THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 56 No. 7 April 12, 2023

PRE-PUBLICATION ISSUE

SEC ENFORCEMENT SWEEPS: IMPLICATIONS FOR AGENCY AND INDUSTRY

The SEC is increasingly conducting sweep investigations to address market conduct. In the past 18 months, the SEC has instituted enforcement actions arising from five different enforcement sweeps involving at least 65 respondents and more than $1 billion in related penalties. These actions are typically focused on violations of strict liability or negligence-based provisions by market participants directly regulated by the SEC. The SEC's use of enforcement sweeps presents benefits and risks for both the agency and respondents.

By Adam Aderton and Melissa Taustine *

The Securities and Exchange Commission is increasingly relying on enforcement sweeps to institute multiple similar enforcement actions quickly and simultaneously. Since 2021, the SEC has instituted at least 65 enforcement actions as a result of at least five high-profile sweeps and has imposed well over $1 billion in related penalties. The sweeps involved a variety of alleged violations ranging from recordkeeping failures and pay-to-play violations to insufficient identity theft prevention practices.

Top SEC leadership has described its purpose behind, and its perceived benefit of, the SEC's use of sweep investigations. On November 2, 2022, SEC Chair Gary Gensler lauded a recent sweep investigation, noting that he hoped it would "send[] a message to other registrants" and that the SEC will continue to "use sweeps, initiatives, and undertakings to shape market behavior."[1] Similarly, in remarks on November 15, 2022, Enforcement Director Gurbir Grewal opined on the impact the SEC's recent recordkeeping sweep had on the industry:

> When 17 major Wall Street firms are fined in excess of [ ] 1.2 billion dollars, required to admit their failures, engage consultants and implement safeguards to prevent future violations, not only do those firms improve their culture and practices, but other financial services firms take note and do so as well, the media takes notice, and important to trust-building, the investing public sees accountability.[2]

[1] "*The Law and Its Effective Administration," Remarks Before the Practising Law Institute's 54th Annual Institute on Securities Regulation*, Chair Gary Gensler (Nov. 2, 2022), https://www.sec.gov/news/speech/gensler-remarks-practising-law-institute-110222.

[2] *Remarks at Securities Enforcement Forum*, Director Gurbir S. Grewal (Nov. 15, 2022), https://www.sec.gov/news/speech/grewal-speech-securities-enforcement-forum-111522.

* *ADAM ADERTON is a partner and MELISSA TAUSTINE is an associate at Willkie Farr & Gallagher LLP. Their e-mail addresses are aaderton@willkie.com and mtaustine@willkie.com.*

INSIDE THIS ISSUE

•

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2023 by RSCR Publications LLC. ISSN: 0884-2426. All rights reserved. Reproduction in whole or in part prohibited except by permission. For permission, contact Copyright Clearance Center at www.copyright.com. *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

Those who practice before the SEC have seen a continued rise in its use of sweep investigations, and there is every indication that this practice will continue. In this Article, we will first discuss the differing purposes between sweeps initiated by the Division of Examinations as compared with the Division of Enforcement. Next, we will examine the SEC's recent use of enforcement sweeps, as well as the SEC leadership's explanation of its purposes in conducting them. Then, we will analyze some typical characteristics of recent enforcement sweeps. Finally, we will consider the benefits and risks that the SEC's increased reliance on sweeps presents for both the SEC and potential respondents.

COMPARING EXAMINATION AND ENFORCEMENT SWEEPS

Both the Division of Examinations and the Division of Enforcement conduct sweeps, but the sister divisions typically utilize sweeps for different purposes. On the one hand, the Division of Examinations has long relied on sweeps as a tool to gather information in order to inform SEC policy, guidance, or rulemaking. The results of these sweeps often appear in risk alerts or other guidance published by the Division of Examinations. On the other hand, the Division of Enforcement typically initiates sweeps when it believes it has developed a tailored approach that will allow it quickly to identify similar violations of the federal securities laws by multiple market participants. Simply put, examination sweeps are most used when the SEC is seeking additional information regarding industry practices, while enforcement sweeps are used when the SEC staff believes it will be able to identify violations through streamlined investigations.

