

## How To Keep Up With The SEC's Breakneck Rulemaking Pace

By **David Woodcock, Timothy Zimmerman and Eitan Arom**

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Critics often accuse the U.S. Securities and Exchange Commission of pushing the bounds of its enforcement authority beyond what existing rules seem to authorize.[1]

But the SEC is no longer shying away from this criticism, instead embracing it as necessary to ferret out evolving fraudulent schemes.

"Some market participants may call this 'regulation by enforcement,'" SEC Chair Gary Gensler said in an address shortly after taking office in 2021. "I just call it 'enforcement.'"[2]

This brash approach is just one piece of an aggressive and expansive regulatory mindset that is keeping those regulated by the commission on high alert. Because at the same time that it is pushing the boundaries of enforcement, the SEC is also engaging in a historic amount of actual rulemaking by rulemaking — and at a blistering pace.

All told, the burden on those regulated by the SEC is greater than it has been in decades, and though the rules seem to be changing faster than anyone — even the commission itself — can keep up with, there are steps that boards, executives and their counsel can take to mitigate the new regulatory risks.

This article highlights how the SEC's approach to regulation and enforcement will have long-term effects on issuer, registrant and individual exposure to liability, as well as the enormous regulatory burdens imposed on corporate and firm-compliance programs.

Everyone regulated by the commission needs to be prepared for increased scrutiny and greater costs of compliance.

### Rulemaking by Enforcement

The SEC's continued move toward rulemaking by enforcement arguably allows the agency to regulate in evolving areas — such as crypto and environmental, social and governance — without having to take on



David Woodcock



Timothy  
Zimmerman



Eitan Arom

costly and time-consuming rulemaking efforts.

But that is hardly comforting for those who find themselves the subject of enforcement actions — and significant settlements — often having had no notice that what they were doing was not allowed.

Here are just a few examples of recent SEC enforcement actions that pushed the bounds of what the rules provide for, causing some to dub the current SEC era the "age of dissent":<sup>[3]</sup>

- A video game company paid \$35 million to settle the SEC's claim that "it lacked controls and procedures among its separate business units to collect and analyze employee complaints of workplace misconduct," allegedly violating Exchange Act Rule 13a-15(a).<sup>[4]</sup> In dissent, Commissioner Hester Peirce wrote that workplace harassment "is deeply concerning, but it is not our concern. The Commission's Order contorts the securities laws to reach for a nexus, but never fully makes the connection."<sup>[5]</sup>
- A crypto platform paid \$30 million for failing to register its "staking-as-a-service" program — whereby crypto owners pool their tokens in exchange for proceeds when those tokens are used to validate blockchain transactions — as an offer and sale of securities.<sup>[6]</sup> Dissenting again, Peirce wrote, "[u]sing enforcement actions to tell people what the law is in an emerging industry is not an efficient or fair way of regulating."<sup>[7]</sup>
- An investment advisor paid out a six-figure disgorgement for allegedly violating the duty of best execution by selecting a share class that paid its affiliate 12b-1 fees when a cheaper share class was available.<sup>[8]</sup> Commissioner Mark Uyeda joined Peirce in dissent, writing, "[i]n a substantive area where significant efforts have been undertaken to define fiduciary duty through the notice and comment process, it is unfortunate that the Commission chooses to create novel regulatory interpretations through enforcement."<sup>[9]</sup>
- A registrant paid more than \$2.3 million in penalties and disgorgement for purportedly offering variable interest rate structured products, or VSPRs, to retail investors "for whom the investments were unsuitable in light of each Customer's investor profile."<sup>[10]</sup> As part of the settlement, the firm adopted a policy prohibiting its personnel from buying VSRPs for any of its customers. Commissioner Peirce, in dissent, found it "particularly problematic" that the commission relied on the adoption of this policy as a remedial measure because "investors, working with their chosen financial professional, should be free to fashion their investment portfolios in the way that best suits their investment objectives and life circumstances" and "[t]he Commission's orders should not intimate that certain types of investments are never suitable for particular classes of investors."<sup>[11]</sup>

