Speech

2021 SEC Regulation Outside the United States - Scott Friestad Memorial Keynote Address

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Good morning, everyone and thank you for inviting me to deliver the Scott Friestad Memorial Keynote address. I didn't have the privilege of knowing Scott, but in my few months as Director, I've frequently heard his name, and I've noticed that it is always uttered with respect and affection. Staff considered him a leader, a model Enforcement attorney, a mentor, and a friend. I'm honored to deliver this address that bears his name.

It's also a privilege to address so many of our foreign counterparts. As our economies and securities markets become increasingly interconnected, it's important that we continue to support each other in our shared mission of protecting investors and maintaining market integrity. I thank you all for your partnership and I look forward to continuing to find new ways to collaborate.

Before I continue, I must provide the standard disclaimer that my remarks today express my views, and do not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.[1]

Given that we are all here virtually in London today, I thought it appropriate to begin my remarks by quoting from Lewis Carroll's well-known and much-loved poem, *The Hunting of the Snark*:

"Just the place for a Snark!" the Bellman cried,

As he landed his crew with care;

Supporting each man on the top of the tide

By a finger entwined in his hair.

"Just the place for a Snark! I have said it twice:

That alone should encourage the crew.

Just the place for a Snark! I have said it thrice:

What I tell you three times is true."

While literary scholars classify this poem as "nonsense poetry," they've nevertheless debated its meaning for over two centuries. To many, this particular stanza underscores an important concept: the idea that repetition can be used as grounds for truth. Repetition, after all, is a persuasive technique used regularly by effective orators and

children alike to make convincing and, on occasion in my home, winning arguments. That's because repeated information is often perceived as more truthful than new information. But as we all know, just because a statement is made repeatedly doesn't necessarily make it true. In my case, no matter how many times my children promised they'd take care of the dog if we got one, it's never happened.

So what does the *Snark* have to do with the enforcement of U.S. securities laws? In my three months in this role, I have heard more than three times the refrain that we are "regulating by enforcement." In particular, I've heard it when we, as regulators, are contending with emerging challenges, technologies or investment products. Lewis Carroll notwithstanding, I don't find this to be the case.

Since its founding more than 85 years ago, the SEC has stayed true to its three-part mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. Central to that mission is the work of the SEC's Division of Enforcement. Our staff work tirelessly day in and day out to investigate possible violations of the federal securities laws and to prosecute the Commission's civil suits in the federal courts and in administrative proceedings. And the tools we use consist of statutes enacted by the United States Congress and the rules adopted by the SEC pursuant to those statutes, subject, of course, to judicial interpretations of these statutes and rules by the courts of original and appellate jurisdiction before which SEC staff appear throughout the United States.

And so it was this past fiscal year; a year in which, even with all of the challenges presented by the global pandemic, we brought more standalone enforcement actions than in the prior fiscal year.[2] That is not "regulating by enforcement"; it's using all of our tools to pursue wrongdoers, protect investors, and fulfill our mission.

But these days, most often in the context of crypto matters and our investigations of certain ESG – or environmental, social, and governance – related products and services, we hear that we should avoid "regulation by enforcement." I'd like to touch upon both areas today. With respect to crypto, let me first be clear that we encourage and welcome the use of new technologies for capital formation. They have the potential to make our markets more efficient and dynamic, and to increase access for investors. But – equally importantly – all securities offered or sold to U.S. investors – regardless of their form or name – must comply with the U.S. securities laws. The purpose here is to protect investors and the integrity of our markets by ensuring that investors are provided proper disclosures and the products are subject to regulatory scrutiny.

More than four years have passed since we formed the Cyber Unit within the Enforcement Division.[3] In that time, an important area of focus for the Division, and the Cyber Unit in particular, has been digital assets and initial coin offerings – or "ICOs." We have brought dozens of cases concerning fraudulent and unregistered ICOs, and related touting violations – and we will continue that focus.[4]

We have also focused on market intermediaries who facilitate trading in unregistered securities, including unregistered securities exchanges and broker-dealers. For example, we recently brought settled charges against a web-based trading platform that facilitated buying and selling of digital asset securities, for operating as an unregistered online digital asset exchange.[5] And we have been on the lookout for platforms that illegally tout digital asset securities because promoting securities in exchange for undisclosed compensation is illegal, regardless of whether the security is a stock, a bond, or a digital asset.[6]

