 1.

[50] *See* Kelleher et al., *supra* note 40, at 29–30.

registered clearing agencies.[51] The challenge facing the SEC is reversing the trend toward market fragmentation and directing more trading to the lit exchanges, where there is more robust regulation, transparency, and investor protection. The SEC has proposed significant changes to the structure of the equity markets as well as the fixed income markets, specifically the trading of U.S. Treasury securities. These proposals likely face stiff resistance by industry players intent on maintaining their ability to prey on unsuspecting investors.

A. PAYMENT FOR ORDER FLOW AND BEST EXECUTION: The SEC is pursuing important reforms in the way retail orders are executed, but the strength of those proposals remains to be seen.

The Gamestop trading frenzy in early 2021 brought attention to several longstanding equity market structure issues, including the increasingly fragmented state of our markets, practices such as payment for order flow, the duty of broker-dealers to obtain the best execution prices for their clients, and the required time in which trades must be settled or completed. The breakdowns in the trading and settlement of securities during that time period damaged public confidence in our markets and inflicted hundreds of millions, if not billions, of dollars of losses on everyday investors.

In response to these market events, the SEC staff released a report in October 2021 entitled, “Staff Report on Equity and Options Market Structure Conditions in Early 2021,” which examined the trading activity in Gamestop and other meme stocks and its impact on investors and markets during this period.[52] In June 2022, Chair Gensler delivered an important speech identifying six aspects of market structure that called for closer scrutiny and reform: minimum pricing increments; the national best bid and offer; disclosure of order execution quality; best execution; order-by-order competition; and payment for order flow, exchange rebates, and related access fees.[53] In addition, the SEC’s Fall Agenda included rulemaking activity (under the label Equity Market Structure Modernization) “to modernize rules related to equity market competition and structure such as those relating to order routing, conflicts of interest, best execution, market concentration, pricing increments, transaction fees, core market data, and disclosure of order execution quality statistics.” And on December 14, 2022, the SEC proposed a package of reforms aimed at solving these market structure problems, as discussed below.

To read more about the Gamestop frenzy in 2021 read Better Markets’ white paper,[54] fact sheet,[55] and law review article[56] that explores these issues in more depth.

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[51] *Hearing Before the H. Subcomm. on Fin. Serv. & Gen. Gov’t of the Appropriations Comm*. (2022) (testimony of Gary Gensler, Chair, Sec. & Exch. Comm’n), https://www.sec.gov/news/testimony/gensler-testimony-fsgg-subcommittee.

[52] *See generally* SEC. & EXCH. COMM’N, STAFF REPORT ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021 (2021), https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf.

[53] Gary Gensler, Chair, Sec. & Exch. Comm’n, “Market Structure and the Retail Investor:” Remarks Before the Piper Sandler Global Exchange Conference (June 8, 2022), https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060 822.

[54] Dennis Kelleher & Joseph Cisewski, *White Paper: Select Issues Raised by the Speculative Frenzy in GameStop and Other Stocks*, BETTER MKTS. (2021), https://bettermarkets.org/wp-content/uploads/2022/03/Better_Markets_White_Paper_Select_Issues_Raised_GameStop_03-26-2021.pdf.

[55] *Reddit, Robinhood, GameStop & Rigged Markets: The Key Issues for Investigation*, BETTER MKTS. (2021), https://bettermarkets.org/wp-content/uploads/2022/03/Better_Markets_Reddit_Robinhood_Gamestop_RiggedMarkets_02-01-2021.pdf.

[56] *See* Kelleher et al., *supra* note 18.

(1) Payment for Order Flow

This practice, known as "PFOF," refers to market makers paying broker-dealers to route their retail investor orders to them for execution. It creates significant conflicts of interests, costs investors billions of dollars a year, and draws trading away from transparent exchanges. PFOF has become widespread among retail broker-dealers in recent years. For instance, in 2020 alone, broker-dealers collected at least $2.6 billion from market makers in the form of PFOF.[57] Market makers are willing to pay such large amounts for retail order flow because they can derive huge revenues from trading against those orders, capturing price spreads or receiving rebates when they send trades on to the exchanges. The market makers can execute orders not at the best possible price for the investors but within an inferior price range that leaves room for them to take a slice of profit. The regulatory benchmark for the best available price is the "NBBO" or National Best Bid and Offer, which does not represent the actual best available price, thus allowing the wholesalers to claim compliance with the best execution requirement while still collecting huge profits.

In his June 2022 speech on market structure, Chair Gensler observed that payment for order flow can "raise real issues around conflicts of interest," "distort routing decisions," and "may incentivize broker-dealers to use digital engagement practices, such as gamification, to increase customer trading."[58] The Chair directed SEC staff to consider recommendations to the Commission regarding how conflicts of interest may be mitigated with respect to payment for order flow.

For additional information, see Better Markets' short[59] and long[60] fact sheets on payment for order flow.

(2) Best Execution

The duty of best execution requires that broker-dealers "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."[61] This FINRA rule applies to all FINRA-registered broker-dealers. Notably, the SEC does not have its own best execution rule. Compliance with the best execution standard is exceedingly difficult to monitor, much less enforce. It has not kept pace with the increasing fragmentation of the markets and has effectively been reduced to a general requirement—applicable to all of a broker-dealer's customer orders in the aggregate—to periodically assess which order routing practices offer the most favorable terms of execution under the circumstances. In short, the best-execution requirement, while critical, has not kept pace with order routing technology or practices and is too malleable to mitigate the conflicts of interest presented by PFOF arrangements. Better Markets has called upon the SEC to adopt a strong and simple best execution rule that would require brokers always to obtain the best price available for customer orders given market conditions and order specifics.[62]

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[57] *See* Alexander Osipovich, *GameStop Mania Drives Scrutiny of Payments for Online Brokers*, WALL ST. J. (Feb. 4, 2021), https://www.wsj.com/articles/gamestop-mania-drives-scrutiny-of-payments-to-online-brokers-116 12434601.

[58] Gensler, "Market Structure and the Retail Investor," *supra* note 53.

[59] *Payment for Order Flow: How Wall Street Costs Main Street Investors Billions of Dollars through Kickbacks and Preferential Routing of Customer Orders*, BETTER MKTS. (2021), https://bettermarkets.org/wp-content/uploads/2022/03/Better_Markets_Payment_for_Order_Flow_Short_02-21-2021.pdf.

[60] *Id.*

[61] FIN. INDUS. REGUL. AUTH., 5310. BEST EXECUTION AND INTERPOSITIONING, (2023), https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310#the-rule.

[62] *See Better Markets Files Comment Letter with SEC on Digital Engagement Practices*, *supra* note 21.

In Chair Gensler's speech on market structure issues delivered in June 2022, he mentioned that "investors might benefit if the SEC considered proposing its own best execution rule."[63] The Chair also said that he directed SEC staff to consider recommendations to the Commission on a best execution rule for equities and other securities. In addition, as noted above, the SEC's Fall Agenda includes rulemaking activity on equity market structure modernization, which specifically mentions modernizing rules relating to best execution.

(3) The SEC's Proposals

On December 14, 2022, the SEC took a major step in addressing long-standing equity market structure issues by proposing a set of reforms intended to improve the way securities trades are routed and executed.[64] These four separate rule proposals include: Regulation Best Execution; Order Competition Rule; Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders; and Disclosure of Order Execution Information.

Specifically, the Regulation Best Execution proposal would establish an SEC best execution standard that would essentially adopt the FINRA rule and require broker-dealers to use reasonable diligence to ascertain the best market for the security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.[65] It would also require broker-dealers with conflicts of interest, namely those receiving PFOF, to document their compliance with the best execution requirements. The Order Competition proposal would require some orders of individual investors to be exposed to competition in fair and open auctions before they could be executed internally by any trading center that restricts order-by-order competition.[66] The Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders proposal would establish reduced quoting and trading pricing increments, known as tick sizes, for certain NMS stocks; reduce the access fees that exchanges can charge for trading against the best priced quotations displayed in any market; and increase disclosures regarding round lot, odd-lot, and best odd-lot order information.[67] Finally, the Disclosure of Order Execution Information proposal would expand the scope of the monthly reports required under Rule 605 on the quality of order executions to include broker-dealers with more than 100,000 accounts, and also expand the content of the reports to include additional statistics on execution quality.[68]

Taken together, these proposed reforms have the potential to improve the fairness and transparency of our securities markets and ensure retail investors are not unfairly exploited by their brokers and other financial intermediaries. However, the proposals are complex and detailed, and an assessment of how effective they will be must await a more detailed analysis, which Better Markets will provide in its comment letters due in the Spring.

[63] Gensler, "Market Structure and the Retail Investor," *supra* note 53.

[64] *See* John Mccrank, *U.S. SEC Votes to Advance Stock Market Overhaul Proposals*, REUTERS (Dec. 14, 2022), https://www.reuters.com/markets/us/us-sec-vote-proposal-overhaul-stock-market-rules-2022-12-1 4/.

[65] *See, e.g.*, SEC. & EXCH. COMM'N, SEC PROPOSES REGULATION BEST EXECUTION (Dec. 14, 2022), https://www.sec.gov/news/press-release/2022-226.

[66] *See generally* Order Competition Rule, 88 Fed. Reg. 128 (Jan. 3, 2023).

[67] Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, 87 Fed. Reg. 80,266 (Dec. 29, 2022).

[68] *See* SEC. & EXCH. COMM'N, SEC PROPOSES AMENDMENTS TO ENHANCE DISCLOSURE OF ORDER EXECUTION INFORMATION (Dec. 14, 2022), https://www.sec.gov/news/press-release/2022-223.

B. SETTLEMENT CYCLE: The SEC is proposing to reduce the time in which trades must be finalized or settled to within one day of the trade date.

In the 1920s, the standard settlement cycle—the time between when a trade is made and when the securities and cash that make up the trade are delivered to the respective counterparties—was one day. However, as securities markets grew larger and the infrastructure required to handle them became more complex, the time required to settle transactions increased, especially in light of the technological limitations of the time, until the typical settlement cycle was T+5 (i.e. settlement occurred 5 business days after the trade date).[69] However, it has long been recognized that when it comes to settlement of securities transactions "time equals risk." Hence, the SEC established a settlement cycle of T+3 in 1993 and further reduced it to T+2 in 2017. This shortening of in the settlement cycle has reduced risks and costs associated with settlement delays, but because there is still a delay associated with settlement, there are still significant risks and costs to markets and investors. This was recently illustrated during the trading frenzy surrounding GameStop and other so-called "meme stocks" in January 2021, when Robinhood suspended securities purchases based in part on claims that it could not meet the margin requirements of the clearing house, which in turn had to account for the risks associated with extreme volatility coupled with delays in clearing Robinhood's orders.

Earlier this year, the SEC proposed a rule to further shorten the settlement cycle from T+2 to T+1. The proposed rule would facilitate the transition to T+1 by eliminating an exception to the standard settlement cycle for certain firm commitment offerings, requiring "same day affirmation" for institutional trades, and requiring that central matching service providers establish policies and procedures for facilitating straight-through processing. If finalized, the proposed rule would reduce settlement risk and cost, to the benefit of investors and market stability.

For additional resources, see Better Markets' comment letter on the proposal to shorten the settlement cycle, available here.[70]

3. FINANCIAL STABILITY

Executive compensation, Treasury markets, money market funds, and credit rating agencies.

When the subject of financial stability comes up, the focus tends to be on the banking system. But the topic is hugely relevant to the securities markets, which played a major role in the 2008 financial crisis due to a number of practices and gaps in the regulatory framework. Widespread fraud pervaded the issuance of and credits ratings assigned to, residential mortgage-backed securities, which fueled the crisis. Moreover, those inflated credit ratings were embedded in the SEC's rules as metrics for regulatory compliance, thus contaminating the regulatory framework. Money market funds experienced massive runs, requiring one of the largest taxpayer backstops—$3.4 trillion—in the history of financial markets. And corporate compensation policies allowed executives to pursue high-risk strategies aimed at fattening their compensation and bonuses.

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[69] *See* Securities Transaction Settlement, 58 Fed. Reg. 52,891, 52,892 (Oct. 13, 1993).

[70] *SEC Proposal Will Make Stock Trading More Efficient, Less Risky*, BETTER MKTS. (Apr. 11, 2022), https://bettermarkets.org/impact/sec-proposal-will-make-stock-trading-more-efficient-less-risky/.

The SEC has made strong progress on executive compensation and Treasury market reform. However, the agency has more work to do. It has failed to adequately limit the run risk that money market funds constantly face, and while it has strengthened the oversight of the credit rating agencies (the "Nationally Recognized Statistical Rating Organizations" or "NRSROs"), it has failed to address the core problem that continues to pervade that industry: the powerful conflicts of interest inherent in the "issuer" pay model of compensation. Those conflicts continue to incentivize the rating agencies to inflate ratings to win and retain lucrative rating arrangements with companies issuing debt securities.

A. EXECUTIVE COMPENSATION: The SEC is closing in on the remaining reforms required under the Dodd-Frank Act.

Major contributors to the financial crisis were misaligned incentives generally, and executive compensation policies in particular, at many financial institutions, which motivated corporate leaders to engage in high-risk activities for short-term profit and lucrative bonuses.[71] These short-sighted policies, fueled by misguided competitiveness and greed rather than principles of sound corporate governance, came at the expense of the long-term viability of those institutions, the entire financial system, and, ultimately, the U.S. economy. A specific problem in the realm of corporate governance was the tendency of some corporate executives to engage in accounting fraud or manipulation and high-risk business strategies to bulk up revenues and attempt to justify inflated compensation awards.

To address these abuses, Congress enacted a collection of corporate governance and executive compensation reforms in the Dodd-Frank Act, from shareholder votes on executive compensation to the recovery of erroneously awarded compensation.[72] They are an important collection of reforms that increase transparency surrounding executive compensation, enable shareholders to play a larger role in setting compensation, and limit bloated executive compensation packages that undermine a firm's long-term success and encourage high-risk activities.

While the SEC has taken far too long to implement this collection of reforms, this year, it took two positive steps towards completing the process. On August 25, 2022, the SEC finalized its rule on "Pay Versus Performance," mandated by Section 953(a) of Dodd-Frank, which requires companies to disclose to investors how their actual executive compensation relates to the company's financial performance.[73] As we explained in our comment letter,[74] this rule is a win for investors and for the transparency of our markets.

Once implemented, the Pay Versus Performance Rule will provide several benefits. Through heightened transparency, it will inhibit bloated executive compensation packages that drain capital, reduce productivity, and ultimately hurt shareholders and employees. In particular, it will enable shareholders to see what factors are driving compensation for the executives of the companies they own and ensure that compensation bears a reasonable relationship to company performance. The rule will also provide information that will better inform shareholders who wish to vote on executive compensation pursuant

[71] *See generally* Fin. Crisis Inquiry Comm'n, Financial Crisis Inquiry Report xxv (2011).