As the SEC is breaking new ground with these enforcement actions, it has not pulled back with respect to settlement value. In fiscal year 2022, financial remedies ordered in enforcement actions totaled a record \$6.439 billion — a nearly 70% increase over 2021 — with penalties in 2022 more than double those ordered in 2021.<sup>[12]</sup>

And the commission's enforcement ire was also broad in its scope, imposing large fines on some who were not personally involved in wrongdoing.<sup>[13]</sup>

### **Rulemaking by Rulemaking**

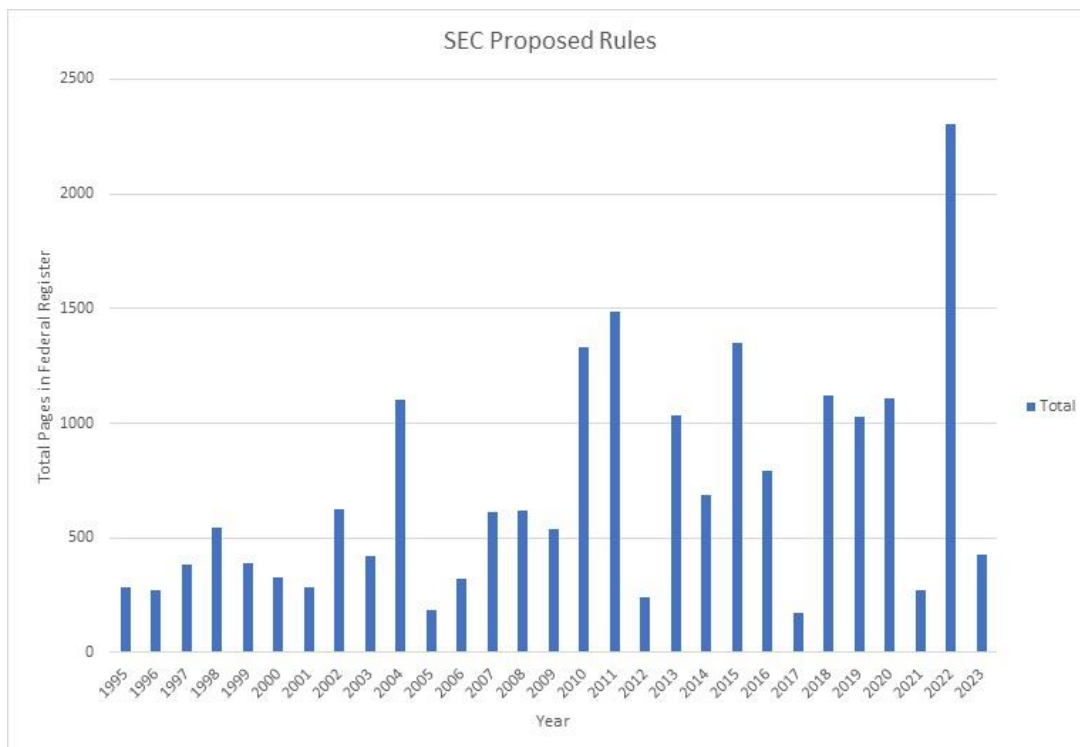
Even as it is making new "rules" through enforcement, the SEC is generating actual rules — and proposed rules — at a pace that is stretching even the SEC's ability to keep up with.

The agency's former acting inspector general, Nicholas Padilla, noted in October that some managers had "raised concerns about increased risks and difficulties managing resources and other mission-related work because of the increase in the SEC's rulemaking activities."<sup>[14]</sup>

In addition to the impact on employee morale, this environment has affected the rulemaking itself because, for example, managers reported having to rely "on detailees, in some cases with little or no experience in rulemaking," according to Padilla. More than that, he added, this rulemaking agenda meant that "fewer resources have been available to complete other mission-related work, as rulemaking teams have borrowed staff from other organizational areas."

As one metric for this rulemaking blizzard, the sheer number of pages that the SEC put into the Federal Register in 2022 was historically unprecedented.

