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Enforcement Priorities Could Shift in a Downturn

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Key Points

- In economic downturns, companies perceived to have been overvalued or closely linked to the causes of the slowdown often face increased scrutiny from government enforcement authorities.
- Industries viewed as high-risk are likely to receive increased attention, with enforcement agencies prioritizing transparency, consumer protection and individual accountability.
- The unique aspects of the current social and political climate — notably, ESG priorities, geopolitical issues involving Russia and China, and the ongoing pandemic — could also shape enforcement efforts.

In 2022, we saw steep drops in the U.S. stock market, comparable to the bursting of the dot-com bubble of 2000-01 and the crash set off by the global financial crisis of 2007-09. Additionally, cryptocurrency markets have lost more than $2 trillion in value over the past two years. As in those earlier periods, these losses follow a period in which price-earnings ratios rose to historic highs and many investors prioritized short-term growth potential.

During economic downturns, governments often adjust their enforcement strategies. Although it is difficult, if not impossible, to predict any particular enforcement action, examining enforcement authorities' activities during previous downturns can reveal patterns and help companies prepare for potential government scrutiny.

Enforcement Activity During Past Economic Downturns

When the dot-com bubble burst, resulting in significant losses for investors, enforcement authorities, including the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), launched investigations into some of the largest and most high-flying companies of the late 1990s. Those investigations revealed a variety of misconduct, including fraudulent accounting and inaccurate or incomplete disclosures by senior executives. SEC Chair Bill Donaldson spoke of "a serious erosion in business principles … [and] the grossest displays of greed and malfeasance: taking excessive risks without disclosing the potential consequences, hiding the true state of their finances, and self-dealing."

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One of the largest corporate enforcement actions during this period involved the telecommunications firm WorldCom, Inc. According to the SEC, WorldCom fraudulently overstated its income and understated its operating expenses, leading to estimated losses of as much as $200 billion. WorldCom ultimately settled with the SEC for $2.25 billion and with private investors for $6.13 billion. The DOJ brought criminal securities fraud charges and obtained convictions and prison sentences against WorldCom's co-founder and CEO, and its CFO, treasurer and secretary, as well as its senior vice president and controller.

Criminal and civil enforcement actions were brought against other companies and their executives, as well, including Adelphia Communications, Enron and Tyco International, and Congress increased accounting controls and disclosure obligations for public companies via the Sarbanes-Oxley Act.

The 2007-09 financial crisis involved similar patterns of corporate misconduct and government enforcement actions. The economic crash was tied closely to the housing market, as high-risk lending practices combined with massive growth securitization and related derivatives left financial institutions vulnerable. Subsequent enforcement actions focused heavily on the sectors related to the market crash. The SEC, for example, charged more than 20 companies in the housing and mortgage markets for mortgage-related misconduct, alleging that they concealed from investors risks, terms and improper pricing in collateralized debt obligations (CDO) and other complex structured products.

The DOJ entered into multibillion-dollar settlements with a number of large financial institutions for allegedly misleading the investing public with respect to the packaging, marketing, sale and issuance of residential mortgage-backed securities. Many of those settlements involved the appointment of independent monitors to ensure the institutions' compliance with their obligations under their agreements with the government.

In addition, the so-called Great Recession resulted in the 2010 passage of the Dodd-Frank Act, which the Obama White House hailed as the "most far-reaching Wall Street reform in history" that would "prevent the excessive risk-taking that led to the financial crisis."

Notwithstanding the large institutional settlements, very few individuals were prosecuted in connection with conduct related to the financial crisis, which led to criticism of the DOJ's Criminal Division and resulted in increased emphasis on individual enforcement actions.

In both economic downturns in the 2000s, enforcement authorities focused on companies (and, to some extent, individuals) engaged in what the government perceived to be extreme speculation and risk-taking. Legislative and regulatory reforms in the wake of the downturns generally sought to require greater corporate transparency, encourage proactive compliance measures and protect consumers.