[72] *See generally* Subtitle E of Title IX of the Dodd-Frank Act, §§ 951-957.

[73] *See generally* Reopening of Comment Period for Pay Versus Performance, 87 Fed. Reg. 55,134 (Sept. 8, 2022); *see also* Pay Versus Performance, 80 Fed. Reg. 88, 26330 (May 7, 2015).

[74] *Better Markets Supports SEC Rule Requiring Enhanced Executive Compensation Disclosures to Investors*, Better Mkts. (Mar. 4, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-rule-requiring-enhanced-executive-compensation-disclosures-to-investors/; *see also* Stephen Hall & Jason Grimes, *Comments: Reopening of Comment Period for Pay Versus Performance Compensation*, Better Mkts. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Pay_Ver sus_Performance.pdf.

to the related say-on-pay reform mandated under the Dodd-Frank Act and implemented by the SEC. And it will help curb high-risk activities by shedding light on companies that are rewarding executives for engaging in such activities.

In a second significant accomplishment, in October, the SEC finalized its rule on the recovery of erroneously awarded executive compensation, referred to as the "clawback" rule.[75] This is among the last reforms required under the Dodd-Frank Act aimed at preventing another devastating financial crisis on the scale we witnessed in 2008. We know that major contributors to that crisis were executive compensation policies that incentivized financial firms and others to engage in accounting fraud or manipulation and high-risk business strategies to bulk up revenues and justify inflated salaries and bonuses. That put companies, clients, and investors at heightened risk once the financial system began to unravel.

The SEC's clawback rule will help curb these abuses by disincentivizing them. It will require companies to recover excessive compensation paid to executives as a result of the errors that led to an accounting restatement. In our comment letter filed with the SEC,[76] we responded to the SEC's request for additional input in light of new data on the types of accounting restatements that should trigger a compensation recovery analysis. That data confirmed our view that the rule should be framed broadly so that a wide range of accounting restatements trigger the clawback rule, including the so-called "little r" revision restatements. Otherwise, companies will game the system, evade the rule requirements, and undermine the clear purposes of the law.

To read Better Markets' comment letters on pay versus performance and the SEC's clawback rule, click here[77] and here,[78] respectively.

B. TREASURY MARKETS: The SEC has taken positive steps and more are planned to increase transparency and stability in the Treasury markets.

The Treasury markets have a long history as one of the most important and foundational financial markets in the global financial system. U.S. Treasury securities are held in significant quantities by foreign governments, banks, and large investment management firms. Of the $18.1 trillion in Treasury debt privately held as of March 2022, $7.8 trillion was held by foreign governments, $4.6 trillion by mutual and pension funds, and $1.8 trillion by depository institutions.[79] Therefore, markets for or related to Treasuries are critically important to the functioning of the global financial system, and any disruption in those markets can lead to or exacerbate broader financial instability.

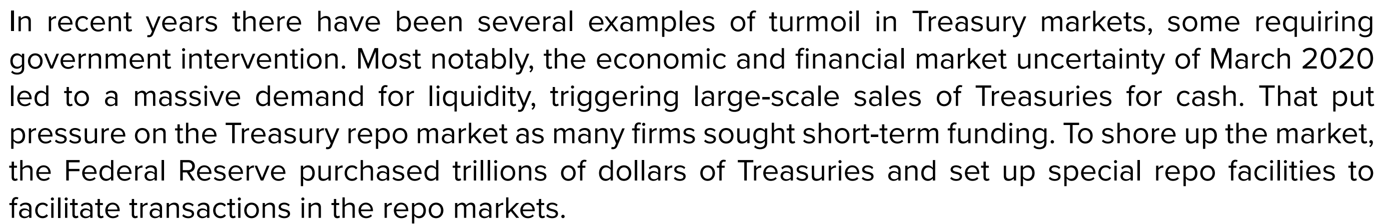
[75] *See, e.g.*, Gary Gensler, Chair, Sec. & Exch. Comm'n, Statement on Final Rules Regarding Clawbacks of Erroneously Awarded Compensation (Oct. 26, 2022), https://www.sec.gov/news/statement/gensler-statement-clawbacks-102622.

[76] *See* Stephen Hall & Scott Farnin, *Comments: Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation*, Better Mkts. (2022), https://bettermarkets.org/wp-content/uploads/2022/07/Better_Markets_Comment_Letter_SEC_Cl awback_Rule_Reopening.pdf; *SEC Rule to Clawback Excessive Compensation Is Win for Investors and Deterrent for Risky Corporate Behavior*, Better Mkts. (Oct. 22, 2022), https://bettermarkets.org/newsroom/sec-rule-to-clawback-excessive-compensation-is-win-for-investors-and-deterrent-for-risky-corporate-behavior/; *see also* Dennis Kelleher & Stephen Hall, *Comments: Listing Standards for Recovery of Erroneously Awarded Compensation*, Better Mkts. (2021), https://www.sec.gov/comments/s7-12-15/s71215-52.pdf.

[77] Stephen Hall & Jason Grimes, *Comments: Reopening of Comment Period for Pay Versus Performance Compensation*, Better Mkts. (Mar. 4, 2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Pay_Versus_Performance.pdf.

[78] Stephen Hall & Scott Farnin, *Comments: Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation*, Better Mkts. (July 14, 2022), https://bettermarkets.org/wp-content/uploads/2022/07/Better_Markets_Comment_Letter_SEC_Clawback_Rule_Reopening.pdf.

[79] U.S. Dep't of the Treasury, Treasury Bulletin (2022), https://fiscal.treasury.gov/reports-statements/treasury-bulletin/.



In recent years there have been several examples of turmoil in Treasury markets, some requiring government intervention. Most notably, the economic and financial market uncertainty of March 2020 led to a massive demand for liquidity, triggering large-scale sales of Treasuries for cash. That put pressure on the Treasury repo market as many firms sought short-term funding. To shore up the market, the Federal Reserve purchased trillions of dollars of Treasuries and set up special repo facilities to facilitate transactions in the repo markets.

Robust federal regulation of the U.S. Treasury markets was not put in place until the 1980s. Following the collapse of several firms that traded in government securities, the Government Securities Act was passed and signed into law in 1986. The bill focused on bringing activities related to Treasuries into the regulatory fold to give the government more insight into and regulatory authority over those markets. Brokers and dealers of government securities were required to register with the appropriate regulatory agency; non-bank dealers were required to register with the SEC; and clearinghouses of government securities were placed under the SEC's regulatory authority. By 2000, all interdealer broker (IDB) platform users were members of clearinghouses, and their trades were therefore centrally cleared.[80]

However, over time—as with the markets for other assets—technological advancements provided a faster, simpler means of trading government securities and at the same time led to dealer fragmentation within Treasury markets. There has been a significant rise of algorithmic trading by so-called principal trading firms (PTFs) or high-frequency trading firms. These firms are able to trade without registering with the SEC or trading through a clearing counterparty. They account for over 50 percent of the volume reported on IDB platforms.[81] That is a significant portion of trading in the Treasury cash markets into which regulators and other market participants have little or no visibility.

The lack of visibility in the Treasury markets and the move away from central clearing undermines regulators' ability to monitor risks in those markets, to understand how those risks may evolve into potentially systemic risks, and to address such risks in real time. That is why the SEC has taken several positive steps in the form of proposed rules to increase insight into these markets.

First, the SEC has proposed a rule to eliminate the exemption for Government Securities Alternative Trading Systems (ATS) from compliance with Regulation ATS and to require that Communication Protocol Systems, namely Request-for-Quote protocols, must register as an exchange or under Regulation ATS. These reforms will enhance transparency, promote more fair competition, and above all, result in stronger investor protections in the government securities markets.

Second, the SEC has proposed a pair of rules designed to expand the definition of a "dealer" and "government securities dealer" to include principal trading firms, who account for significant volume and liquidity in both the equities and Treasury securities markets. These two rules will require firms that are acting as *de facto* market makers due to their level of trading in these markets to register with the SEC as dealers or government securities dealers. Taken together, these two proposed rules will greatly enhance the transparency of the Treasury markets for market participants and regulators by requiring PTFs to report their transaction data to the FINRA TRACE reporting system.

Third, the SEC has proposed amendments to require more U.S. Treasury market transactions to be cleared by a central clearinghouse. This change would lower risk in the system by centralizing the

[80] Treasury Market Practices Grp., Fed. Reserve Bank of N.Y., White Paper on Clearing and Settlement in the Secondary Market For U.S. Treasury Securities at 2 (2018).

[81] *See More Clearing, Less Risk: Increasing Centrally Cleared Activity in the U.S. Treasury Cash Market*, Depository Tr. & Clearing Corp. (May 2021), https://www.dtcc.com/-/media/Files/PDFs/DTCC-US-Treasury-Whitepaper.pdf.

collection of initial and variation margin on U.S. Treasury market transactions and giving regulators better insights into Treasury market activity during times of market stress.

In a separate but related vein, the SEC has undertaken a more ambitious effort to overhaul the regulation of open-end funds (OEFs). During the March 2020 market turmoil in the Treasury market, OEFs faced a critical liquidity mismatch as OEF investors sold their investments in an effort to raise cash. In turn, these OEFs, which offer investors daily liquidity redemption rights on products that are inherently not as liquid, were forced to sell their most liquid bonds—Treasury securities—into the market selloff to raise funds to meet redemption demand. This panic selling exacerbated chaos already occurring in the Treasury markets and only subsided after the Federal Reserved announced it would step in. The SEC has proposed rules to improve liquidity risk management in OEFs and institute swing pricing, a measure intended to mitigate the risk of investor runs on funds in times of stress and to more fairly allocate the costs associate with investor withdrawals, and the comment period remains open until February 14, 2023.

To learn more about transparency in the Treasury markets, read Better Markets' comment letters on the SEC's proposal, found here,[82] here,[83] and here.[84]

C. MONEY MARKET FUNDS: The SEC continues to disappoint and must establish additional reforms to increase transparency and stability in this market.

Money market funds (MMFs), created in the 1970's, purported to offer investors higher returns than a bank account, while at the same time offering the same security as a bank account. However, unlike bank deposit accounts, MMFs are not supported by extensive regulations like those that ensure the safety and soundness of banks and explicitly protect depositors from losses. The differences between bank deposit accounts and MMFs were crystalized during the Financial Crisis of 2008 when there was a run on prime MMF funds—investors rapidly withdrew approximately $310 billion (or 15 percent) of prime MMF assets. As a result, the Federal Reserve and the Treasury were forced to intervene, guarantee investor assets, and ensure liquidity in the MMF markets. Similarly, in March 2020, the MMF market once again served as a source of significant contagion that imperiled the markets broadly and forced government intervention. For the second time in just a dozen years, taxpayer money had to be put at risk to support a backstop of MMFs.

The SEC has adopted an incremental approach to these challenges, issuing or proposing three separate sets of MMF reforms since 2010, none of which has fully addressed the persistent stability, transparency, and investor fairness concerns associated with these investments. The SEC issued its latest proposal in December 2021, which would enhance liquidity and reporting obligations and rollback the redemption fees and gates adopted under the prior administration. But they do not implement the floating Net Asset Value across all types of funds to accurately reflect the pricing of fund shares, nor do they establish a capital buffer requirement, the best way to reduce the risk and impact of investor runs when the

[82] *Better Markets Supports SEC Proposal to Expand Definition of Exchange and Scope of Regulation ATS*, Better Mkts. (Apr. 19, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-proposal-to-expand-definition-of-exchange-and-scope-of-regulation-ats/.

[83] *Better Markets Supports SEC Rules to Expand Regulation on High Frequency Trading Firms*, Better Mkts. (May 27, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-rules-to-expand-regulation-on-high-f requency-trading-firms/.

[84] *Better Markets Supports SEC Proposal to Modernize Outdated Regulations That Act as Loopholes in Today's Capital Markets*, Better Mkts. (Sept. 27, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-proposal-to-modernize-outdated-regulations-that-act-as-loopholes-in-todays-capital-markets/.

markets show signs of stress. In short, they will be insufficient to avoid yet another MMF bailout during the next period of significant market stress.

To learn more about the risks posed to the financial system by MMFs, read Better Markets' Banking Report found here.[85]

D. CREDIT RATING AGENCIES: The SEC must move more aggressively to combat conflicts of interest, make the credit rating agencies accountable, and increase transparency.

Credit ratings play an important role in the markets by helping investors understand the risk of default on debt instruments and the likelihood of recovery in the event of such a default. Starting in the 1970s, regulatory reliance on credit rating agencies began to dramatically increase. Indeed, overreliance on such credit ratings was a key factor leading to the global financial crisis of 2008.[86] The financial crisis was triggered when it became clear that major financial institutions had been using complex and opaque transactions to take on substantial undisclosed exposure to the subprime mortgage markets.[87] Credit rating agencies facilitated these transactions by assigning inflated credit ratings to a range of risky financial instruments related to subprime mortgages, to attract and retain clients and fees for their ratings. When the subprime mortgage market collapsed, so did these transactions and the crisis ensued. Indeed, several government investigations ultimately found that the credit rating agencies, particularly Moody's and S&P, were central causes of the crisis and that the crisis would not have occurred without their misconduct. The Financial Crisis Inquiry Commission called the ratings agencies "key enablers of the financial meltdown."[88]

In 2010, Congress passed the Dodd-Frank Act, which provided for a number of reforms aimed at increasing transparency into rating assumptions and methodologies and curbing conflicts of interest. It also required federal agencies to replace regulatory references to credit ratings with appropriate alternative standards of creditworthiness.[89] It further created a new Office of Credit Ratings within the SEC to oversee the rating agencies.[90] Dodd-Frank also sought to increase the accountability of the credit rating agencies. For example, it nullified Rule 436(g), which insulated the NRSROs from liability as experts for misstatements in registration statements or prospectuses.

Finally, Section 939F of Dodd-Frank took aim at the powerful conflicts of interest inherent in the issuer- or subscriber-pays model of compensation. It provided that after carrying out a study of the credit

[85] Philip Basil & Stephen Hall, *The Increasing Dangers of the Unregulated "Shadow Banking" Financial Sector: Money Market Funds*, Better Mkts. (2022), https://bettermarkets.org/wp-content/uploads/2022/08/BetterMarkets_Report_Dangers_of_the_Shadow_Banking_MMFs_August2022.pdf.

[86] For a detailed description of the role of the credit rating agencies in the financial crisis, see Frank Partnoy, Overdependence on Credit Ratings Was a Primary Cause of the Crisis, in The Panic of 2008: Causes, Consequences, and Implications for Reform (Lawrence Mitchell & Arthur Wilmarth, eds. 2010).