Importantly, in many of these cases, we have been able to secure meaningful relief for defrauded investors. For example, in addition to monetary relief, we have obtained undertakings that require issuers of digital asset securities to destroy tokens in their possession, request removal of tokens from trading platforms, publish the SEC's order on social media channels, and refrain from participating in future digital asset offerings.[7]

The threshold issue in each of these cases is whether the digital asset or token is a security, and therefore subject to the registration and disclosure requirements of the federal securities laws. Congress defined "security" all the way back in the 1930s to include, among other things, "investment contracts" and "notes." A decade later, in 1946, the U.S. Supreme Court held in *SEC v. Howey*, that an investment contract exists when there is an "investment of money in a common enterprise with profits to come solely from the efforts of others."[8] And more than 30 years

ago, in 1990, the Supreme Court held in *Reves v. Ernst & Young* that a note is presumed to be a security unless it bears a strong "family resemblance" to certain judicially crafted exceptions to notes that are not securities.[9]

In the intervening decades, courts have time and again affirmed the *Howey* and *Reves* tests in connection with a wide range of investment vehicles – including, at issue in *Howey*, citrus groves. The *Howey* court showed great foresight in describing the *Howey* test as "flexible" and "capable of adaptation to meet the countless and variable schemes devised by those who seek to use the money of other on the promise of profits."[10]

And courts have done just that in the crypto space. For example, recently, a federal district court in New York held in *SEC v. Kik Interactive Inc*. that the "Kin" token was an investment contract under *Howey*, and therefore a "security." The court went on to find that Kik, the issuer, had violated the federal securities laws when it conducted an unregistered offering that did not qualify for any exemption from registration requirements.[11]

The *Kik* decision made a couple points that are worth highlighting here in that they show that the court looked to the token's substance over its form in reaching the conclusion that it is a security. First, in response to Kik's argument that the term "investment contract" was unconstitutionally vague as applied to Kik, the court stated that "*Howey* provides a clearly expressed test for determining what constitutes an investment contract, and an extensive body of case law provides guidance on how to apply that test to a variety of factual scenarios."[12]

In other words, the regulations we apply when investigating possible misconduct in the crypto space are long-standing and well-established. The court also dismissed Kik's argument that the SEC had failed to issue guidance on securities enforcement related specifically to cryptocurrencies, stating that "the law does not require the Government to reach out and warn all potential violators on an individual or industry level."[13]

Nevertheless, the Commission has not only issued guidance concerning the potential applicability of the U.S. securities laws to distributed ledger technology and digital assets,[14] but also investor alerts about the risks associated with investing in digital asset securities.[15]

So, to borrow from Lewis Carroll a bit with license—regardless of whether you call your new product a "Snark," "Boojum," or "Jubjub" coin doesn't take it outside of our securities regime. As Chair Gensler aptly stated at the Aspen Security Forum this summer: "Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These products are subject to the securities laws and must work within our securities regime."[16] And investor protection requires us to use our well-established tools to examine the substance, or the economic realities, of the transaction or offering.

In other words, just because you give something a label – perhaps in an attempt to avoid securities regulation – doesn't make it so. This is evident from a recent case we filed against a so-called "decentralized finance," or "DeFi," lender. In that case, we charged two Florida men and their Cayman Islands company for unregistered sales of more than $30 million of securities and for misleading investors concerning the operations and profitability of their business, which, as it turns out, was neither decentralized nor finance.[17] It was plain fraud.

We also recently brought a case against a so-called online crypto "lending program."[18] The SEC alleged that the defendants in that case raised $2 billion based on false representations to investors that the lending program would deploy its "volatility software trading bot" to generate exorbitantly high returns for investors. But, according to the complaint, rather than deploy investor funds for trading with the purported trading bot, the defendants siphoned investors' funds off for their own benefit.

Again—for the third time—just because you call a project "decentralized" or a "lending program" or "stable" will not dictate how and whether we look at it. Investor protection requires more. Because as SEC Commissioner Caroline Crenshaw recently observed, had we not brought our existing tools to bear during "the Initial Coin Offering or ICO boom of 2017 and 2018, [] the results would have been even worse for investors and the markets. ICOs and other digital asset offerings raised billions from investors, but most never delivered on their promises. Investors suffered the losses."