### ***Annual SEC Proposals by Number of Federal Register Pages<sup>[15]</sup>***



It is true that there have been recent periods when the SEC has proposed rules at a similar pace as it did in 2022, for example, in 2003 to 2004 and 2009 to 2011.<sup>[16]</sup> But the spikes in proposals in those earlier periods were the direct result of new laws passed by Congress: the Sarbanes-Oxley Act in 2002 <sup>[17]</sup> and the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010,<sup>[18]</sup> respectively.

There has been no authorizing legislation for the vast majority of the new rules proposed by Chair Gary Gensler's administration.<sup>[19]</sup> This breakneck pace and executive-only action have understandably led some to criticize the agency for overwhelming the markets with costly regulation.<sup>[20]</sup>

It's not just the number of rules or their length that has markets overwhelmed, but also their reach.

Rather than merely insisting on full and accurate disclosures or cracking down on fraud, some have criticized the agency for engaging in merits-based regulation: taking positions that reflect the current policy of the administration.[21]

This is not just a matter of optics, as merit-based regulation has the tendency to lay the groundwork for future enforcement activity.

For instance, in its proposed rules regarding climate disclosures, the SEC explained that "information filed as part of a registrant's Form 10-K carries certain additional potential liability, which itself can cause registrants to prepare and review information filed in the Form 10-K more carefully than information presented outside SEC filings." [22]

In short, rulemaking by enforcement and increased formal — merits-based — rulemaking creates a cycle of increasing regulatory burdens: More and more far-reaching rules give the SEC a broader purview, and the commission continually expands that purview via enforcement. And, at least during the current administration, it seems that there's no relief in sight.

### **What To Do About It**

It's no exaggeration to say that issuers and registrants face the greatest regulatory burden from the SEC in decades. In this regulatory environment, companies and registrants should consider the following actions to mitigate this regulatory risk:

- Consider how to continually enhance financial and disclosure controls, as well as work more closely with corporate gatekeepers, such as internal and external auditors and counsel who are most likely focused on ever-changing regulations and timely enforcement actions.
- Maintain a robust compliance program that is adequately resourced to deal with the new rules and enforcement environment.
- Make your voices heard on new rule proposals — do not skip the comment periods, and consider working with industry partners and trade associations to prepare or simply amplify comments submitted by others.
- Plan for new rules well ahead of their finalization, with the understanding that the final rule is often different from the proposal, and stay abreast of developments throughout the entire process.
- Look for opportunity in the flurry of rulemaking. Extensive rulemaking almost always produces unintended consequences and market disruption.

To be sure, the trends out of the SEC are concerning. Industry can make its voice heard by being part of the rulemaking process, but ultimately, the best way forward is to be prepared for what's coming. In this day and age, that alone is a full-time job.

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*David Woodcock is a partner, Timothy Zimmerman is of counsel and Eitan Arom is an associate at Gibson Dunn & Crutcher LLP.*

*Gibson Dunn associate Brian Richman contributed to this article.*

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[1] See Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement: A Look Ahead at the Next Decade, 7 Yale J. on Reg. 149, 156 (1990) (SEC has engaged in "ad hoc enforcement of the federal securities laws . . . in the absence of meaningful advance guidance (or warning) to those subject to the agency's jurisdiction").

[2] Richard Satran, U.S. SEC Embraces "Regulation by Enforcement" as Securities Industry Morphs Beyond Rulebooks, Reuters (Nov. 12, 2021), <https://www.reuters.com/article/bc-finreg-sec-regulation-by-enforcement/u-s-sec-embraces-regulation-by-enforcement-as-securities-industry-morphs-beyond-rulebooks-idUSKBN2HX1OR>.

[3] Gibson Dunn & Crutcher, 2022 Mid-Year Securities Enforcement Update (August 11, 2022), available at <https://www.gibsondunn.com/2022-mid-year-securities-enforcement-update>.

[4] SEC Press Release, Activision Blizzard to Pay \$35 Million for Failing to Maintain Disclosure Controls Related to Complaints of Workplace Misconduct and Violating Whistleblower Protection Rule (Feb. 3, 2023), available at <https://www.sec.gov/news/press-release/2023-22>; In re: Activision Blizzard, Inc., Exchange Act Release No. 96796 (Feb. 3, 2023).