[87] *See generally The Cost Of The Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is More Than $12.8 Trillion*, Better Mkts. (Sept. 2012), https://bettermarkets.org/wp-content/uploads/2021/07/Cost-Of-The-Crisis_0.pdf.

[88] Financial Crisis Inquiry Report, *supra* note 71 ("We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms."), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[89] Dodd-Frank Act § 939A(a)(1)-(2), (b); *see also SEC Must Do More to Reform The Corrupt, Conflict-Ridden Credit Ratings Process Before It Fuels Another Crisis and Crash*, Better Mkts. (May 24, 2022), https://bettermarkets.org/newsroom/sec-must-do-more-to-reform-the-corrupt-conflict-ridden-cred it-ratings-process-before-it-fuels-another-crisis-and-crash/.

[90] *See* Dodd-Frank Act § 932.

rating process "for structured finance products and the conflict of interest associated with the issuer-pay and the subscriber-pay models," the SEC shall "establish a system for the assignment of [credit rating agencies] to determine the initial credit rating of structured finance products" in a manner that prevents the issuers from selecting the credit rating agencies.[91]

The SEC has accomplished some meaningful work on credit rating agency reform since the passage of Dodd-Frank, notably through its 2014 rules. In March of this year, the SEC made further progress by proposing a rule to remove references to credit ratings from the SEC's Regulation M, an important rule designed to prevent manipulation by individuals with an interest in the outcome of an offering and to prohibit conduct that could artificially influence the market for an offered security.[92] This rule will finally complete one of the Dodd-Frank reforms, the process of removing references to credit ratings from the SEC's regulations, and it will play its part in making sure that regulators do not rely on inflated or conflicted ratings as benchmarks.[93]

In our comment letter to the SEC, we supported the proposed rule, while calling upon the SEC to fortify its approach to the use of credit risk models.[94] More broadly, we called upon the SEC to address all of the regulatory challenges that still surround credit ratings, as they are required to do by law. Much work remains to be done.[95] Credit ratings still suffer from a series of intractable problems: powerful conflicts of interest still inflate ratings; the NRSROs still avoid legal accountability in direct conflict with the Dodd-Frank Act; and the SEC's examination and enforcement program still suffers from a lack of transparency.

For example, while it completed the study of the credit rating process for structured products and the conflicts of interest surrounding them, the SEC has taken no action to establish an alternate assignment system free from conflicts of interest, despite the mandate in Dodd-Frank. In addition, the SEC essentially nullified the Dodd-Frank repeal of Rule 436(g) through a 2010 no-action letter that became permanent. Thus, the reforms implemented thus far have not adequately addressed the central problems associated with credit ratings, and they continue to pose risks as they did leading up to the 2008 financial crisis.[96]

The SEC must prioritize several key steps. First, the SEC should finally fulfill the mandate of Section 939F of the Dodd-Frank Act by establishing an assignment system for initial ratings on complex structured products that will help mitigate the conflicts of interest arising from the issuer pay model. Second, the

[91] *See* Pub. L. No. 111-203 § 939F(b)(2).

[92] Removal of References to Credit Ratings from Regulation M, 87 Fed. Reg. 18,312 (Mar. 30, 2022).

[93] *See generally* Sec. & Exch. Comm'n, Report on Review of Reliance on Credit Ratings: As Required by Section 939A(C) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011), https://www.sec.gov/files/939astudy.pdf.

[94] *See* Stephen Hall, *Comments: Removal of References to Credit Ratings from Regulation M*, Better Mkts. (2022), https://bettermarkets.org/wp-content/uploads/2022/05/Better_Markets_Comment_Letter_Removal_Credit_Agency_References_Regulation_M.pdf; *see also SEC Must Do More to Reform the Corrupt, Conflict-Ridden Credit Ratings Process Before It Fuels Another Crisis and Crash*, Better Mkts. (May 24, 2022), https://bettermarkets.org/newsroom/sec-must-do-more-to-reform-the-corrupt-conflict-ridden-cred it-ratings-process-before-it-fuels-another-crisis-and-crash/.

[95] *See generally* Frank Partnoy, *What's (Still) Wrong with Credit Rating Agencies*, 92 Wash. L. Rev. 1407 (2017); *SEC Needs to Change Credit Rating Agencies Now*, Better Mkts. (May 14, 2013), https://bettermarkets.org/newsroom/sec-needs-change-credit-rating-agencies-now/; Steve Hall, Better Mkts., Remarks Before the SEC Roundtable on Credit Rating Agencies (2013), https://bettermarkets.org/sites/default/files/Statement-%20SEC%20CR%20Roundtable-%205-14- 13.pdf; *see also Credit Rating Agency Conflicts of Interest Again Fueling A Financial Crisis*, Better Mkts. (May 19, 2020), https://bettermarkets.org/sites/default/files/CRA_Fact_Sheet_updated_5-19-20.pdf.

[96] *See, e.g.*, Frank Partnoy, *The Looming Bank Collapse*, The Atlantic (July/Aug. 2020), https://www.theatlantic.com/magazine/archive/2020/07/coronavirus-banks-collapse/612247/ (describing risks associated with Collateralized Loan Obligations and other highly rated instruments).

Commission should take steps to clarify that credit rating agencies are subject to liability under Section 11 of the Securities Act of 1933. Finally, the Commission should bolster transparency by specifically naming credit rating agencies when describing compliance violations in the annual examination reports required by Dodd-Frank. Each of these actions are necessary steps to fulfill the statutory mandates of Dodd-Frank as well as the SEC's mission to protect investors and market integrity. Better Markets recently joined other prominent public interest advocates and academics in a petition asking the SEC to reaffirm or adopt a number of these accountability and transparency reforms.[97]

Reform of the credit rating system must be completed. Until it is, the risk to the markets persists and it is inevitable that the continuing deficiencies in credit ratings will surface once again as major sources of instability, necessitating another round of taxpayer bailouts to protect our financial system from collapse.[98]

4. CAPITAL FORMATION

SPACs and private offering exemptions.

The basic purpose of the securities markets is to enable companies to raise money from investors so those enterprises have a chance to start up, grow, hire, produce goods and services, and fuel the real economy. The problem, of course, is that investors face considerable risks in these markets, especially if the promoters are unscrupulous. Since the dawn of securities regulation in the early 1930s, therefore, the law has appropriately required those seeking investment funds from others to play by certain rules. Most important is the core requirement that, in the initial public offering or "IPO" process, they provide investors—and the SEC—with complete and accurate information about the investment opportunity so investors can make informed decisions about where to put their money at risk. And the law ensures accountability and compliance under that disclosure framework with the threat of enforcement, including civil penalties, disgorgement, and even criminal sanctions.

However, the legal landscape surrounding capital formation has grown increasingly complex and, in many ways, less protective for investors. For example, through a combination of statutory amendments and SEC rules adopted over the last several decades, a vast array of alternative capital formation devices has emerged, known as exempt offerings,[99] and collectively they now account for far more capital-raising activity than the traditional IPO process. (See Better Markets' report on public versus private offerings here.[100]) These exemptions were once premised on the notion that the exempt offerings were small in amount or private in scope, and thus required fewer investor safeguards. But those fictions have been abandoned, as some of the exemptions now allow for public solicitation, unlimited investors, and no dollar limits.

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[97] *See* Petition for Policy Clarification on Credit Rating Agencies, signed by Better Markets *et al*. (Jan. 13, 2023), https://bettermarkets.org/newsroom/consumer-protection-advocates-call-on-sec-to-increase-transparency-and-accountability-of-credit-rating-agencies/.

[98] In a move promising both financial stability and investor protection benefits, the SEC recently proposed a rule that will prohibit a securitization participant from engaging in any transaction that would result in a major conflict of interest between the securitization participant and an investor. It will target some of the most outrageous abuses we saw in the lead-up to the 2008 financial crisis, in which banks bundled low-grade residential mortgages into investment packages, hyped them to unsuspecting investors, and then secretly bet against them in the derivative markets. *See* SEC. & EXCH. COMM'N, SEC PROPOSES RULE TO PROHIBIT CONFLICTS OF INTEREST IN CERTAIN SECURITIZATIONS (Jan. 25, 2023), https://www.sec.gov/news/press-release/2023-17.

[99] *See, e.g.*, SEC. & EXCH. COMM'N, OVERVIEW OF CAPITAL-RAISING EXEMPTIONS (Apr. 28, 2022), https://www.sec.gov/education/smallbusiness/exemptofferings/exemptofferingschart.

[100] Dennis Kelleher & Stephen Hall, *Special Report: The SEC Must Stop Bleeding Public Markets Dry*, BETTER MKTS. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/BetterMarkets_Public_vs_Private_Markets_Report_April2022.pdf.

The result is less transparency for the SEC, which remains largely in the dark about these offerings; less accountability among the promoters; and above all, greater risk to investors who receive less information about the investments being touted. In keeping with the boundless ingenuity of "those who seek the use of the money of others on the promise of profits,"[101] yet another hybrid capital formation tool surged in popularity recently, namely SPACs. SPACs have inflicted huge damage on countless unsuspecting investors. Below we canvass the SEC's largely successful effort to address SPACs and we call on the SEC to address other gaps in the regulation of the capital-raising process.

A. REINING IN SPACs: Through proposed rules and enforcement actions, the SEC has significantly curtailed these abusive capital-raising vehicles.

A SPAC is an investment vehicle that "goes public" with nothing more than a plan to identify and acquire a private operating company. It is, in effect, a shortcut for the operating company to go public. The SPAC IPO model saw tremendous growth in 2020 and 2021, raising more than $80 billion in 2020 and $160 billion in 2021.[102] This accounted for 60 percent of all IPOs in public markets in 2020 and 66 percent in 2021, significantly more than the 34.5 percent and 25 percent of IPOs in 2019 and 2018, respectively.[103] During the SPAC boom, SPAC deals were being sponsored by celebrities, athletes, former politicians, and notable financiers, many of whom promised exorbitant returns for retail investors.

Obscured by the pomp and circumstance is the fact that investors face a host of risks from these deals, including reliance on sponsor honesty and acumen; less disclosure; wildly optimistic revenue forecasts; and share dilution. Their track record over the last three years proves the point. Nearly all of them left retail investors holding the bag, while the sponsors of the deals walked away with millions. Specifically, the mean- and median-adjusted returns of SPAC shareholders that held their shares through the SPAC IPO process were negative 64 percent and negative 88 percent, respectively.[104] Meanwhile, the sponsors and underwriters saw huge windfalls from these transactions, even when the SPAC failed to perform well in the public market. For example, an analysis of SPAC deals since 2015 found that despite the abysmal returns for retail investors, SPAC sponsors earned an average annualized return of 110 percent.[105] This transfer of wealth from retail investors to wealthy SPAC sponsors was largely the result of the perverse incentive structures inherent in these deals.

The SEC recently began to address SPACs through a combination of enforcement and rulemaking. In December 2021, the SEC brought enforcement actions against several high-profile SPAC deals, including against Digital World Acquisition Corp. and electric car makers Lucid Motors and Nikola.[106]

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[101] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

[102] *See* Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29,458, 29,460 (May 13, 2022).

[103] Usha Rodrigues & Michael Stegemoller, *Redeeming SPACs* 6 (U. of Ga. Rsch. Paper Series, Research Paper No. 2021-09, 2021).

[104] Michael Klausner et al., *A Sober Look at SPACs*, 39 Yale J. On Regul. 228, 233 (2022).

[105] Eliot Brown, *SPAC Sponsors Were Winners Even on Losers*, Wall St. J. (Oct. 15, 2022), https://www.wsj.com/articles/spac-sponsors-were-winners-even-on-losers-11665794518.

[106] *See* Sec. & Exch. Comm'n, Digital World Acquisition Corp., Form 8-K (Dec. 4, 2021), available electronically on EDGAR at https://www.sec.gov/Archives/edgar/data/1849635/000119312521348598/d242442d425.htm (In DWAC's 8-K filing with the Commission they announced they received a request from the SEC seeking records related to the de-SPAC transaction); *see also* Sec. & Exch. Comm'n, Lucid Group, Inc., Form 10-K (2021), available electronically on EDGAR at https://www.sec.gov/Archives/edgar/data/1811210/000162828022004253/lcid-20211231.htm (In Lucid Motor's 10-K filing with the Commission they announced they received a subpoena from the SEC); Sec. & Exch. Comm'n, Nikola Corporation To Pay $125 Million To Resolve Fraud Charges (Dec. 21, 2021), https://www.sec.gov/news/press-release/2021-267 (The SEC announces settlement with Nikola to settle charges "that it defrauded investors by misleading them about its products, technical advancements, and commercial prospects").

The disclosures by Digital World Acquisition Corp and Lucid Motors that the SEC had subpoenaed and requested documents from the two SPACs, coupled with the announcement of a $125 million settlement with Nikola, put SPACs and their sponsors on notice that the SEC was enhancing its oversight of these transactions.[107]

On the rulemaking front, Chair Gensler first raised potential investor protection concerns in the SPAC markets in May 2021, shortly after being sworn in as Chair of the SEC.[108] In a December 2021 speech, he publicly stated that he had asked SEC staff to consider recommendations to address information asymmetries and inherent misalignment of incentives in the SPAC IPO model.[109] On March 30, 2022, the SEC voted to propose a rule designed to enhance investor protections and more closely align regulations with those applicable to traditional IPOs.[110] First, the proposal would require enhanced disclosures regarding information on sponsors, conflicts of interest, potential dilution, and certain information on prospectuses and summaries. In addition, it would require specialized disclosures in de-SPAC transactions, including a fairness determination relating to the acquisition phase. Second, it would further align the disclosures investors receive in a SPAC IPO with those that investors receive in a traditional IPO, including financial and nonfinancial information. Third, it would require a target private operating company to be a co-registrant in business combination transactions. Fourth, it would clarify that the Private Securities Litigation Reform Act safe harbor for forward-looking statements does not apply in connection with SPACs. Finally, the proposal would create a safe harbor for SPACs from compliance with the Investment Company Act of 1940.

The SEC's proposed rule effectively addresses many of the investor protection concerns surrounding SPACs. Nevertheless, it can and should be strengthened during the final rulemaking process. The proposal fails to adequately reconcile SPAC investors' ability to redeem their shares while simultaneously voting in favor of a de-SPAC transaction, something the proposal recognizes as a form of "moral hazard." Additionally, the proposal's safe harbor from compliance with the Investment Company Act conflicts with the plain text of the Act and past Commission regulations.