RECENT SEC ENFORCEMENT SWEEPS

A review of recent SEC sweep activity shows the Division of Enforcement's growing use of this investigative approach.

Recordkeeping

On December 17, 2021, the SEC announced a settlement with a large broker-dealer related to its preservation of written communications. The SEC order found that the preservation practices violated the broker-dealer recordkeeping provisions under Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-4(b)(4) and 17a-4(j) thereunder, and that the respondent failed to reasonably supervise certain employees in violation of Section 15(b)(4)(E) of the Exchange Act.[3] In announcing the settlement, Chair Gensler noted that the recordkeeping and books-and-records obligations are "an essential part of market integrity" as they "help the SEC conduct its important examinations and enforcement work" and "build trust in our system."[4] Director Grewal encouraged registrants, in light of this settlement, to "not only scrutinize their document preservation process and self-report failures," but also to "consider the types of policies and procedures [the respondent] implemented to redress its failures in this case."[5]

The SEC subsequently completed an enforcement sweep into similar conduct at other broker-dealers,[6] and, on September 27, 2022, the SEC announced settlements with 15 additional broker-dealers.[7] The SEC's orders instituting the actions were virtually identical. Each respondent admitted to engaging in the wrongdoing. The orders included substantially uniform descriptions of the conduct, charges, and remedial undertakings. All of the orders included penalties, and none required

3 Rel. No. 34-93807 (2021).

4 Press Rel. No. 2021-262 (2021).

5 *Id.*

6 "*The Law and Its Effective Administration," Remarks Before the Practising Law Institute's 54th Annual Institute on Securities Regulation*, *supra* note 1; Chris Prentice and Jody Godoy, *U.S. SEC opens inquiry into Wall Street banks' staff communications sources*, Reuters (Oct. 12, 2021), https://www.reuters.com/legal/litigation/exclusive-us-sec-opens-inquiry-into-wall-street-banks-staff-communications-2021-10-12/.

7 Press Rel. No. 2022-174 (2022). An additional charge was brought against one affiliated investment adviser for violations of the Investment Advisers Act of 1940's recordkeeping and supervisions provisions, Section 204, including Rule 204-2(a)(7) thereunder, and Section 203(e)(6), respectively.

disgorgement. The SEC announced the actions in a single press release underscoring their commonality.[8]

Pay-to-Play

Two weeks before announcing the recordkeeping sweep, the SEC announced settlements with four investment advisers involving the Advisers Act pay-to-play rule,[9] which generally prohibits certain investment advisers from providing paid investment advisory services to government entities for two years after the investment adviser or any "covered associate"[10] of the investment adviser makes a contribution to an official of a government entity. Each of the orders alleged that within two years of a covered associate making a campaign contribution to a governmental entity — such as a gubernatorial or mayoral candidate — the investment adviser continued to provide compensated advisory services to government clients, including state university investment accounts or city employees' pension funds. The pay-to-play rule is deemed violated where the candidates had the ability to influence the selection of the government entities' investment advisers, here by sitting on or appointing members to the entities' boards, regardless of whether any actual *quid pro quo* or intent to influence the official existed.[11] As in the recordkeeping sweep, the resolutions in the pay-to-play sweep were substantially identical. Without respondents admitting or denying any wrongdoing, the orders included cease-and-desist orders, censures, and civil penalties, but no disgorgement.

