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Select SEC and FINRA Broker-Dealer Cases and Developments: 2011 Year in Review

In 2011, the SEC and FINRA continued their vigorous enforcement of the securities laws, resulting in an increase in enforcement cases brought against broker-dealers, with a 60% increase in such SEC enforcement actions and a 13.5% increase in FINRA disciplinary actions since 2010.

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The Morgan Lewis Securities Litigation and Enforcement Practice has published an outline highlighting key U.S. Securities and Exchange Commission (the SEC or the Commission) and Financial Industry Regulatory Authority (FINRA) enforcement developments and cases regarding broker-dealers during 2011.[1]

This LawFlash touches on key developments in the enforcement programs of the SEC and FINRA, the metrics used to measure enforcement activity, and the kinds of cases brought by regulators. The full 2011 Year in Review, which includes summaries of approximately 80 cases, is available at http://www.morganlewis.com/pubs/LIT_2011YearInReview.pdf.

The SEC

The SEC brought a record number of enforcement actions in FY 2011.[2] In its first complete fiscal year since the Division of Enforcement's extensive reorganization, the Commission filed 735 enforcement actions. Although senior Commission officials continue to caution that statistics alone do not tell the whole story, the measures traditionally used to assess the SEC's enforcement activity demonstrate that, in FY 2011, the Division of Enforcement vigorously pursued securities law violators. Some of the key statistics from FY 2011 are described below:

- Last year, the Commission brought 735 enforcement actions, an 8% increase from the 681 cases initiated in FY 2010.

1. This LawFlash and its accompanying outline was prepared by partners Ben A. Indek, Ivan P. Harris, Kevin T. Rover, and Anne C. Flannery and of counsel Mary M. Dunbar, with substantial assistance from associates Casey P. Cohen, Alex B. Kaplan, Kerry J. Land, Nicholas J. Losurdo, Charles D. Manice, Julie A. Marcacci, John C. Matthews, Julia N. Miller, Katarzyna Mularczyk, Sarah S. Nilson, Rahul Rao, Todd Smith, E. Andrew Southerling, Shaina Stahl, and David A. Snider. Certain sections of the Outline were drawn from LawFlashes published by the firm. Morgan Lewis served as counsel in certain actions described herein.

2. The SEC's fiscal year begins on October 1. References to FY 2011 are to the year that commenced on October 1, 2010 and ended on September 30, 2011.

- At the end of FY 2011, National Priority or High Impact cases represented 5.11% of the Division of Enforcement's active docket, up from 3.26% in FY 2010.
- In one of the Commission's core areas—regulation of broker-dealers—the SEC's actions increased significantly to 113 cases in FY 2011 from 70 in the prior year. This represents a 60% increase year over year. Also of particular note is the big jump in cases against investment advisers and investment companies. In FY 2011, the Commission brought 146 enforcement actions in this area. This is a single-year record and represents a 30% increase over the prior year. Cases against broker-dealers, investment advisers, and investment companies represented about 35% of the SEC's total enforcement docket.
- The Division of Enforcement opened 578 formal investigations last year. By comparison, in FY 2010, the SEC issued 531 formal orders of investigation.
- Last year, there were 134 criminal actions relating to Commission cases, down slightly from FY 2010's 139 cases.
- The Commission also works closely with other regulators. In FY 2011, 586 SEC investigations were referred to self-regulatory organizations or other state, federal, and foreign authorities for enforcement, up from FY 2010 when 492 such referrals were made. In addition, the SEC increased the number of occasions (772) when it sought assistance from foreign regulatory authorities, and in turn it received a greater number of requests (492) for assistance from such regulators.
- Last year, almost 18.5% of the investigations opened during FY 2011 came from referrals within the Commission or other internal analysis. This represents a slight decrease from FY 2010 (21.9%).
- The Commission sought emergency relief in federal courts in 39 cases; that technique was used 37 times in FY 2010. The Commission also sought 42 asset freezes to preserve money for the benefit of harmed investors in FY 2011 versus 57 such actions in the prior year.
- In FY 2011, the Commission filed 61% of its first enforcement actions within two years of starting an investigation or inquiry, well below its target rate of 70%.
- For FY 2011, the SEC reported that it had obtained orders requiring the payment of approximately $928 million in penalties by securities law violators. This is slightly less than the $1.03 billion the SEC reported for FY 2010. It is interesting to note that, like in FY 2010, a relatively small number of cases seemingly account for a substantial portion of the fines imposed last year. Specifically, it appears that 10 cases represent approximately 46% of the $928 million in penalties imposed by the SEC in FY 2011.
- The Commission obtained orders requiring disgorgement of $1.878 billion in illicit gains last year, a small increase from the $1.82 billion in FY 2010.