The bottom line, though, is that the SEC's combination of enforcement and proposed regulation has done a great deal to reduce the threat that SPACs pose to investors. In fact, despite the popularity of the SPAC IPO model in 2020 and 2021, the SPAC boom abruptly slowed in 2022, raising less than $13 billion in revenues through Q3.[111] Evidently, sponsors and promoters no longer view SPACs as a sure-fire way to collect easy money from vulnerable investors.

To read Better Markets' comment letter on the rule and more about our work on SPACs, click here[112] and here.[113]

[107] Paul Kiernan, *SEC's Gary Gensler Seeks to Level Playing Field Between SPACs, Traditional IPOs*, WALL ST. J. (Dec. 9, 2021), https://www.wsj.com/articles/secs-gary-gensler-seeks-to-level-playing-field-between-spacs-traditi onal-ipos-11639063202.

[108] *See Hearing before the H. Subcomm. on Financial Services and General Government H. Appropriations Comm.*, 117th Cong. (May 26, 2022) (testimony of Gary Gensler, Chair, Sec. & Exch. Comm'n), https://www.sec.gov/news/testimony/gensler-2021-05-26.

[109] *See* Gary Gensler, Chair, Sec. & Exch. Comm'n, Remarks Before the Healthy Markets Association Conference (Dec. 9, 2021) https://www.sec.gov/news/speech/gensler-healthy-markets-association-conference-120921.

[110] *See generally* Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29,458, 29,460 (proposed May 13, 2022).

[111] *See* Kristi Marvin, *Third Quarter of 2022 SPAC Review*, SPAC INSIDER (Oct. 3, 2022), https://spacinsider.com/2022/10/03/third-quarter-2022-spac-ipo-review/.

[112] *See After Years of Ripping Off Investors, SEC Proposal Takes Away SPAC's License to Lie*, BETTER MKTS. (June 13, 2022), https://bettermarkets.org/impact/after-years-of-ripping-off-investors-sec-proposal-takes-away-spa cs-license-to-lie/.

[113] *Better Markets Releases Fact Sheet That Cuts Through the Hype on SPACs*, BETTER MKTS. (Nov. 18, 2021),

B. SCALING BACK PRIVATE OFFERING EXEMPTIONS: The SEC must pursue reforms to restore better balance between the public and private capital-raising markets.

Over the past few decades, the SEC's ever-expanding list of exemptions from U.S. laws governing public securities offerings have shifted capital formation activities from the public markets to the private markets. While public securities markets are transparent, well-regulated, and broadly accessible, the private (or dark) markets are largely unregulated and limited to affluent investors. This trend threatens to bleed the public markets dry, and the SEC should not only halt this trend, but reverse it.[114]

The SEC must strike a better balance between significant public interest achieved through public securities markets and the advantages of small-scale, streamlined, and cost-effective private capital raising. For example, the SEC's ill-advised decision in 2021 to finalize its rule to make it easier for private companies to access capital from retail investors without the level of comprehensive disclosures found in public market offerings further eroded this balance.[115] Similarly, the SEC's expansion of the definition of "accredited investor" without an adequate economic analysis further eroded the line of demarcation between public and private markets.[116]

In a promising sign, the SEC's Fall Agenda suggests that the agency will soon begin to strengthen the rules governing private or limited offerings. Specifically, the SEC has listed several proposed rules for consideration by the Commission that could reevaluate the role exempt offerings play in our capital markets. They include amendments to Regulation D and improvements to Form D, the currently almost meaningless filing that accompanies offerings under rule 506 D; changes to the definition of shareholder of record that helps determine which companies must file periodic reports with the SEC about their operations and financial condition; and adjustments to the Rule 144 holding period, which governs the resale of restricted securities issued in private offerings. While the SEC can and should go further in reexamining its existing exempt offerings framework, these rulemakings represent positive steps.

To be clear, the private securities markets have a legitimate and important role in capital formation. However, they must not be permitted to supplant public markets by facilitating regulatory arbitrage and avoidance of transparency measures, investor protections, and market safeguards in contravention of the fundamental purposes of the securities markets and laws. A comprehensive analysis by SEC staff of both the benefits and the harms arising from its exempt offering framework, for instance, should provide an assessment of how the companies use and abuse the many exempt offerings available to raise money from investors. While certain exempt offerings may have been introduced into our securities legal framework for good reasons over the years, there is no question that the cumulative effect of these exemptions has created a patchwork of regulations that favors companies wishing to receive the benefits of raising money from investors without offering adequate investor protections. While some aspects of the private offering framework can only be reformed through Congressional action, this is clearly fertile ground for further analysis, study, and where possible, rulemaking by the SEC.

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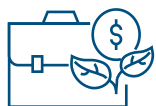
https://bettermarkets.org/newsroom/better-markets-releases-fact-sheet-that-cuts-through-the-hype-on-spacs/.

[114] *The SEC Must Stop Bleeding Public Markets Dry*, Better Mkts. (Apr. 8, 2022), https://bettermarkets.org/newsroom/the-sec-must-stop-bleeding-public-markets-dry/.

[115] *See generally* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3496 (Jan. 14, 2021).

[116] *See SEC Once Again Caters to Wall Street, Big Corporations with Approval of Changes to Regulations S-K and Accredited Investor Definition*, Better Mkts. (Aug. 26, 2020), https://bettermarkets.org/newsroom/sec-once-again-caters-wall-street-big-corporations-approval-c hanges-regulation-s-k-and/.

5. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS



Greenwashing, climate disclosure, racial economic inequality, and corporate governance reforms.

In 2006, leading asset managers from around the world, representing more than $2 trillion in assets under management, gathered at the New York Stock Exchange to sign the Principles for Responsible Investment (PRI). The PRI was a set of principles that, for the first time, recognized that ESG factors should play a more significant role in the investment strategies of capital allocators and asset managers. Ultimately, the PRI would help coin the phrase "ESG" and become a catalyst for what would be tremendous growth in ESG investing. Since the PRI was originally signed by a few dozen asset managers in 2006, there are now more than 3,400 signatories representing more than $121 trillion in assets under management as of March 31, 2021.[117]

In the more than 15 years since the phrase ESG was first coined, the ESG factors have become clearly material financial considerations that have a major influence on the investment decisions of an increasingly wide range of investors. Investment managers and investors continue to manage and invest more and more assets into funds that focus on the ESG factors. For example, according to financial services firm Morningstar, assets in funds that claim to focus on ESG factors or sustainability reached $2.78 trillion in the first quarter of 2022, compared to the less than $1 trillion invested in those same funds in 2020.[118] An analysis of more than 1,000 research papers published between 2015-2020 on financial performance in relation to the ESG factors, conducted by the NYU Stern Center for Sustainable Business and Rockefeller Asset Management, found an overall positive correlation between funds focused on ESG investment strategies and financial performance.[119] The report found that 59% of studies "showed similar or better performance relative to conventional investment approaches while only 14% found negative results."[120]

The rate at which investor assets are flowing into these types of funds reflects the appetite of investors not only for reliable long-range financial returns but also for investment options that align with their core values and beliefs. There is ample evidence that investors are increasingly taking into account ESG factors when making investment decisions.[121] For more information on ESG and why it is so important, click here to read Better Markets' white paper.[122]

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[117] Principles For Resp. Inv., Annual Report 2021 7 (2021), https://dwtyzx6upklss.cloudfron6t.net/Uploads/s/u/b/pri_annualreport_2021_15698.pdf.

[118] Dave Michaels, *SEC Is Investigating Goldman Sachs Over ESG Funds*, Wall St. J. (June 10, 2022), https://www.wsj.com/articles/sec-is-investigating-goldman-sachs-over-esg-funds-sources-say-116 54895917.

[119] *See* Tensie Whelan et al., *ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020* 2 (NYU Stern Ctr. for Sustainable Bus., Report, Feb. 2021), https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance.

[120] *Id.*

[121] *See, e.g.*, Amanda Jacobson Snyder, *As SEC Closes In on ESG Rules for Funds, the Bulk of Frequent Investors Say They Value Such Standards*, Morning Consult (July 12, 2022) (noting a recent survey of investors found that 60 percent of all adults considered ESG ratings important when it came to investment decisions), https://morningconsult.com/2022/07/12/sec-rules-esg-investments-survey-data/.

[122] Stephen Hall & Jason Grimes, *White Paper: What Is ESG and Why Is It So Important? Where the SEC Has Been and Where It Should Head*, Better Mkts. (2021), https://bettermarkets.org/sites/default/files/documents/Better_Markets_White_Paper_SEC_Why_ Is_ESG_Important.pdf.

After years of regulatory inaction to address the various ways investment advisers and issuers disclosed to clients and investors the role different ESG factors played in their investment and business strategies, the SEC began to lay the groundwork for action in early 2021. Under Acting SEC Chair Allison Herren Lee, the SEC established the Enforcement Task Force Focused on Climate and ESG Issues to identify ESG-related misconduct. The task force has already brought several enforcement actions in 2022 against investment advisers and issuers for misleading investors through false statements and omissions regarding ESG or climate disclosures.[123] Under Acting Chair Herren Lee, the SEC issued both a risk alert[124] and an investor bulletin[125] on ESG disclosures, as well as a directive from the Acting Chair to the Division of Corporate Finance to review issuer climate-related disclosures.[126]

All of this work in 2021 laid the groundwork for rule proposals this year on several aspects of ESG, including climate risk disclosure and "greenwashing." The SEC still has work to do in finalizing existing proposed rules and addressing other aspects of ESG, namely diversity and governance disclosures.

A. ESG AND GREENWASHING: Two steps forward.

Despite growing retail and institutional investor interest in ESG investing and the vast sums of money flowing into ESG investment funds, there is still no standardized framework for informing investors about how funds utilize ESG investment strategies. While this gap has been partially filled by several frameworks developed by other entities, including non-profits, those sources cannot substitute for the protections offered by an ESG disclosure framework developed by the SEC. There is a strong consensus forming among investors that they need access to more reliable, consistent, and comparable disclosures regarding the role that the ESG factors play in fund investment strategies.

A clear and comparable understanding of that role equips investors to make optimal financial judgments and to assess the veracity of the claims made by ESG funds using measurable data. The SEC's enforcement action against BNY Mellon earlier this year is an example of the abuses that can occur in the absence of clear rules of the road. In that case, BNY Mellon repeatedly told investors each investment they made was subject to an ESG-quality review screen prior to the investment.[127] The SEC found that 67 of the 186 investments by BNY Mellon did not undergo such a review, representing 25 percent of the assets of the fund.

In June 2022, the SEC proposed two rules to establish a standard ESG disclosure framework and better regulate the use of terms such as "ESG" and "Sustainable" in investment company names. Specifically, the SEC's ESG proposed rule would establish a standardized ESG disclosure framework that would create more reliable, consistent, and comparable disclosures for ESG funds based on the extent to which a fund considers ESG factors in its investment selection and issuer engagement processes. If adopted, this layered approach to ESG disclosure will assist retail and institutional investors, funds, advisers,

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[123] Sec. & Exch. Comm'n, Spotlight on Enforcement Task Force Focused on Climate and Esg Issues (Nov. 29, 2022), https://www.sec.gov/spotlight/enforcement-task-force-focused-climate-esg-issues.

[124] Sec. & Exch. Comm'n, Div. of Examinations, Risk Alert: The Division of Examinations' Review of ESG Investing (2021), https://www.sec.gov/files/esg-risk-alert.pdf.

[125] Sec. & Exch. Comm'n, Environmental, Social and Governance (ESG) Funds – Investor Bulletin (2021), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/inv estor-bulletins-1.

[126] *See* Allison Herren Lee, Comm'r, Sec. & Exch. Comm'n, Statement on the Review of Climate-Related Disclosure (Feb. 24, 2021) ("Today, I am directing the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings."), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure.

[127] *See* Sec. & Exch. Comm'n, Sec Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), https://www.sec.gov/news/press-release/2022-86.

and regulators by providing them with more reliable, consistent, and comparable ESG disclosures. The disclosures provided will help satisfy growing investor demand for material information that can guide their investment decisions and at the same time protect them from misleading and abusive claims surrounding ESG investment strategies. Similarly, the SEC's proposed amendments to update the existing Names Rule will protect investors from investment companies that seek to deceive or mislead investors by including the terms "ESG" or "Sustainable" in their names without investing the assets in accordance with what the names suggest—a practice known as "greenwashing."

Taken together, if adopted, these rule proposals will bring much needed regulatory clarity to ESG investment strategies, which will benefit both investors and investment advisers. To read Better Markets' comment letters on the proposed rules, click here[128] and here.[129]

B. CLIMATE: Disclosure of climate change risks facing issuers.

For years, investors have been demanding more information about how climate change is affecting the financial outlook of the companies they own or are considering investing in, and the reason is clear. The past several years have starkly illustrated the devastating consequences of unchecked climate change, as the failure to address climate change has led to an increase in hugely costly weather disasters, devasting and deadly wildfires, and other climate-change induced catastrophes. It has also become clear that it will take significant effort to curb greenhouse gas emissions sufficiently to avoid the worst impacts of climate change, with policymakers around the world committing to drastic but difficult to achieve reductions in greenhouse gas emissions.

In other words, almost no business on Earth will be spared the impact of climate change, whether arising from threats to physical assets from more extreme weather and wildfires, from the transition to a carbonless economy, or both. The investors who own those companies have for years demanded enhanced climate-related disclosures to help them make better investment decisions, but the absence of a mandatory disclosure framework has left them with a patchwork of voluntary resources that may not produce meaningful, comparable disclosures.

In April 2022, the SEC proposed a sweeping rule to require enhanced and standardized disclosures of the risks that companies are facing and the measures those companies are taking to address those risks. This wide-ranging rule would establish a mandatory disclosure regime for registrants in response to broad investor demand for better disclosure about how the companies they own are responding to the financial risks and opportunities presented by climate change. The proposed rule will benefit investors who are entitled to decision-useful information about how the companies they invest their money in are responding to one of the most urgent economic and financial risks our society faces. The proposal will also benefit our financial system, which will come under increasing strain as the impacts of climate change and the transition away from a carbon-based economy become progressively more apparent.

The SEC, tasked with protecting investors and the public interest, has clear authority to mandate these disclosures, and can it and should go even further to ensure that investors are provided with all of the

[128] *Better Markets Supports SEC Rule to Require Reliable, Consistent, and Comparable ESG Fund Disclosures to Investors*, Better Mkts. (Aug. 16, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-rule-to-require-reliable-consistent-and-comparable-esg-fund-disclosures-to-investors/.