Custody Rule

Less than a week before announcing the pay-to-play sweep, the SEC announced settlements with several investment advisers arising from a "targeted sweep" involving Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, known as the "custody rule."[12] The custody rule provides investment advisers of limited partnerships or other types of pooled investment vehicles who have custody of client assets an alternative method of complying with the requirements of Advisers Act Rules 206(4)-2(a)(2), (3), and (4), which generally require such investment advisers to send delineated notifications regularly to clients concerning their account information. In general, an investment adviser to a private fund is "deemed to have complied with" the custody rule provided that the fund it advises is subject to at least an annual audit and the investment adviser distributes audited financial statements to the limited partners within 120 days of the end of the fund's fiscal year.[13] An investment adviser can violate the custody rule by failing to fulfill these requirements, regardless of any actual intent to deceive.

The SEC alleged that eight advisers in the sweep failed to comply with the custody rule by failing to have audits performed or by failing to deliver the audited financials to the limited partners in a timely manner. It also alleged that seven of those advisers failed properly to amend their Form ADVs to reflect accurately the status of the funds' audit reports in violation of Section 204(a) of the Advisers Act and Rule 204-1(a) promulgated thereunder. Once again, without respondents admitting or denying the findings, the settlements included substantially similar descriptions of the conduct and similar relief, including a censure, a cease-and-desist order, and a civil penalty. The settlements did not include disgorgement. In the SEC's press release announcing the settlements, Director Grewal said that the matters "presented a unique circumstance for promptly resolving [the SEC's] investigations with this group of advisers" but that "[c]ounsel should not assume that the Division [of Enforcement] will recommend similar resolutions going forward."[14]

Regulation S-ID

On July 27, 2022, the SEC announced settlements with three firms involving the SEC's Identity Theft Red Flags Rule, or Regulation S-ID, that resulted from a sweep investigation.[15] The orders alleged that the financial institutions' identity theft prevention programs lacked reasonable policies and procedures to identify or incorporate relevant red flags of identity theft.[16]

---

[8] Press Rel. No. 2022-174, *supra* note 7.

[9] Administrative Summary, Adv. Act Rel. Nos. IA-6126, IA-6127, IA-6128, IA-6129 (2022).

[10] Covered associates are defined to include: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates. Adv. Act Rule 206(4)-5(f)(2).

[11] Adv. Act Rule 206(4)-5.

[12] Press Rel. No. 2022-156 (2022).

[13] Adv. Act Rule 206(4)-2(b)(4).

[14] Press Rel. No. 2022-156 (2022), *supra* note 12.

[15] 17 C.F.R. § 248.201.

[16] Press Rel. No. 2022-131 (2022).

Regulation S-ID requires certain financial institutions registered with the SEC to develop and implement an identity theft program designed to "detect, prevent, and mitigate identity theft."[17] The SEC alleged that the firms' prevention programs were not properly updated regularly and did not include reasonable policies and procedures to respond appropriately when identity theft red flags were identified. Each of the firms was also charged with additional various correlated oversight failures, such as failure to adequately involve the board of directors in oversight and development of the program as mandated by Regulation S-ID. To settle the charges, without admitting or denying the findings, the financial institutions agreed to cease-and-desist from future violations of Regulation S-ID, to be censured, and to pay civil penalties. The resolutions did not include disgorgement.

Form CRS

Finally, on July 26, 2021, the SEC announced settled charges against 21 investment advisers and six broker-dealers for failing to timely file a Form Client Relationship Summary ("Form CRS"), which provides retail investors with a brief summary about the services a firm offers, its fees, conflicts of interest, and other information that can help investors make more informed decisions.[18] Seven months later, the SEC brought simultaneous actions against six more investment advisers and six additional broker-dealers for similar failures.[19] In June 2019, the SEC adopted Rule 204-5 promulgated under Section 204 of the Advisers Act and Rule 17a-14 promulgated under Section 17(a)(1) of the Exchange Act (the "Form CRS Rules"), which, respectively, required retail registered investment advisers and broker-dealers to file an initial Form CRS no later than June 30, 2020 and to deliver their current Form CRS to their clients or customers in accordance with certain guidelines.[20] In addition, the Form CRS Rules require that retail registered investment advisers and broker-dealers prominently display their current Form CRS on their website.[21]

The SEC alleged that each of the firms in the sweep had missed the regulatory deadlines set by the Form CRS Rules. According to the SEC, none of the firms had filed or delivered its Form CRS despite being informed of the missed deadline by regulators. Without admitting or denying any wrongdoing, each firm agreed to be censured, to cease-and-desist from violating the Form CRS Rules, and to pay a civil penalty. No disgorgement was included in these resolutions.