We're also starting to hear the popular refrain "regulation by enforcement" in the context of ESG. ESG issues, including business risks posed by climate issues, have become increasingly important to issuers' financial health and investors' investment decisions.[19] In response, issuers have begun to disclose more information on ESG and climate-related issues. Investment advisers – both U.S. and foreign – have likewise begun to offer more investment products and financial services that claim to incorporate ESG. At the same time, as our European counterparts well know, greenwashing has emerged as an investor protection concern.[20]

To sharpen our focus in this area, earlier this year we announced the formation of the Climate and ESG Task Force within the Division of Enforcement.[21] The Task Force works closely with the other SEC Divisions and Offices to proactively detect climate and ESG-related misconduct. But there is nothing "new" about how the Task Force – or the Enforcement Division as a whole – investigates possible climate and ESG-related misconduct.

As with any investigation, we look to make sure our current rules and laws are being followed. For issuers, this means that we apply long-standing principles of materiality and disclosure. If an issuer chooses to speak on climate or ESG – whether in an SEC filing or elsewhere – it must ensure that its statements are not materially false or misleading, or misleading because they omit material information – just as it would when disclosing information in its income statement, balance sheet, or cash flow statement.

And in the asset management space, it means we apply long-standing principles regarding fiduciary duties and honest disclosure regarding how products will be managed. If an asset manager is marketing an ESG fund or strategy, it must do so in a way that's not materially false or misleading while adhering to client mandates and restrictions – just as it would when marketing any fund or strategy. Asset managers must also adhere to the requirement to adopt and implement written compliance policies and procedures that are reasonably designed to prevent violations of our laws.

This is not a new mandate for us. In 2008, the Commission filed a settled case against Pax World Management, an SEC-registered investment adviser to several socially responsible mutual funds.[22] The SEC found that Pax World told investors and the boards of the mutual funds it advised that it complied with various "socially responsible investing" restrictions. Those restrictions precluded Pax World from purchasing for the funds securities issued by companies involved with producing weapons, alcohol, tobacco or gambling products. This likely was the primary reason many investors chose to invest in these funds.

But, contrary to what Pax World had promised, it purchased at least 10 securities that were prohibited under the funds' socially responsible investing restrictions. The SEC found that by failing to comply with the funds' restrictions, Pax World breached its fiduciary duty to its clients and violated certain anti-fraud and false filing provisions of the federal securities laws.

More recently, in late 2020, the SEC brought a settled case against Fiat Chrysler for violating the reporting provisions of the federal securities laws by making materially misleading statements about their vehicles' emissions.[23] The SEC's order found that, in the wake of the Volkswagen diesel emissions scandal, Fiat Chrysler issued a press release and an annual report, both of which stated that an internal audit confirmed the company's vehicles complied with environmental regulations concerning emissions. These statements were misleading because they failed to disclose the limited scope of the internal audit and that it was not a comprehensive review of compliance with emissions regulations. In fact, by the time Fiat Chrysler made these misleading statements, U.S. environmental regulators had raised concerns to Fiat Chrysler about the emissions systems in certain of its diesel vehicles.

While I could cite a third matter to keep with the Bellman's rule of three, I'll leave it at these two cases, which demonstrate that the requirements that companies' disclosures be accurate and not misleading, and that investment advisers adhere to their fiduciary duty and accurately describe their investment strategies, are not new, and should be of surprise to no one.

Although the focus of the Enforcement Division may change and evolve over time depending on issues facing and of importance to investors, companies, and the economy as a whole, or in response to new and emerging

technologies and investment products, we will continue to apply long-standing, well-known and understood regulations and standards that govern the securities industry when investigating possible misconduct.

This is not "regulation by enforcement."

This is not "regulation by enforcement."

This is not "regulation by enforcement."

There. I have said it thrice and what I tell you three times is true.

Thank you for inviting me to speak today and please enjoy the rest of your conference.

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[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[2] Remarks at SEC Speaks 2021 (Oct. 13, 2021), *available at* https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[3] Press Release 2017-176, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-176.