Last year, there were also a number of important enforcement developments at the Commission, including the SEC's first ever deferred prosecution agreement, the finalization of the Dodd-Frank whistleblower rules, and the continued focus on individual liability in enforcement actions. The SEC also started the process of seeking congressional approval to enhance its penalty authority and reportedly began leaning toward filing negligence charges rather than scienter-based fraud claims in connection with certain cases.

In 2011, the SEC's long-standing settlement practice, which includes defendants neither admitting nor denying the allegations against them, came under increasing judicial attack. In March 2011, Judge Jed Rakoff of the U.S. District Court for the Southern District of New York took issue with this practice in connection with his review of a proposed settlement between the SEC and a corporation and two individual defendants. Judge Rakoff ultimately approved the agreement and reserved for another time the substantial questions the SEC's settlement practices raised. That time came in November 2011, when Judge Rakoff rejected another SEC settlement with a large financial institution, finding that the proposed agreement was neither fair, reasonable, adequate, nor in the public interest. That case is now on appeal to the U.S. Court of Appeals for the Second Circuit.

As the calendar turned to 2012, the Commission reportedly changed its "no admit or deny" policy in cases involving parallel criminal actions. In such cases, the SEC will no longer allow a settling defendant to neither admit nor deny the Commission's allegations while at the same time admitting to a criminal violation or entering into a deferred prosecution agreement with the U.S. Department of Justice. Congress will hold hearings on the SEC's settlement policy in early 2012.

Last year, the SEC brought significant cases in several of its traditional areas, including insider trading, fraudulent trading schemes, municipal bonds, short selling, and broker-dealer supervision. In connection with its efforts to investigate misconduct during the financial crisis, the Commission continued to be active in the collateral debt obligation and mortgage-backed securities areas. Finally, the SEC instituted interesting cases against two securities exchanges, an alternative trading system, and a self-regulatory organization.

FINRA

Last year brought with it to FINRA a new leadership team, new rules, revised Sanction Guidelines, and a new disciplinary action database. J. Bradley Bennett became the new Head of Enforcement, promising a "tough but fair" approach and efforts to streamline the investigation process. Several senior enforcement officials left FINRA in 2011; Mr. Bennett internally promoted at least two enforcement staffers to new positions and recruited a new Deputy Director of Enforcement resident in FINRA's New York office.

All of the traditional statistics used to measure FINRA's enforcement program showed marked increases in 2011. FINRA brought more cases, harshly disciplined more brokers and principals, obtained significantly more money from the industry through the fines it imposed, and returned substantially more money to investors than in the prior year. Some of the key statistics from 2011 are described below:

- In 2011, FINRA filed 1,488 new disciplinary actions against firms and individuals, up from 1,310 cases from the prior year—an increase of 13.5%. FINRA also resolved 1,287 formal actions last year; in 2010, it had concluded 1,178 such cases.
- Last year, FINRA expelled 21 firms from its membership (compared to 14 in the prior year), barred 329 people (versus 288 in 2010), and suspended 475 individuals (an increase over the 428 such actions in the prior year).
- As of December 16, 2011, FINRA reported that it had levied fines of more than $63 million versus almost $42.2 million in all of the prior year. The 2011 figure would represent a 50% increase year-over-year.