COMMON CHARACTERISTICS OF RECENT SWEEPS

Examining these recent actions reveals some common characteristics that lend themselves to resolution as part of an enforcement sweep. First, each of the sweeps targeted firms directly regulated by the SEC, namely investment advisers or broker-dealers. The SEC's clear authority to regulate these businesses under the Advisers Act and Exchange Act, respectively, allows the streamlined sweep investigation to go forward without implicating more complex questions of jurisdiction or regulatory authority over the potential respondents.

Second, all of the violations involved in the recent sweep investigations are either strict liability or simple negligence offenses. In conducting these sweeps, the SEC did not need to conduct an extensive or time-consuming inquiry into each respondent's mental state.

Third, the recent sweep investigations involved potential violations that could be shown through straightforward facts, allowing the SEC to investigate across numerous firms simultaneously and to identify violations with limited investigatory burden. For example, to identify pay-to-play violations, the SEC could review publicly available information regarding investment advisers' employees' campaign contributions and compare that information with the investment advisers' governmental clients in the two years following the contributions.

Finally, the remedies the SEC pursued enabled the sweeps to proceed expeditiously. Most notably, none of the sweeps involved financial harm to investors that would require calculation of disgorgement. Although the SEC orders suggested that many of the violations had the potential to harm investors — by depriving them of important information on a Form CRS or by exposing them to a greater risk of identity theft — none of the orders found that investors were actually harmed by the alleged conduct. Relieved of the obligation to conduct a sometimes complicated, individualized disgorgement analysis, the SEC could focus on seeking uniform remedies like censures, cease-and-desist orders, penalties, and undertakings.

In sum, the SEC's recent sweep investigations have targeted entities directly regulated by the SEC for

[17] 17 C.F.R. § 248.201(d)(1).

[18] Press Rel. No. 2021-139 (2021).

[19] Press Rel. No. 2022-27 (2022).

[20] Adv. Act Rule 204-1(e); Rule 204-5(b)(1) & (b)(2); Exchange Act Rule17a-14(f); Exchange Act Rule 17a-14(c)(1) & (c)(2).

[21] Adv. Act Rule 204-5(b)(3); Exchange Act Rule 17a-14(c)(3).

violations that do not require burdensome inquiry into the potential respondent's state of mind and that the SEC can resolve without finding client harm or conducting the attendant disgorgement analysis.

BENEFITS AND RISKS OF SWEEPS FOR THE SEC

The SEC is relying heavily on sweeps for a simple reason: it sees substantial benefit from doing so. As Chair Gensler emphasized in his November 2022 speech, sweep investigations "send[] a message to other registrants" regarding the SEC's view of the seriousness of the conduct and the practices that the SEC would like to see the industry adopt. This market-signaling impact is a significant factor that likely will cause the SEC to continue to "use sweeps, initiatives, and undertakings to shape market behavior."[22] Using sweeps, the Division of Enforcement sends a message to the market that it will continue to address aggressively certain courses of conduct and thereby deters additional misconduct. In addition, by imposing uniform remedial undertakings, the SEC demonstrates its expectations for compliance: Director Grewal has described that the SEC views enforcement undertakings as "potential roadmaps for compliance by other firms."[23]

Sweeps are also an efficient way to investigate conduct at multiple market participants simultaneously. As mentioned, many sweeps involve straightforward fact patterns that limit the need for extensive individualized factual development. For example, many sweep investigations may require limited document production and no testimony at all. At the same time, it may be easier for the SEC to obtain settlements in sweep investigations because some respondents may prefer to settle as part of a larger group of respondents engaged in the same conduct. Such settlements may diffuse attention that might otherwise be focused on a particular firm involved in the sweep. The result is the preservation of significant SEC resources while simultaneously increasing the number of enforcement actions. In addition, from the SEC's perspective, the ability to bring swift enforcement actions to address practices the SEC finds problematic instills public trust that the marketplace is being monitored by vigilant regulators.