[129] *Better Markets Supports SEC Rule to Modernize the Names Rule and Help Ensure Investors Are Not Misled by Misleading Fund Names*, Better Mkts. (Aug. 16, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-rule-to-modernize-the-names-rule-a nd-help-ensure-investors-are-not-misled-by-misleading-fund-names/.

climate risk information they need to make informed investment decisions. To read Better Markets' comment letter on the SEC's proposed climate disclosure rule, click here.[130]

C. RACIAL ECONOMIC INEQUALITY: Modest early steps with hopefully more to come.

The legacy of 400 years of slavery, segregation, and racial discrimination continues to cause profound racial economic inequality in our society. This inequality is not only a moral issue; it has also undermined shareholder returns, productivity, and economic prosperity. However, a new movement is underway in the realm of business and finance that promises some forward progress in addressing racial economic inequality and other aspects of racial injustice. Companies, and the shareholders that own and ultimately govern them, are increasingly recognizing that they can and should do more to correct and reverse racial injustice for financial as well as moral reasons.

The SEC and all of the financial regulators have an important role to play in integrating this potentially transformative way of thinking into the financial markets. In July 2021, the SEC's Subcommittee on Diversity and Inclusion of the Asset Management Advisory Committee (AMAC) published a set of recommendations the SEC should adopt to increase diversity and inclusion in our capital markets. They include workforce disclosure by regulated entities, board diversity disclosure by issuers, clarifying the role diversity plays in the fiduciary duty of investment advisers, and examining pay-to-play practices in asset allocation in the institutional markets, among others. These carefully constructed and well-thought-out recommendations established a framework for SEC action. While the SEC has yet to act on several of these important recommendations, public remarks by Commissioner Lizárraga,[131] and the SEC's regulatory agenda, suggest that more work on this issue is forthcoming.

Earlier this year, SEC staff implemented one of the AMAC's recommendations by issuing an FAQ relating to investment adviser consideration of diversity, equity, and inclusion factors.[132] This FAQ was an important step to clarify that diversity, equity, and inclusion are appropriate factors for investment advisers to consider when selecting other advisers to manage client assets, consistent with the client's investment objectives. This change will help break down barriers that have served as structural obstacles for diversity among investment advisers, such as minimum assets under management requirements or minimum length of track records. Another AMAC recommendation is reflected in the Fall Agenda, which indicates that the Commission plans to consider rule amendments to enhance registrant disclosures about the diversity of board members and nominees. These actions are welcome measures designed to help inform investors about the racial composition of corporate governing bodies so they can make more informed investment decisions and ultimately help address racial economic inequality.[133]

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[130] *We Support the SEC's Climate-Risk Disclosure Proposal, A Very Strong Measure That Can Be Made Even Better*, BETTER MKTS. (June 21, 2022), https://bettermarkets.org/impact/we-support-the-secs-climate-risk-disclosure-proposal-a-very-strong-measure-that-can-be-made-even-bette/.

[131] Jaime Lizárraga, Comm'r, Sec. & Exch. Comm'n, "Raising the Bar on Diversity, Equity and Inclusion," Remarks Before the ICI Securities Development Conference (Oct. 13, 2022), https://www.sec.gov/news/speech/lizarraga-remarks-raising-bar-diversity-equity-and-inclusion-10 1322.

[132] SEC. & EXCH. COMM'N, STAFF FAQ RELATING TO INVESTMENT ADVISER CONSIDERATION OF DEI FACTORS (Oct. 13, 2022), https://www.sec.gov/tm/staff-faq-relating-investment-adviser-consideration-dei-factors.

[133] In August 2021, the SEC approved a NASDAQ rule requiring each company listed on the exchange to publicly disclose the self-identified gender, racial, and LGBTQ+ status of each member of the company's board of directors. The rule also requires each listed company to have, or explain why it does not have, at least two members of its board who are diverse, including at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority or LGBTQ+. The SEC's approval was promptly challenged in court. *See Alliance for Fair Board Recruitment v. SEC*, No. 21-60626 (5th Cir. filed Aug. 10, 2021). A decision is expected soon.

To see Better Markets' white paper on how the SEC can further address racial and economic inequality, click here.[134]

D. CORPORATE GOVERNANCE: Beneficial ownership reporting, share repurchase disclosure, and human capital disclosure.

(1) Modernizing Beneficial Ownership Reporting

Under the securities laws, any person who acquires beneficial ownership of more than 5% of a class of securities must disclose that fact by filing a public report with the SEC within 10 days. The basic purpose of the report is to alert companies and other investors that a bid to influence or gain control of the company may be underway, information that can affect the share price and long-term prospects of the company. That delay in reporting matters because it gives those accumulating a large stake in a company an unfair profit opportunity. Since share prices generally rise when their large ownership interests are publicly disclosed, activists can accumulate additional shares over the 10-day period that are likely to increase in price once their holdings are disclosed, all at the expense of shareholders not yet aware that the stock price will change.

In March 2022, the SEC proposed a rule to shorten the reporting deadline from 10 days to 5 days.[135] As we argued in our comment letter, Congress clearly perceived the need to curtail opportunistic trading when it gave the SEC explicit authority to shorten the deadline in the Dodd-Frank Act.[136] As we further argued, the proposed rule will enhance transparency and market stability by ensuring that certain types of derivatives holdings count toward the level of beneficial ownership required to be reported. We know from the Archegos debacle last year[137] that derivatives can be used to acquire massive, highly leveraged, and systemically risky interests in companies, all of which should be subject to greater transparency. We also supported the SEC's effort to prevent evasion of the reporting requirement by ensuring that those acting together in groups are appropriately subject to the reporting requirement. Finally, we observed that activists hoping to influence or control companies to increase long-term shareholder value will still be able to pursue those goals under the shorter reporting deadline.

To read Better Markets' comment letter, click here.[138]

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[134] Stephen Hall & Jason Grimes, *How Can the SEC Address Racial Economic Inequality Through Regulation of the Securities Markets for All Americans*, Better Mkts. (2021), https://bettermarkets.org/wp-content/uploads/2021/12/BetterMarkets_SEC_Steps_To_Improve_R acial_Inequality_Dec-2021.pdf.

[135] *See* Modernization of Beneficial Ownership Reporting, 87 Fed. Reg. 13,846, 13,847 (proposed Mar. 10, 2022).

[136] *See* Stephen Hall, *Comments: Modernization of Beneficial Ownership Reporting*, Better Mkts. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Beneficial_Ownership_Reporting_Requirements.pdf; *Better Markets Supports SEC Proposal To Increase Transparency and Fairness by Modernizing The Beneficial Ownership Reporting Rules*, Better Mkts. (Apr. 11, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-proposal-to-increase-transparency-and-fairness-by-modernizing-the-beneficial-ownership-reporting-rules/.

[137] Erik Schatzker, Sridhar Natarajan, & Katherine Burton, *Bill Hwang Had $20 Billion, Then Lost It All in Two Days*, Bloomberg (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost- 20-billion-in-two-days?sref=mQvUqJZj.

[138] Hall, *supra* note 131.

(2) Share Repurchase Disclosure Modernization (Stock Buybacks)

In February 2022, the SEC proposed a rule known as the "Share Repurchase Disclosure Modernization" rule.[139] The proposed rule would improve the quality, quantity, and timeliness of information regarding an issuer's repurchase of its own shares, otherwise known as "stock buybacks."

Those transactions are increasingly viewed as a strategy that corporate insiders use to line their pockets at the expense of the long-term financial health of the company, its employees, and its shareholders. Announcements of repurchases, along with the repurchases themselves, tend to exert short-term upward price pressure on a company's stock. This creates opportunities for management to directly increase their profits from repurchases of their own stock. It also may enable management to boost their executive compensation in other ways by triggering certain performance metrics. Buybacks also divert capital away from investment in the operations and employees of a company, undermining its productivity and the welfare of its labor force. The existing disclosure requirements applicable to buybacks are weak, and investors need more information to understand the impact of buybacks and the potential for management abuses associated with repurchases.

The SEC's proposed rule on stock buybacks would go a long way toward satisfying this need. It would require much more timely reporting, moving from a molasses-like quarterly timetable to an "end of next business day" deadline following repurchases. It would also enhance the quality of the reporting by requiring disclosure of the objective or rationale for the repurchases and whether any of the issuer's officers or directions purchased or sold shares 10 business days before or after the announcement of a repurchase plan.

Better Markets urged the SEC to follow through with these beneficial reforms in the final rule.[140] We also identified a number of ways the final rule could be improved by requiring additional disclosures, incentivizing accurate reporting, and limiting the participation of management in repurchases to mitigate the conflicts of interest in play.[141] We applaud the SEC for taking action to enhance the quantity, quality, and timeliness of reporting on these controversial transactions.[142]

To read Better Markets' comment letter to the SEC on stock buybacks, click here.[143]

(3) Human Capital Disclosures

In 2019, following recommendations by several organizations, as well as the SEC's Investment Advisory Committee,[144] the SEC proposed rules intended to improve the information available to investors on

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[139] *See generally* Share Repurchase Disclosure Modernization, 87 Fed. Reg. 8443 (proposed Feb. 15, 2022).

[140] *See generally* Stephen Hall & Jason Grimes, *Comments: Share Repurchase Disclosure Modernization*, BETTER MKTS. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Share_R epurchase_Disclosures.pdf.

[141] *See Better Markets Backs SEC Rule to Improve Disclosures of Stock Buybacks*, BETTER MKTS. (Apr. 1, 2022), https://bettermarkets.org/impact/better-markets-backs-sec-rule-to-improve-disclosures-of-stock-buybacks/.

[142] *See Better Markets Urges SEC to Shine More Light on Stock Buybacks, Transactions Under Fire for Benefiting Management Over Companies and Shareholders*, BETTER MKTS. (Apr. 5, 2022), https://bettermarkets.org/newsroom/better-markets-urges-sec-to-shine-more-light-on-stock-buyba cks-transactions-under-fire-for-benefiting-management-over-companies-and-shareholders/.

[143] Stephen Hall & Jason Grimes, *Comments: Share Repurchase Disclosure Modernization*, BETTER MKTS. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Share_R epurchase_Disclosures.pdf.

[144] *See* SEC. & EXCH. COMM'N, SPOTLIGHT ON INVESTOR ADVISORY COMMITTEE (2023), https://www.sec.gov/spotlight/investor-advisory-committee.shtml.

human capital, including the collective knowledge, skills, and experiences of the workforce.[145] Those rules were finalized by the Commission in 2020.[146] Now, under the current reporting standards, public companies are required to describe "any human capital measures or objectives that the registrant focuses in on in managing the business," in addition to the existing headcount requirements, which were retained.[147]

The 2020 changes to Reg S-K have had a positive impact on human capital disclosure, requiring that more information be provided to investors. However, while some observers view the rules as a step in the right direction, many investors voiced concerns that the rules fell short in providing the kind of high-quality actionable data they needed to develop a clear and effective understanding of a company's skill in managing its own workforce, while also permitting corporate management to exercise too much latitude in what human capital information would be reported.

In August 2021, Chairman Gensler signaled his openness to further revising the rules surrounding human capital disclosure, raising the prospect of mandatory disclosures.[148] The Fall Agenda indicates that the SEC will be considering "rule amendments to enhance registrant disclosures regarding human capital management." Better Markets applauds the SEC's work on human capital disclosure rules and encourages the Commission to do more in this area.

6. PRIVATE FUNDS

Form PF and Disclosure to Investors.

One of the consistent themes of the financial crisis was the extraordinary degree to which regulators were surprised and caught uninformed about some of the most basic practices, products, and exposures then prevailing in the financial markets and at financial firms. This grievous lack of transparency shielded a massive, unseen buildup of risk. That information gap resulted in policy makers and regulators being consistently unprepared for the 2008 crisis and forced to react as the crisis approached, unfolded, metastasized, and ultimately exploded.

Congress responded to these information gaps with many reforms in the Dodd-Frank Act in the areas of securities, banking, and derivatives. Among them were provisions removing the exemption from SEC registration that applied to private funds, along with the imposition of registration, recordkeeping, and reporting requirements on private fund advisers.

Since passage of the Dodd-Frank Act, the private funds industry has grown significantly, both in terms of assets under management and in terms of investment strategies. According to Form ADV data, there are more than 5,000 registered private fund advisers, representing 35% of all Commission-registered advisers, with over $18 trillion in assets under management.[149] This large pool of capital is roughly

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[145] *See* SEC. & EXCH. COMM'N, SEC PROPOSES TO MODERNIZE DISCLOSURES OF BUSINESS, LEGAL PROCEEDINGS, AND RISK FACTORS UNDER REGULATION S-K (Aug. 8, 2019), https://www.sec.gov/news/press-release/2019-148.

[146] *See generally* Modernization of Regulation S-K Items 101, 103, and 105, 85 Fed. Reg. 63,726 (Oct. 8, 2020) (codified at 17 C.F.R. Parts 229, 239, 240).

[147] *See id.* at 63,760 (codified at 17 C.F.R. § 229.101(c)(2)(ii)).

[148] *See* Paul Kiernan, *SEC Weighs Requiring Companies to Give More Details on Workers*, WALL ST. J. (Aug. 20, 2021), https://www.wsj.com/articles/sec-weighs-requiring-companies-to-give-more-details-on-workers-1 1629489647.

[149] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886, 16,887 (Mar. 24, 2022).

equivalent to the combined assets under management in the entire countries of the United Kingdom, France, and Germany.

Private funds are deeply interconnected with the financial system and the economy more broadly. Private funds are involved in the credit markets as both users and sources of credit; they invest significantly in both public and private markets; and especially in the case of private equity, they own and run operating companies. Additionally, many funds also manage and invest assets of Main Street savers (albeit a small percentage of their overall assets), including retirement savers and pension funds, and they therefore raise significant investor protection issues.

Beyond the amount and nature of their holdings, private funds are also deeply interconnected with the rest of the financial system, as well as the broader economy. In the low-interest rate environment that has prevailed over the past decade, institutional investors representing pension systems, university endowments, non-profit foundations, and mutual funds have invested heavily in private funds in search of yield. For example, the average U.S. public pension's capital allocation to private equity alone is up nearly 50% from 2010 to 2021, with some large pension plans increasing their private equity allocation targets to 17% of their portfolios.[150] Similarly, hedge funds serve as significant sources of speculative investment and can fuel speculative bubbles; during the runup to the financial crisis many hedge funds were heavily invested in the housing market, which contributed to the dramatic expansion of the housing bubble.[151] And, of course, they were deeply involved in creating the demand for derivatives to bet on the housing market, including in particular the creation and distribution of fraudulent and built-to-blow-up derivatives that played a central role in igniting the crash and spreading it around the globe.[152]

Hedge funds are also exposed to other important financial institutions through their prime brokerage relationships, which means that distress at a hedge fund can be transmitted to large banks and other systemically important institutions.[153] Private funds in stress may also be forced to engage in fire sales of assets in an attempt to survive. This can pose systemic risk, especially in times of market stress, because these fire sales can depress asset prices further, impacting other firms and creating a spiral of falling prices.