[5] SEC Statement, The SEC Levels Up: Statement on In re Activision Blizzard (Feb. 3, 2023) (Commissioner Hester M. Peirce), available at <https://www.sec.gov/news/statement/peirce-statement-activision-blizzard-020323>.

[6] SEC Press Release, Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-as-a-Service Program and Pay \$30 Million to Settle SEC Charges (Feb. 9, 2023), available at <https://www.sec.gov/news/press-release/2023-25>.

[7] SEC Statement, Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al. (Feb. 9, 2023) (Commissioner Hester M. Peirce), available at <https://www.sec.gov/news/statement/peirce-statement-kraken-020923>.

[8] SEC Press Release, SEC Orders Affiliated Investment Advisers to Repay Clients for Failing to Disclose Conflicts and Duty of Care Violations (Feb. 27, 2023), available at <https://www.sec.gov/enforce/ia-6251-s>.

[9] SEC Statement, Statement Regarding Huntleigh Advisors, Inc. and Datatex Investment Services, Inc. (Feb. 27, 2023) (Commissioners Hester M. Peirce & Mark T. Uyeda), available at <https://www.sec.gov/news/statement/peirce-uyeda-statement-huntleigh-datatex-022723>.

[10] In re: Aegis Cap. Corp., Exchange Act Release No. 95390 (July 28, 2022).

[11] SEC Statement, Statement Regarding In the Matter of Aegis Capital Corporation (July 28, 2022) (Commissioner Hester M. Peirce), available at <https://www.sec.gov/news/statement/peirce-statement->

aegis-capital-corporation-072822.

[12] SEC Press Release, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), available at <https://www.sec.gov/news/press-release/2022-206>.

[13] Gurbir S. Grewal, Remarks at Securities Enforcement Forum (Nov. 15, 2022), available at <https://www.sec.gov/news/speech/grewal-speech-securities-enforcement-forum-111522> (SEC Enforcement Division director highlighting a seven-figure clawback from executives under the Sarbanes-Oxley Act for misconduct at their firms, "even though the executives were not personally charged with the underlying misconduct").

[14] Sec. & Exch. Comm'n Off. of Inspector Gen., The Inspector General's Statement on the SEC's Management and Performance Challenges 3 (Oct. 13, 2022), <https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf>.

[15] Source: Federal Register, FR API Documentation, [https://www.federalregister.gov/developers/documentation/api/v1#/Federal%20Register%20Documents/get\\_documents\\_\\_format\\_](https://www.federalregister.gov/developers/documentation/api/v1#/Federal%20Register%20Documents/get_documents__format_) (last visited Mar. 3, 2023). Special thanks to Brian Richman of Gibson Dunn for highlighting this data.

[16] SEC Proposed Rule Archive, <https://www.sec.gov/rules/proposed/proposedarchive/proposed2022.shtml> (last visited March 3, 2023).

[17] Sarbanes–Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745.

[18] Dodd–Frank Wall Street Reform & Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[19] A few of the proposals in 2022 relate to open Dodd–Frank rulemaking, but the vast majority are untethered to any contemporaneous legislative authorization.

[20] E.g. Letter from Republican Senators to Gary Gensler, SEC Chair 3 (Oct. 27, 2022), available at <https://www.tillis.senate.gov/services/files/0581BB17-525C-45AB-A875-6E499F2025DF>.

[21] E.g., Joseph Grundfest, The Most Curious Rule Proposal in Securities and Exchange Commission History, Harv. L. Sch. F. on Corp. Governance (May 17, 2022), <https://corpgov.law.harvard.edu/2022/05/17/the-most-curious-rule-proposal-in-securities-and-exchange-commission-history/> ("The[ Prohibited Activity Rule] transform[s] the Commission into a merit regulator. This transition is fraught with institutional and political peril. As a merit regulator, particularly in the context now proposed, the Commission will be hard pressed to decline the entreaties of special interest constituencies petitioning for merit-based regulations calculated to advance their parochial interests. The agency's identity and mission will be forever changed if it adopts these rules.").

[22] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21339 (proposed Ar. 11, 2022).