[4] https://www.sec.gov/spotlight/cybersecurity-enforcement-actions

[5] Press Release 2021-147, SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange (Aug. 9, 2021), *available at* https://www.sec.gov/news/press-release/2021-147.

[6] Press Release 2021-125, ICO "Listing" Website Charged With Unlawfully Touting Digital Asset Securities (July 14, 2021), *available at* https://www.sec.gov/news/press-release/2021-125.

[7] *See, e.g.,* Litigation Release No. 25157, SEC Charges Issuer for Conducting Fraudulent and Unregistered Digital Asset Security Offering (Aug. 4, 2021), *available at* https://www.sec.gov/litigation/litreleases/2021/lr25157.htm; Press Release 2021-108, SEC Charges ICO Issuer and CEO With Fraud and Unregistered Securities Offering (June 22, 2021), *available at* https://www.sec.gov/news/press-release/2021-108; Press Release 2020-181, SEC Charges Issuer and CEO With Misrepresenting Platform Technology in Fraudulent ICO (Aug. 13, 2020), *available at* https://www.sec.gov/news/press-release/2020-181.

[8] *SEC v. W.J. Howey Co., et al.*, 328 U.S. 293 (1946), *available at* https://supreme.justia.com/cases/federal/us/328/293/.

[9] *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *available at* https://supreme.justia.com/cases/federal/us/494/56/.

[10] *Howey*, 328 U.S. at 299.

[11] *SEC v. Kik Interactive Inc.*, 19 Civ. 5244 (S.D.N.Y. Sept. 30, 2020), *available at* https://law.justia.com/cases/federal/district-courts/new-york/nysdce/1:2019cv05244/516941/88/.

[12] *Id.* at 18.

[13] *Id.* (citations omitted).

[14] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Rel. No. 81207, at p. 10 (July 25, 2017).

[15] *See Digital Asset and "Crypto" Investment Scams*, *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/digital-asset (Sept. 1, 2021); *Funds Trading in Bitcoin Futures*, *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/funds (June 10, 2021); *Initial Exchange Offerings (IEOs)*, *available at* https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_initialexchangeofferings (Jan. 14, 2020); *Watch Out for Fraudulent Digital Asset and "Crypto" Trading Websites*, *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-3 (Apr. 24, 2019); *Watch Out for False Claims About SEC and CFTC Endorsements Used to Promote Digital Asset Investments*, *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-10 (Oct. 11, 2018); *The SEC Has an Opportunity You Won't Want to Miss: Act Now!*, *available at* https://www.sec.gov/news/press-release/2018-88 (May 16, 2018); *Initial Coin Offerings*, *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-16 (July 25, 2017).

[16] Remarks Before the Aspen Security Forum (Aug. 3, 2021), *available at* https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03.

[17] Press Release 2021-145, SEC Charges Decentralized Finance Lender and Top Executives for Raising $30 Million Through Fraudulent Offerings (Aug. 6, 2021), *available at* https://www.sec.gov/news/press-release/2021-145.

[18] Press Release 2021-172, SEC Charges Global Crypto Lending Platform and Top Executives in $2 Billion Fraud (Sept. 1, 2021), *available at* https://www.sec.gov/news/press-release/2021-172.

[19] *See* Commissioner Allison Herren Lee, Keynote Address at the 2021 Society for Corporate Governance National Conference: *Climate, ESG, and the Board of Directors: "You Cannot Direct the Wind, But You Can Adjust Your Sails,"* at *fn 3-4 (June 28, 2021), *available at* https://www.sec.gov/news/speech/lee-climate-esg-board-of-directors.

[20] *See* Regulation (EU) 2019/2088 of the European Parliament and of the Counsel on sustainability-related disclosures in the financial services sector (Nov. 27, 2019), *available at* https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

[21] Press Release 2021-42, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), *available at* https://www.sec.gov/news/press-release/2021-42.

[22] Press Release 2008-157, SEC Charges Mutual Fund Manager for Violating Socially Responsible Investing Restrictions (July 30, 2008), available at https://www.sec.gov/news/press/2008/2008-157.html.

[23] Press Release 2020-230, Fiat Chrysler Agrees to Pay $9.5 Million Penalty for Disclosure Violations (Sept. 28, 2020), available at https://www.sec.gov/news/press-release/2020-230.