The private funds industry is obviously significant to the U.S. and global financial systems, and it therefore warrants rigorous oversight by the SEC to protect investors and ensure financial stability.[154] In remarks given in November, 2021, Chairman Gensler previewed several areas of interest to the SEC within the private funds industry, including a review of fees and expenses; the use of side letters; performance metrics; fiduciary duties and conflicts of interests; and data quality in Form PF.[155] The agency has moved forward on several of these issues.

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[150] Heather Gillers, *Retirement Funds Bet Bigger on Private Equity*, WALL ST. J. (Jan. 10, 2022), https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604 ("The $75 billion Los Angeles County Employees Retirement Association lifted its private equity target to 17% of its portfolio in May from 10% while dialing back its target for stock to 32% from 35%").

[151] LLOYD DIXON ET AL., RAND CORP., HEDGE FUNDS AND SYSTEMIC RISK XIX (2012), https://www.rand.org/content/dam/rand/pubs/monographs/2012/RAND_MG1236.pdf.

[152] *See, e.g.*, FINANCIAL CRISIS INQUIRY REPORT, *supra* note 71, ch. 8.

[153] Hossein Nabilou & Alessio M. Pacces, *The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183, 211 (2015) ("The top prime brokers are almost all LCFIs that have exposure to hedge funds and to each other. This interconnectedness makes them a key channel of systemic risk contagion stemming from hedge funds.").

[154] *See* EUROPEAN FUND AND ASSET MGMT. ASS'N, AN OVERVIEW OF THE ASSET MANAGEMENT INDUSTRY: FACTS AND FIGURES 5 (2021), https://www.efama.org/sites/default/files/files/Asset%20Management%20Report%202021_3.pdf.

[155] *See* Gary Gensler, Chair, Sec. & Exch. Comm'n, Prepared Remarks At the Institutional Limited Partners Association Summit (Nov. 10, 2021), https://www.sec.gov/news/speech/gensler-ilpa-20211110.

A. FORM PF: Strengthening SEC oversight by modernizing the data quality and timing of Form PF submissions.

One of the principal tools the SEC uses to carry out its oversight of the private funds industry following Dodd-Frank is Form PF. Since its adoption in 2011, certain private fund advisers have been required to periodically report information regarding the funds they advise to the Commission on a confidential basis. The information provided on Form PF has proven significantly beneficial, not only allowing the SEC and the Financial Stability Oversight Council (FSOC) to better monitor ongoing risks to the financial system but also enabling the agencies to better understand trends in broader financial markets, to better understand the practices of private funds, and to better understand how those practices are evolving over time. This information in turn allows the SEC to craft better rules and efficiently focus its regulatory resources.[156]

However, after nearly ten years' experience reviewing and assessing Form PF submissions by private fund advisers, the SEC has proposed two rulemakings within the past year designed to (1) increase the frequency of reporting in times of market stress; and (2) enhance and modernize the quantity and quality of data being reported. It is entirely appropriate for the SEC, considering its experience in the intervening years (which has included multiple instances of market stress) to revisit Form PF and address what shortcomings it may have, particularly those related to the timeliness and granularity of key information. Taken together, if adopted as proposed, these rules will improve the ability of the SEC and FSOC to carry out their congressionally mandated duties to protect investors and monitor systemic risks in the markets.

To read Better Markets' comment letter on the proposed rules to amend Form PF, click here[157] and here.[158]

B. PROTECTIONS FOR PRIVATE FUNDS INVESTORS: Strengthening investor protection by enhancing transparency and regulation of the private fund industry.

The reforms made in the Dodd-Frank Act to bring more regulatory oversight to the private fund industry marked the beginning of a new era in the SEC's oversight of private fund advisers, enhancing its ability both to protect investors and monitor systemic risk. However, the rules implementing this framework have remained weak and incomplete since the Dodd-Frank Act was signed into law, as evidenced by the numerous risk alerts issued by the SEC staff. For example, in January 2022, the SEC Division of Examinations issued a risk alert identifying several failures witnessed by exam staff, including failures to follow practices in fund disclosures regarding management fees; misleading prospective investors about a track record; inaccurate performance calculations; and the inclusion of clauses in agreements that limit or eliminate the advisers' fiduciary duty to investors, in effect creating a license to act in their own interests in direct conflict with the requirements of the Investment Advisors Act.[159]

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[156] *See* SEC. & EXCH. COMM'N, ANNUAL STAFF REPORT RELATING TO THE USE OF FORM PF DATA 5-6 (Nov. 3, 2020), https://www.sec.gov/files/2020-pf-report-congress.pdf.

[157] *Better Markets Supports Stronger Reporting Requirements for Private Funds*, BETTER MKTS. (Mar. 21, 2022), https://bettermarkets.org/impact/better-markets-supports-stronger-reporting-requirements-for-priv ate-funds/.

[158] *Better Markets Supports SEC and CFTC Joint Rule That Strengthens Key Dodd-Frank Regulation of Large Private Funds*, BETTER MKTS. (Oct. 12, 2022), https://bettermarkets.org/impact/better-markets-supports-sec-and-cftc-joint-rule-that-strengthens- key-dodd-frank-regulation-of-large-private-funds/.

[159] *See* SEC. & EXCH. COMM'N, DIV. OF EXAMINATIONS, RISK ALERT: OBSERVATIONS FROM EXAMINATIONS OF PRIVATE FUND ADVISERS 2–5 (2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

In response to the abuses by private fund advisers and the lack of investor protections in place, the SEC proposed a rule in March 2022 to make this increasingly important financial sector substantially more fair and transparent. The proposed rule would require private fund investors to issue quarterly disclosures to investors on metrics such as fees, expenses, and fund-level performance; obtain annual financial statement audits; require the use of fairness opinions for adviser-led secondary transactions; limit preferential treatment for certain investors; and prohibit certain activities that cannot be cured by disclosure. If adopted, this rule will go a long way to rein in the long list of unfair, predatory, and opaque practices that have become standard practice in the world of private funds.

To read Better Markets' comment letter on the proposed rule to expand disclosures by private fund advisers, click here.[160]

ENFORCEMENT

The Commission does not just write the rules for U.S. capital markets. It enforces those rules, too, thanks to the efforts of its Enforcement Division. Below, we survey three enforcement topics of particular importance from the past year: (1) general changes or trends in SEC enforcement, including its approach to fines, individual accountability, and the use of non-monetary sanctions; (2) developments in the agency's whistleblower program; and (3) its enforcement efforts in the field of cryptocurrencies and digital assets.

1. GENERAL TRENDS

In the past Fiscal Year, the SEC recovered an impressive $6.4 billion through enforcement actions, a substantial increase from the prior year, during which the Commission recovered less than $4 billion.[161] Moreover, the amount the SEC recovered through civil penalties increased from $1.4 billion in Fiscal Year 2021 to $4 billion in Fiscal Year 2022.[162] This increase in the Commission's use of civil penalties reflects Chair Gensler's repeatedly stated commitment to increasing deterrence against securities law violators.[163]

Despite these record enforcement numbers for the past Fiscal Year, the SEC has not always sought sufficient remedies in each case to effectively punish and deter violators. Three principles should guide the Commission's enforcement actions. First, enforcement must extend beyond the corporate entity to those individuals driving the corporate misconduct. Second, monetary penalties must be sufficiently large to have a true deterrent effect; they cannot be just another cost of doing business. Third, fines alone are usually not sufficient; they should often accompany admissions of liability, conduct-based remedies, and even disqualifications. Judged by these factors, the past year of enforcement results paints a more complicated picture than the dollar figures suggest.

[160] *SEC Proposal on Private Fund Advisers Will Give Investors More Insight Into Opaque Fees, Expenses, and Fund Performance*, Better Mkts. (Apr. 26, 2022), https://bettermarkets.org/impact/sec-proposal-on-private-fund-advisers-will-give-investors-more-insight-into-opaque-fees-expenses-and-fund-performance/.

[161] Sec. & Exch. Comm'n, Sec Announces Enforcement Results for Fy 2021 (Nov. 18, 2021), https://www.sec.gov/news/press-release/2021-238.

[162] *Id.*

[163] *See* Mengqi Sun, *SEC Had a Record Year for Enforcement Actions*, Wall St. J. (Nov. 15, 2022), https://www.wsj.com/articles/sec-had-a-record-year-for-enforcement-actions-11668553421.

A. INDIVIDUAL ACCOUNTABILITY: Behind every violation by a firm is an individual.

Individual accountability is a bedrock principle of effective enforcement. If the corporate entity acts as a shield, the persons who actually committed misconduct will not be punished or deterred. The Commission certainly understands this point; it did charge individual corporate executives in a number of cases this past year.[164] Better still, some of these figures were either powerful executives (like a former CEO of Boeing[165]), or well-known celebrities (and few are better known than Kim Kardashian). These are exactly the sorts of defendants many Americans with nine-to-five jobs have seen too often buy their way out of accountability through status, power, connections, or sheer media influence.[166] Luckily, that expectation did not hold many times this year. And perhaps nowhere is that clearer than with the downfall of Sam Bankman-Fried and FTX. The Commission, and particularly Chair Gensler, represented one of the last bastions against his multi-million-dollar influence campaign around Washington.

Still, the Commission was far from perfect last year in demanding individual accountability. For instance, in September the agency announced large fines against sixteen Wall Street firms for pervasive, systematic violations of record-keeping laws through the use of "off-channel communications."[167] This may sound technical or unimportant, but the SEC requires companies to maintain records of communications so that it can discover lawbreaking and punish those responsible. The failure to maintain those records is fundamentally no different than the destruction of evidence in any illegal enterprise—crooks destroying evidence to prevent the cops from catching them in the first place. It's a serious violation. And, in some of these cases, the violations were aggravated as some firms continued to destroy records even after being cautioned against the practice. Remarkably, only the banks were charged—no trader or banker from any of the sixteen firms faced an SEC complaint—not one person. The same result occurred with the SEC's settlement with international accounting firm Ernst & Young, where, despite allegations of widespread misconduct up to and including management figures, the Commission charged only the corporate entity.[168]

That must stop. The SEC is not going to stem the tide of lawbreaking until individuals, including supervisors and executives, are personally charged and meaningfully punished. That should be the presumption in every enforcement case. While that means more companies and individuals will litigate the cases and the SEC will even lose some of them, the current practice must make individual accountability a higher priority.

[164] *See, e.g.*, Sec. & Exch. Comm'n, New Jersey Real Estate Development Firm and Four Executives Charged With $600 Million Ponzi-Like Fraud (Oct. 13, 2022), https://www.sec.gov/news/press-release/2022-188.

[165] *See* Sec. & Exch. Comm'n, Boeing To Pay $200 Million To Settle Sec Charges That It Misled Investors About The 737 MAX (Sept. 22, 2022), https://www.sec.gov/news/press-release/2022-170.

[166] For instance, the golfer Phil Mickelson made nearly $1 million from an insider trading scheme involving a Vegas sports gambler, but the SEC sought neither civil penalties nor criminal charges. Instead, Mickelson only paid back the amount of money he accrued from the scheme. *See, e.g.*, Final Judgment as to Relief Defendant Philip A. Mickelson at 1–3, *SEC v. Walters*, No. 1:16-cv-3722 (S.D.N.Y. May 24, 2016), ECF No. 18.

[167] Sec. & Exch. Comm'n, Sec Charges 16 Wall Street Firms With Widespread Recordkeeping Failures (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174.

[168] *See Ernst & Young LLP*, Exchange Act Release No. 95167, Accounting & Auditing Enf't Release No. 4313, 2022 WL 2339592 at *1 (June 28, 2022).

B. FINES: They must be more than a cost of doing business.

As a threshold matter, the SEC should routinely require the defendant to "disgorge" the fruits of its wrongdoing (with interest).[169] This is an essential element of enforcement but also an inherently limited one, as it is bounded by the "net profits" the wrongdoer has received.[170] Accordingly, meaningful fines must complement disgorgement to ensure wrongdoers and others are really deterred from committing securities fraud.

The impact of a fine depends first and foremost on its size and then on who actually pays it. As to amounts, in some cases, the SEC has exacted total fines that are woefully small. In others, the SEC has not assessed fines at all. For example, in its case against HeadSpin, Inc., the SEC settled fraud charges without assessing any penalty, in large part because the company voluntarily disgorged its profits.[171] But without the complementary deterrent effect of civil penalties, many corporate wrongdoers will not be incentivized to refrain from wrongdoing. In fact, some corporate wrongdoers may simply view an SEC fine as the "cost of doing business"—a cost worth bearing in many cases. If the worst that can happen—***if*** you get caught—is that you must return your ill-gotten gains, why not at least try? After all, a rational person would calculate the odds of getting caught as low; the odds of getting caught and punished as lower; and the odds of getting caught and ***meaningfully*** punished above and beyond disgorgement as still lower. Steep civil penalties ensure that potential wrongdoers are in fact punished, which may cause them to think twice before engaging in wrongful conduct at the outset. Otherwise, violating the law might become a nearly risk-free proposition.

The impact of a fine also depends on the assets of the defendant or respondent. In 2022, the SEC brought several significant cases with ostensibly heavy fines. Among those who received fines of at least $100 million from the SEC during the past year include Barclays,[172] Charles Schwab,[173] Boeing,[174] Ernst & Young,[175] Nikola,[176] and a subsidiary of Allianz Global Investors,[177] among others.[178] Eye-catching numbers, for sure. But how much did they truly matter to some of these entities, whose balance sheets reflect income in the billions of dollars or even assets in the trillions? Even the fines levied against some individual persons might have represented little more than an annoyance; that might

[169] *See* 15 U.S.C. § 78u-2(e) ("In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, the Commission or the appropriate regulatory agency may enter an order requiring accounting and disgorgement, including reasonable interest.").

[170] *Liu v. SEC*, 140 S. Ct. 1936, 1940 (2020).

[171] Sec. & Exch. Comm'n, SEC's Fraud Case Against Silicon Valley-Based Headspin, Inc.'s Former CEO Is Ongoing (Jan. 28, 2022), https://www.sec.gov/litigation/litreleases/2022/lr25320.htm.

[172] *See* Sec. & Exch. Comm'n, Barclays Agrees to a $361 Million Settlement to Resolve SEC Charges Relating to Over-Issuances of Securities (Sept. 29, 2022), https://www.sec.gov/news/press-release/2022-179.

[173] *See* Sec. & Exch. Comm'n, Schwab Subsidiaries Misled Robo-Adviser Clients About Absence Of Hidden Fees (June 13, 2022), https://www.sec.gov/news/press-release/2022-104.

[174] *See The Boeing Co.*, Securities Act Release No. 11105, 2022 WL 4445459 at *12 (Sept. 22, 2022).