While the benefits of sweeps are substantial for the SEC, the practice also presents some risks. For one, some may argue that the SEC's resources are better spent focusing on investigations that involve actual investor harm, and that sweeps are diverting those resources to less significant misconduct. In addition, sweeps for violations that do not involve investor harm also risk creating an impression that the SEC is focusing resources on "gotcha" compliance failures at least in part to bolster its enforcement statistics. The SEC's stated goal of promoting public trust in the marketplace may be undermined by an appearance that the SEC is overcommitting resources to compliance failures that do not involve wrongdoers who engaged in intentional misconduct or conduct that caused financial harm.

Bringing simultaneous charges against multiple respondents also creates additional risks for the SEC. Although the comfort of being in a larger group may incentivize respondents to more easily settle the charges, SEC press releases and media coverage of the matters tend to summarize the general conduct involved and may not clearly differentiate between each settling respondent's level of culpability. As a result, sweeps may allow more culpable actors to shield themselves from increased scrutiny by hiding within the crowd.

BENEFITS AND RISKS OF SWEEPS FOR RESPONDENTS

There are benefits and risks for respondents in SEC enforcement sweeps as well. Of course, all potential respondents' primary goal is to avoid public enforcement actions. However, a respondent that has decided to settle can sometimes benefit from participating in a sweep investigation rather than in an individualized resolution. For example, respondents may benefit from a truncated investigative process for similar reasons as the SEC. Most likely, the respondents will be required to produce fewer documents and few or no witnesses for interviews or testimony. The lower production burden can lead to significant cost savings as well as less disruption to a respondent's business. In addition, respondents may benefit from the safety in numbers, as the SEC press releases and media coverage often focus more on the conduct at issue rather than the individual respondents. Finally, as particularly demonstrated by the civil penalties assessed in the Form CRS sweep, the SEC generally standardizes the penalties in sweep investigations. This provides an additional benefit to respondents because it does not risk that their individualized negotiations with the SEC will be less favorable than a peer firm facing the same charges.

Nonetheless, there are some potential drawbacks for respondents participating in a sweep. Although being part of a larger group settling may reduce individualized

[22] *The Law and Its Effective Administration," Remarks Before the Practising Law Institute's 54th Annual Institute on Securities Regulation*, *supra* note 1.

[23] Press Rel. No. 2022-206 (2022).

negative publicity and maintain uniform penalties, it may also make it difficult for a less culpable respondent to differentiate its conduct from that of the group and may cause a respondent to pay a higher penalty than it would have if the penalties were not standardized. Similarly, a less culpable respondent may feel pressure to settle along with the group to avoid additional individualized scrutiny, and potential litigation, despite a sincerely held belief that it did not engage in the alleged misconduct or not to the same extent as its fellow respondents. In addition, the uniform resolutions limit each respondent's ability to negotiate the language in the order or to modify imposed undertakings to suit its needs, sometimes leading to over-inclusive or unnecessary undertakings for less culpable actors.

CONCLUSION

In recent years the SEC increasingly has employed enforcement sweeps to investigate and redress various industry practices. These investigations have provided both the SEC and respondents with a streamlined alternative to traditional individualized investigations that provide both benefits and risks to all parties involved. While sweep investigations generally are less costly and burdensome to both the SEC and the respondents, they also deprive the parties of the opportunity to differentiate the conduct of each respondent and to tailor the resolution to the facts of each particular matter. Because SEC leadership sees sweep investigations as an effective approach for changing market practices, the SEC is likely to continue to increase its reliance on sweeps in the coming years. ■