What Enforcement Activity To Expect in a Downturn

What, then, can companies expect from enforcement authorities in the event of an economic downturn in 2023?

Past Trends

Perceived high-risk economic sectors. Enforcement action in a future economic downturn is likely to focus on emerging and growth sectors that are perceived to have aggressive business and earnings models or to lack mature compliance systems. In this regard, cryptocurrency and decentralized finance (DeFi) may attract particular scrutiny. As digital assets have entered the mainstream over the past several years, they also have attracted more enforcement scrutiny, especially as a number of high-profile cryptocurrency companies failed in 2022.

Both the SEC and DOJ already are active in this area. The SEC filed several noteworthy first-of-their-kind actions alleging violations of the securities laws involving DeFi technology. The SEC also has nearly doubled the size of its Crypto Assets and Cyber Unit, a specialized team focused on enforcement actions involving the cryptocurrency markets and cyber-related threats. (See "Rise in Crypto Securities Filings Could Persist.") The DOJ, meanwhile, created a National Cryptocurrency Enforcement Team of prosecutors experienced in cybersecurity fraud and money laundering to investigate and prosecute digital assets-related crimes, as well as a specialized Virtual Asset Exploitation Unit within the Federal Bureau of Investigation.

Transparency and consumer protection. As in prior downturns, companies in all sectors (but especially those in industries seen to be responsible for, or emblematic of, the country's economic woes) can expect that the SEC and DOJ will scrutinize their disclosures to investors and consumers.

Individuals. Both the SEC and DOJ have recently signaled that they are likely to increasingly pursue enforcement actions against individual defendants, as they did in the wake of the dot-com bubble, including seeking novel remedies in certain cases. For example, as part of a June 2022 settlement with a New Jersey-based software company for alleged accounting fraud, the SEC required the company's CEO to reimburse the company from his compensation package, even though the CEO had not personally engaged in misconduct.

For its part, the DOJ has announced that a company seeking cooperation credit must disclose all nonprivileged information about any employee involved in misconduct. In addition, it has made clear that its evaluation of a company's compliance program will consider whether the company's compensation structure for individual executives promotes compliance.

Novel Areas

Although the enforcement actions that followed prior economic downturns can provide clues as to where the government is likely to focus in the event of another slump, every era is different, and companies also should consider how the lessons of the past interact with present conditions. The current social and political climate could result in additional enforcement scrutiny in these areas:

ESG. With the growing interest in companies' environmental, social and governance (ESG) activity, the SEC created a Climate and ESG Task Force in March 2021, and it has increased enforcement actions based on allegedly misleading ESG disclosures. The SEC has also proposed new rules to enhance and standardize ESG disclosures. (See "ESG Momentum Remains Strong but May Face Headwinds in 2023.")

Geopolitical issues. After Russia's invasion of Ukraine in February 2022, the U.S. and many of its allies, including the U.K. and the EU, imposed significant new sanctions on Russia and Russian interests around the globe. (See "Disparate US, EU and UK Sanctions Rules Complicate Multinationals' Exits From Russia.") Like its predecessor, the Biden administration has used export controls and other tools, such as the Foreign Agents Registration Act, to counter the perceived national security threat from China.

Pandemic overhang. Congress authorized massive economic stimulus and relief programs during the COVID-19 pandemic. And, just as a special inspector general was appointed to investigate potential fraud, waste and abuse under the Troubled Assets Relief Program (TARP) after the Great Recession, a special inspector general position was created to examine misconduct relating to pandemic relief funds. The DOJ also has brought a number of prosecutions alleging fraud in obtaining or using relief funds.

In Sum

Even if the economy does not move into recession, companies can expect enforcement authorities to devote attention to their ESG-related activity, interactions with Russia- or China-based entities or individuals, and receipt or use of pandemic relief funds. In the event of a downturn, those factors could combine with the historical areas of enforcement focus during hard economic times to shine an even harsher spotlight on companies and their senior executives.