[175] *See Ernst & Young LLP*, Exchange Act Release No. 95167, Accounting & Auditing Enf't Release No. 4313, 2022 WL 2339592 at *13 (June 28, 2022).

[176] *See Nikola Corp.*, Securities Act Release No. 11018, Exchange Act Release No. 93838, 2021 WL 6062954 at *11 (Dec. 21, 2021).

[177] *See Allianz Glob. Invs. U.S. LLC*, Exchange Act Release No. 94927, Investment Advisers Act Release No. 6027, 2022 WL 1644317 at *7–8 (May 17, 2022).

[178] *See Nikola Corp.*, 2021 WL 6062954 at *11.

well have been the case for the penalty imposed on Kim Kardashian for touting a cryptocurrency on Instagram without disclosing what she was paid to do so.[179]

Other factors come into play. Fines levied against companies are ultimately borne by the shareholders or in some cases even paid out under insurance policies. These are yet additional reasons to ensure that individual wrongdoers suffer meaningful consequences if they violate the law. Also important is how much of the large nominal fine was actually recovered. Consider the Commission's $50 million penalty last year against BlockFi, a cryptocurrency lending platform (a case we examine in more detail below).[180] That number stands out among SEC penalties, especially for a company that has never crossed the minds of most Americans. Yet public reporting indicates that BlockFi had paid less than half of the total fine by the time it sought bankruptcy protection in November.[181] We expect that bankruptcy, dissolution, or sheer evasion will likely result in actual fines being significantly reduced.

C. NON-MONETARY SANCTIONS: They are a critical complement to disgorgement and fines.

Last but not least, the Commission must use non-monetary sanctions more often in its enforcement actions. As important as penalties are, only by seeking additional measures can the SEC adequately deter wrongdoing. Among these critical remedies are (1) admissions of fault; (2) injunctions to require remedial or prophylactic actions; and (3) statutory disqualifications, including officer and director bars. Only by exhaustively utilizing the full panoply of remedies available to it can the Commission truly fulfill its mission to protect our securities markets and its investors.

Though we commend Commission leadership for identifying such remedies as critical priorities,[182] the SEC must increase the frequency and degree with which it seeks these measures going forward. The agency did notably secure admissions of wrongdoing from several large banks or accounting firms subject to enforcement last year—notable progress on this issue.[183] But admissions are still far from the norm in SEC settlements; we can only hope that they will become the default.

The past year tells a similar story for mandatory injunctive relief. Again, the Commission secured some noteworthy gains on this front, especially in a few of its highest-profile settlements. Some of the largest Wall Street banks were required to procure independent compliance monitors, for example.[184] But a corrective measure of this sort should be the norm, not a rarity, if the Commission wants to reduce future misconduct. Disqualification of wrongdoers, unfortunately, is very much still a rarity for the most powerful financial institutions that might inflict the most harm; the Commission routinely grants waivers from the default statutory sanction. That too must end.

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[179] Sec. & Exch. Comm'n, Sec Charges Kim Kardashian For Unlawfully Touting Crypto Security (Oct. 3, 2022), https://www.sec.gov/news/press-release/2022-183.

[180] *See* Sec. & Exch. Comm'n, Blockfi Agrees To Pay $100 Million In Penalties And Pursue Registration Of Its Crypto Lending Product (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26.

[181] *See* Kevin Simauchi & Hannah Miller, *Crypto Lender BlockFi Goes Bankrupt in Wake of FTX's Fall*, Bloomberg (Nov. 28, 2022) ("The SEC is listed on the bankruptcy filing as BlockFi's fourth-largest creditor, with $30 million owed to the agency."), https://www.bloomberg.com/news/articles/2022-11-28/blockfi-latest-to-go-bankrupt-in-aftermath-of-ftx-s-meltdown?sref=mQvUqJZj.

[182] *See*, e.g., Gurbir Grewal, Director, Div. of Enf't, Sec. & Exch. Comm'n, Remarks at SEC Speaks 2021 (Oct. 13, 2021), https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[183] *See, e.g.*, SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures, *supra* note 162 ("'These 16 firms not only have admitted the facts and acknowledged that their conduct violated these very important requirements, but have also started to implement measures to prevent future violations.'").

[184] *See, e.g., Goldman Sachs & Co. LLC*, Exchange Act Release No. 95922, 2022 WL 4545825 at *5–8 (Sept. 27, 2022).

Further insights on the Commission's enforcement results over the past Fiscal Year can be found in Better Market's recent Law360 article.[185]

2. THE WHISTLEBLOWER PROGRAM

The Commission's whistleblower program has been another enforcement domain to see notable change. Under Section 922 of the Dodd-Frank Act, Congress directed the SEC to establish a program to incentivize individuals to come forward with knowledge of potential securities violations.[186] Under the program's directives, individuals who provide information leading to a successful action are entitled to receive a monetary award in the amount of 10 to 30 percent of the total monetary sanctions the SEC collects. Since the program's inception in 2012, the SEC has awarded over $1.3 billion to successful whistleblowers.[187]

In the past Fiscal Year, the SEC awarded approximately $229 million in 103 whistleblowing awards, making this the SEC's second-highest year in terms of dollar amounts and number of whistleblowing awards.[188] The Commission also received over 12,300 whistleblower tips during the past Fiscal Year, making it the highest number of tips ever received in a Fiscal Year.[189]

On August 26, 2022, the SEC adopted two amendments to the rules governing its whistleblower program.[190] The first rule change made clear the Commission's authority and intention to pay out whistleblower awards even if the awards could otherwise be paid under another federal agency's whistleblowing program. The second rule affirmed the Commission's authority to consider the dollar amount of a potential award for the limited purpose of increasing an award but not to lower an award.[191]

As SEC Chair Gensler put it, "[t]hese amendments . . . would help ensure that whistleblowers are both incentivized and appropriately rewarded for their efforts in reporting potential violations of the law to the Commission."[192] However, as Better Markets explained in our comment letter on the proposals, while these changes go a long way toward fixing problems in the SEC's whistleblowing program, the Commission should consider further changes, particularly with respect to the treatment of independent analyses provided by whistleblowers.

To read Better Markets' comment letter detailing our view on the SEC's 2022 whistleblowing rule changes, click here.[193]

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[185] Stephen Hall & Houston Shaner, *SEC Must Improve Enforcement Quality With 3 Key Factors*, LAW360 (Dec. 7, 2022), https://www.law360.com/articles/1555348.

[186] 15 U.S.C. § 78u-6.

[187] SEC. & EXCH. COMM'N, SEC WHISTLEBLOWER OFFICE ANNOUNCES RESULTS FOR FY 2022 at 1 (2022), https://www.sec.gov/files/2022_ow_ar.pdf; *see also* SEC. & EXCH. COMM'N, 2021 ANNUAL REPORT TO CONGRESS, WHISTLEBLOWER PROGRAM (2021) https://www.sec.gov/files/owb-2021-annual-report.pdf.

[188] SEC Whistleblower Office Announces Results for FY 2022, *supra* note 182, at 1.

[189] *Id.*

[190] *See* SEC. & EXCH. COMM'N, SEC AMENDS WHISTLEBLOWER RULES TO INCENTIVIZE WHISTLEBLOWER TIPS (Aug. 26, 2022), https://www.sec.gov/news/press-release/2022-151.

[191] *Id*.

[192] *See id*.

[193] Stephen Hall & Jason Grimes, *Comments: Whistleblower Program Rules*, BETTER MKTS. (2022), https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_SEC_W histleblower_Program_Rules.pdf.

3. CRYPTOCURRENCIES AND DIGITAL ASSETS

One final area of Commission enforcement deserves special attention this year: the agency's effort to crack down on cryptocurrency offerings and exchanges that have flouted the securities laws. The SEC deserves high marks for its effort to crack down on abuses in this wave of investment offerings, as Better Markets recently detailed.[194] As Chair Gensler has explained in his public remarks, "the vast majority" of cryptocurrency tokens likely fall under the jurisdiction of the securities laws as "investment contracts";[195] these tokens, then, are a type of security that generally must be registered with the Commission prior to their marketing or sale.[196] The Chair in fact publicly offered the Commission's assistance in registering digital tokens.[197] And as securities, they are subject to the full range of requirements and prohibitions under the securities laws, including the provisions outlawing fraud and market manipulation.

Yet the cryptocurrency industry widely considers even basic regulation as anathema, painting it as overly burdensome,[198] and only a handful of firms are believed to have taken the Chair up on his offer. That has left large numbers of digital token operations—perhaps thousands—in open defiance of federal law.[199] As a result, the Enforcement Division has ramped up the fight to force industry into compliance.

And the Enforcement staff has had some notable successes during the past year. Perhaps its biggest win came against a digital asset company called LBRY, against which the agency secured a judgment in federal court for selling unregistered securities.[200] LBRY created a blockchain-based system to compile and share videos and other digital content.[201] After some venture capital investment, LBRY began funding its new system by offering a digital token called LBC tied to its blockchain.[202] Crucially, LBRY did so by touting the prospects of LBC price appreciation as its video content ecosystem grew, much like one would when promoting the IPO of a traditional media company.[203] In fact, LBRY often described its token in terms taken directly from the equities world, including LBC's "market

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[194] *The SEC's Excellent Record on Crypto: Regulation and Enforcement*, Better Mkts. (Jan. 25, 2023), https://bettermarkets.org/newsroom/report-the-sec-has-an-excellent-record-reining-in-the-lawless-crypto-industry-contrary-to-industry-and-partisan-attacks/.

[195] Remarks Before The Practising Law Institute's SEC Speaks in 2022, *supra* note 13 (citing *SEC v. W. J. Howey Co.*, 328 U.S. at 299).

[196] *See* 15 U.S.C. § 77e(a). Some types of securities are exempted from the registration requirement. *See id*. § 77e(a)–(b).

[197] Remarks Before The Practising Law Institute's SEC Speaks in 2022, *supra* note 13 ("If you fall into any of these buckets, come in, talk to us, and register.").

[198] *See, e.g.*, David Yaffe-Bellamy, *Inside a Crypto Nemesis' Campaign to Rein In the Industry* , N.Y. Times (Nov. 21, 2022) ("The crypto industry has fought the government's efforts to classify digital assets as securities, arguing that the legal requirements are overly burdensome."), https://www.nytimes.com/2022/11/21/technology/gary-gensler-crypto-sec.html.

[199] *SEC's Gensler: The 'runway is getting shorter' for non-compliant crypto firms*, Yahoo! News (Dec. 7, 2022) ("GARY GENSLER: ....And what we've said to what is largely a non-compliant field—there's about 10,000 of these crypto tokens."), https://news.yahoo.com/sec-gensler-runway-getting-shorter-161605453.html.

[200] *See SEC v. LBRY, Inc.*, No. 21-cv-260-PB, — F. Supp. 3d —, 2022 WL 16744741, at *1 (D.N.H. Nov. 7, 2022) (granting summary judgment to the SEC and denying summary judgment to the defendant).

[201] *Id*.

[202] *Id*. at *1–2.

[203] *See id*. at *4–6.

capitalization," a "private placement" of LBC, factors for "investment decisions" in LBC, and LBC's "long-term value proposition."[204] The district court thus found LBC's status as a security so clear that it saw no need for a trial and handed the Commission a quick victory.[205]

Of course, one court victory will not induce industry-wide compliance, particularly for an industry that has knowingly chosen to break the law.[206] The industry's conduct in another Commission suit against a cryptocurrency outfit called Ripple Labs proves the point. As far back as 2013, Ripple offered a digital token, XRP, to fund and promote the use of its blockchain technology, allegedly marketing XRP as a liquid investment opportunity. Ripple raised billions of dollars this way despite warnings from a large law firm that XRP might be an unregistered security.[207] The SEC sued; discovery in the case concluded this year; and both sides recently moved for summary judgment.[208] Several industry entities have filed their own briefs against the SEC,[209] presumably because they see this case as a bellwether. We therefore continue to watch this case closely, and it will likely be appealed whoever wins in the district court.

Not all problems in this space arise from the sale of digital tokens, and the Commission has had a busy year prosecuting actions against other cryptocurrency-related violations. On Valentine's Day, for instance, the Commission gave the investing public the gift of the BlockFi settlement mentioned above.[210] BlockFi offered accounts in which investors lent it cryptocurrency assets in exchange for variable interest payments; it funded these interest payments by lending the cryptocurrency to third parties and other activities.[211] The company attracted nearly 400,000 U.S. investors to these accounts, which, of course, were not registered with the SEC as securities.[212] When the Commission came calling, BlockFi agreed not only to pay a $50 million penalty for its violations but also to cease offering its non-compliant products.[213] Going forward, the company committed to registering with the Commission and redesigning its products.[214] In early 2023, the Commission followed up with a civil suit against two entities offering a "Gemini Earn" account similar to the BlockFi program.[215]

We survey many more of the past year's notable cryptocurrency-related enforcement and regulatory actions in the attached Appendix to this report.

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[204] *Id*. at *4–5 (internal quotation marks omitted).

[205] *See id*. at *1.

[206] *See Fact Sheet Setting the Record Straight on Crypto, FTX, Sam Bankman-Fried, Jamie Dimon, the SEC and CFTC, and the Revolving Door*, Better Mkts. (Nov. 13, 2022), https://bettermarkets.org/newsroom/fact-sheet-setting-the-record-straight-on-crypto-ftx-sam-bank man-fried-jamie-dimon-the-sec-and-cftc-and-the-revolving-door/.

[207] *See, e.g.*, First Amended Complaint ¶¶ 51–53, 170 tbl. 3, 241, 315, *SEC v. Ripple Labs, Inc.*, No. 1:20-cv-10832 (S.D.N.Y. Feb. 18, 2021), ECF No. 46.

[208] *See, e.g.*, Pl.'s Motion for Summary Judgment, *SEC v. Ripple Labs, Inc.*, No. 1:20-cv-10832 (S.D.N.Y. Sept. 17, 2022), ECF No. 639.

[209] *See, e.g.*, Brief for Coinbase, Inc. as *Amicus Curiae* Supporting Defendants, *SEC v. Ripple Labs, Inc.*, No. 1:20-cv-10832 (S.D.N.Y. Nov. 14, 2022), ECF No. 705.

[210] *See* BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product, *supra* note 175.

[211] *BlockFi Lending LLC*, Securities Act Release No. 11029, Investment Company Release No. 34503, 2022 WL 462445, at *1 (Feb. 14, 2022).

[212] *Id*.

[213] *See id*. at *10.

[214] *See id*.

[215] *See* Sec. & Exch. Comm'n, SEC Charges Genesis and Gemini for the Unregistered Offer and Sale of Crypto Asset Securities through the Gemini Earn Lending Program (Jan. 12, 2023), https://www.sec.gov/news/press-release/2023-7?utm_medium=email&utm_source=govdelivery.

APPENDIX

Notable Enforcement Actions Brought, Prosecuted, or Concluded by the SEC During 2022 Against Cryptocurrency Offerings as Unregistered Securities

SEC v. Ripple Labs Inc., No. 1:20-cv-10832 (S.D.N.Y.). This is a civil enforcement action alleging that the defendants sold digital assets (known as "XRP") that were unregistered securities under the *Howey* investment contract test, and seeking an injunction, disgorgement, and civil monetary penalties. The parties have briefed cross-motions for summary judgment.

SEC v. LBRY, Inc., No. 1:21-cv-00260 (D.N.H.). Similar to *Ripple*, the SEC sued LBRY on the theory that the latter's digital tokens were unregistered securities, specifically "investment contracts." LBRY denied the allegations and asserted a due process defense. On November 7th, the district court granted summary judgment to the SEC and denied summary judgment to LBRY. LBRY has since moved to limit the SEC's remedies and has asserted that it will dissolve as an entity.

SEC v. Chicago Crypto Capital LLC, No. 1:22-cv-4975 (N.D. Ill.). In September, the SEC sued Chicago Crypto Capital, its founder, and two of its salespeople for the unregistered offering and sale of cryptocurrency asset securities on behalf of an online exchange, as well as for fraudulent statements in the sale of those securities. These defendants, according to the SEC, managed to raise $1.5 million through such activities; they did so partly through cold calls, social media, and targeting of unsophisticated investors. As of mid-December, the court has entered default judgments against the company and two individual defendants; a third individual defendant settled the claims for roughly $240,000 in combined disgorgement and civil penalties.

SEC v. Block Bits Capital, LLC, Nos. 3:22-cv-2563, -2565 (N.D. Cal.). Block Bits, a related corporate entity, and its two founders raised nearly $1 million by offering unregistered investments in a proprietary, automated operation to trade cryptocurrencies across multiple platforms with some assets held in risk-free "cold storage" mechanisms. The SEC sued the corporate entities and the founders, alleging that the investments were not registered as securities and that the offering was false. In reality, the SEC alleged, the firm had no automated trading or cold storage mechanisms at all. The Department of Justice brought a separate criminal action for wire fraud against the founders, and the civil case against the corporate entities and one founder has been stayed during the pendency of the criminal case. The second founder settled with the SEC for disgorgement of $75,000 plus prejudgment interest.

SEC v. MCC International Corp., No. 2:22-cv-14129 (S.D. Fla.). In the Spring of 2022, the SEC filed a civil suit alleging that MCC and its founders raised over $8 million of investments in a cryptocurrency mining and trading operation with guaranteed daily returns and an initial coin offering. The SEC alleged that the entire operation was fabricated and nothing more than an ongoing fraud, and it secured a temporary restraining order, preliminary injunction, and asset freeze against MCC once the founders fled to Brazil upon learning of the SEC's investigation. In September, the SEC moved to hold the founders in contempt for violating the asset freeze. One founder defendant has appealed the preliminary injunction.

SEC v. Dragonchain, Inc., No. 2:22-cv-1145 (W.D. Wash.). This civil suit alleges that Dragonchain offered and sold cryptocurrency assets that were unregistered securities under *Howey*. In total, Dragonchain raised over $16 million over five years. The defendants had yet to respond to the SEC's complaint as of mid-December.

SEC v. Genesis Global Capital, LLC, No. 1:23-cv-00287 (S.D.N.Y.). The SEC filed this civil suit not in 2022 but in early 2023. Gemini, a trust company founded by the Winklevoss twins, provides retail investors with an app-based ability to trade and store cryptocurrencies. In 2021, Gemini partnered with Genesis to offer the "Gemini Earn" program, in which Gemini's retail investors would lend their crypto assets to Genesis in return for interest payments; Genesis pooled these assets and re-lent them to institutional investors at a profit over the interest payments. Gemini, meanwhile, earned an agent fee for each customer that entered the program. The SEC alleges that the Gemini Earn program constituted an unregistered offer and sale of securities. The case has yet to proceed beyond the initial complaint.

BlockFi Lending LLC, Securities Act Release No. 11029, Investment Company Act Release No. 34503 (Feb. 14, 2022). BlockFi offered accounts in which investors lent it cryptocurrency assets in exchange for variable interest payments; BlockFi funded these interest payments by lending the cryptocurrency to third parties and other activities. The company attracted nearly 400,000 U.S. investors to these accounts. The SEC alleged that the BlockFi accounts were unregistered securities under the *Howey* test for investment contracts, operated as an unregistered investment company, and made false or misleading statements regarding its collateral practices. In a settlement with the agency, BlockFi agreed to stop offering its accounts unless or until they were registered as securities, bring itself into compliance with the Investment Company Act, and pay a $50 million civil penalty. BlockFi will also pay another $50 million in penalties through a separate settlement with a group of state governments.

Sparkster Ltd., Securities Act Release No. 11102 (Sept. 19, 2022). Software development company Sparkster and its CEO raised $30 million in a four-month offering of its digital tokens. Like many other digital token creators, Sparkster promoted its tokens as likely to increase in value and as tied to the long-term growth of the Sparkster software ecosystem. The company and CEO settled claims by the SEC that its tokens constituted unregistered securities, agreeing to destroy any tokens it still possessed, ask for removal of its token from trading platforms, disgorge the $30 million raised (plus $4 million in interest), and pay an additional half-million civil penalty. The SEC also filed a separate complaint in federal court against an influencer surreptitiously compensated to promote the Sparkster tokens; that case has yet to reach resolution.

Kim Kardashian, Securities Act Release No. 11116 (Oct. 3, 2022). The SEC reached a settlement with Kim Kardashian over her promotion of cryptocurrency tokens via Instagram. The agency alleged that the tokens were securities (as investment contracts under *Howey*) and that Kardashian did not disclose $250,000 in compensation for her promotion of these tokens, thereby violating anti-touting rules. Under the settlement, Kardashian agreed to forego any potential cryptocurrency promotion, to disgorge the full amount of her compensation plus interest, and to pay a $1 million civil penalty.

American CryptoFed DAO LLC, Securities Act Release No. 11134 (Nov. 18, 2022). In late 2021, the SEC initiated administrative proceedings against American CryptoFed (ACF) for material misstatements in the registration statements for two digital tokens registered as equity securities. Rather than correct the misstatements, ACF subsequently applied to withdraw its application in mid-2022. The SEC denied that application, issued a subpoena to ACF, and, in late 2022, began stop-order proceedings to suspend the effectiveness of the registration.

Nexo Capital, Inc., Securities Act Release No. 11149 (Jan. 19, 2023). Cayman Islands-based Nexo offered an "Earn Interest Product" in which investors deposited crypto assets in return for interest payments; it then re-deployed these crypto assets in a variety of investments. Nexo began offering this product to U.S.-based investors by 2020 but voluntarily ceased transactions with U.S. customers after the SEC announced its settlement with BlockFi. In January 2023, Nexo consented to an administrative order under which it will pay $22.5 million in penalties to the SEC and $22.5 million to state regulators; Nexo will also terminate all Earn Interest Product accounts for U.S. customers by April 2023.

Other Securities Law Violations Related to Cryptocurrency

SEC v. Wahi, No. 2:22-cv-01009 (W.D. Wash.). The SEC sued a Coinbase employee and two of his close associates for trading on inside information about which crypto assets would be listed by Coinbase. The SEC alleges that the coins at issue are securities. The defendants have yet to respond to the complaint, and motions to dismiss are expected in early 2023.

SEC v. Okhotnikov, No. 1:22-cv-3978 (N.D. Ill.). The SEC charged several defendants in connection with an alleged pyramid scheme implemented through cryptocurrency blockchains (e.g., Ethereum). Some defendants have already settled; the remaining defendant moved to dismiss the complaint in late November.

SEC v. Bankman-Fried, No. 1:22-cv-10501 (S.D.N.Y.). After the collapse and bankruptcy of cryptocurrency exchange FTX, the SEC filed a civil suit against FTX's CEO and founder, Sam Bankman-Fried. The agency alleged that Bankman-Fried defrauded investors in FTX, including U.S. investors, through lies about FTX's risk management practices, its relationship to Bankman-Fried's hedge fund (Alameda Research), and other aspects of FTX's governance and operations. On the same day that the SEC filed its civil suit, the U.S. Department of Justice unsealed an indictment against Bankman-Fried for wire fraud, conspiracy to defraud the United States, conspiracy to commit money laundering, and other charges.

SEC v. Da Silva, No. 1:22-cv-10534 (S.D.N.Y.). The SEC filed a civil suit against four individuals allegedly behind "an international pyramid scheme case involving a fake crypto asset trading and mining company." Three of the defendants are U.S. citizens who acted as promoters; according to the complaint, these three specifically targeted retail investors in Spanish-speaking communities and promised large, guaranteed returns. As of mid-December, the defendants have not responded to the complaint.

SEC v. Eisenberg, No. 1:23-cv-503 (S.D.N.Y.). In January 2023, the SEC sued Avraham Eisenberg for his role in draining over $100 million Mango Markets, a cryptocurrency trading platform affiliated with the MNGO token. According to the SEC, Eisenberg used multiple accounts on the Mango platform to bid up the price of MNGO by more than 2,000% and MNGO future by more than 1,300% in a very short period. He then exploited a weakness in the MNGO protocols to take an automatic loan of $116

million of non-MNGO assets from the platform. The MNGO prices crashed back to earth, and Avraham absconded with his assets. Eisenberg has already been charged with criminal commodities fraud and manipulation. Nonetheless, the SEC's suit maintains that the MNGO tokens were investment contracts under *Howey* and therefore securities; the agency alleges that Eisenberg committed fraud and market manipulation with respect to these securities.

ParagonCoin, Ltd., Exchange Act Release No. 94216 (Feb. 10, 2022). ParagonCoin previously registered its digital tokens, intended to add blockchain technology to the cannabis industry after a settlement with the SEC in 2018. By early 2019, however, ParagonCoin had ceased filing periodic reports, reported an annual loss over $10 million, and had no public trading or quotes for its tokens. This year, the SEC initiated proceedings to revoke the registration of ParagonCoin's securities.

Exchange-Traded Products Based on Cryptocurrency

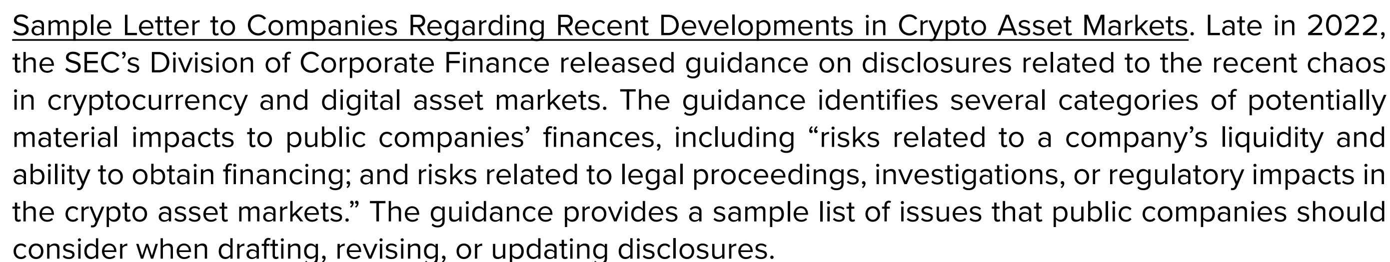
Exchange Proposals to List and Trade Bitcoin-Based Products. Throughout 2022, the SEC received several proposed rule changes from self-regulated exchanges to list shares of trusts or ETFs providing exposure to Bitcoin prices. The proposals included shares of at least the following products: the Grayscale Bitcoin Trust, the NYDIG Bitcoin ETF, the First Trust SkyBridge Bitcoin ETF, the Bitwise Bitcoin ETP, the Global X Bitcoin Trust, the ARK 21Shares Bitcoin ETF, the Wise Origin Bitcoin Trust, the WisdomTree Bitcoin Trust, and the One River Carbon Neutral Bitcoin Trust. The SEC uniformly denied proposals for trusts aimed at the Bitcoin spot price on grounds that each exchange had failed to show that it could prevent fraud and market manipulation, especially through market surveillance-sharing agreements. But the SEC did approve listing of products based on Bitcoin futures. As far as we are aware, the SEC has rejected the listing of every Bitcoin spot-based exchange-traded product since the start of Chair Gensler's term.[216]

Grayscale Investments LLC v. SEC, No. 22-1142 (D.C. Cir.). The SEC denied a NASDAQ subsidiary's attempt to offer an exchange-traded product centered around a Bitcoin trust sponsored by Grayscale; the agency focused on lack of protections against fraud and manipulation for the Bitcoin spot market. Grayscale petitioned the D.C. Circuit to overturn that decision, arguing in part that the SEC has arbitrarily distinguished between approved products for Bitcoin futures and the denied proposals for Bitcoin spot market products. The case is currently in the middle of merits briefing.

Guidance on Cryptocurrency and Compliance

Staff Accounting Bulletin No. 121. In April 2022, the SEC issued new guidance directed at cryptocurrency trading platforms holding assets for their users. This guidance specifically identified and examined the "unique risks and uncertainties" of safeguarding cryptocurrency assets, "including technological, legal, and regulatory risks and uncertainties." It further provides several hypothetical scenarios and compliance considerations for each.

[216] Wall. St. J. Editorial Bd., *Gary Gensler's Bitcoin Regulation Grab*, WALL ST. J. (July 6, 2022), https://www.wsj.com/articles/gary-genslers-bitcoin-land-grab-sec-hester-peirce-bitwise-grayscale-exchange-traded-products-11657144533.



Sample Letter to Companies Regarding Recent Developments in Crypto Asset Markets. Late in 2022, the SEC's Division of Corporate Finance released guidance on disclosures related to the recent chaos in cryptocurrency and digital asset markets. The guidance identifies several categories of potentially material impacts to public companies' finances, including "risks related to a company's liquidity and ability to obtain financing; and risks related to legal proceedings, investigations, or regulatory impacts in the crypto asset markets." The guidance provides a sample list of issues that public companies should consider when drafting, revising, or updating disclosures.

Investor Bulletin: Crypto Asset Interest-Bearing Accounts. In February 2022, the SEC issued guidance meant to educate investors on the risks of interest-bearing accounts for cryptocurrency deposits (like that offered by BlockFi). The guidance explains the lack of regulatory protections these accounts provide compared to more traditional deposits at banks or credit unions. The guidance also warns investors about the inherent risks associated with cryptocurrency investment activities that fund the interest payments for such accounts.

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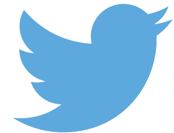

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