- Again, as of December 16, 2011, FINRA ordered firms and individuals to provide more than $19 million in restitution to customers. In 2010, all such orders totaled $6.2 million.
- In line with the increased number of cases and overall fine levels, cases with significant penalties increased sharply in 2011 when compared to 2010. Last year, FINRA increased the number of cases in which it imposed fines of greater than $100,000 to 70 from 53 in the prior year. That represents a 32% increase. This increase is even more pronounced at the higher levels. For example, in 2011 FINRA imposed fines of more than $1.5 million in five times as many cases as it did in 2010 (10 such cases in 2011 compared to only 2 in 2010).

Several significant enforcement developments also occurred at FINRA in 2011. After several years of operating under two regimes (i.e., NYSE Rule 351 and NASD Rule 3070), effective July 1, 2011, FINRA significantly changed its reporting requirements with the implementation of new Rule 4530. Perhaps the most important modification concerns firms' requirement to report certain internal conclusions of rule violations. New Rule 4530(b) obligates a firm to promptly report to FINRA (but in no event later than 30 calendar days) after it has concluded or reasonably should have concluded that the firm or an associated person has violated certain laws, rules, regulations, or standards of conduct.

In March 2011, FINRA announced four revisions to its Sanction Guidelines. First, the Sanction Guidelines now make clear that "proximate causation" is the required standard for restitution orders in FINRA disciplinary actions. Second, the Sanction Guidelines have been revised to recognize that, where appropriate, adjudicators may order the use of disgorged funds to remedy customer harms, rather than adding those moneys as a fine payable to FINRA. Third, the Sanction Guidelines now reflect that not every factor in the Principal Considerations in Determining Sanctions section have the potential to be aggravating and mitigating considerations. Rather, the use of a factor is dependent upon the facts and circumstances of the particular case and the type of violation under consideration. Finally, the Sanction Guidelines have been amended to instruct adjudicators to also consider sanctions imposed by other regulators for the same misconduct and to determine whether that sanction was sufficiently remedial in nature.

In May 2011, FINRA announced the launch of its Disciplinary Actions online database, which makes disciplinary actions available through a Web-based searchable system. The new database provides access to settlements, National Adjudicatory Council decisions, Office of Hearing Officer decisions, and complaints. FINRA has also linked its Monthly Disciplinary Actions case description summary to the corresponding action in its database.

Once again, FINRA was active in several customary areas last year, bringing enforcement actions against member firms for anti-money laundering, municipal securities, prospectus delivery, short selling, and supervision violations. It continued its recent efforts in sanctioning firms for violations relating to auction rate securities, mortgage-backed securities, structured products, and customer confidential information. FINRA opened new enforcement fronts in other areas, including private placements, real estate investment trusts, and variable life settlements.

If you would like further information regarding this LawFlash, please contact any of the following Morgan Lewis attorneys:

New York

Ben A. Indek	212.309.6109	bindek@morganlewis.com
Michael S. Kraut	212.309.6927	mkraut@morganlewis.com

Anne C. Flannery	212.309.6370	aflannery@morganlewis.com
Kevin T. Rover	212.309.6244	krover@morganlewis.com
Leslie Caldwell	212.309.6260	lcaldwell@morganlewis.com
Michele A. Coffey	212.309.6917	mcoffey@morganlewis.com
Bernard J. Garbutt III	212.309.6084	bgarbutt@morganlewis.com
Joanna C. Hendon	212.309.6377	jhendon@morganlewis.com
Brian A. Herman	212.309.6909	bherman@morganlewis.com
Kelly A. Moore	212.309.6612	kelly.moore@morganlewis.com
Robert M. Romano	212.309.7083	rromano@morganlewis.com
John M. Vassos	212.309.6158	jvassos@morganlewis.com
Washington, D.C.		
Christian J. Mixter	202.739.5575	cmixter@morganlewis.com
Mary M. Dunbar	202.739.5358	mdunbar@morganlewis.com
E. Andrew Southerling	202.739.5062	asoutherling@morganlewis.com
Patrick D. Conner	202.739.5594	pconner@morganlewis.com
Philadelphia		
Elizabeth Hoop Fay	215.963.5712	efay@morganlewis.com
Marc J. Sonnenfeld	215.963.5572	msonnenfeld@morganlewis.com
San Francisco		
Joseph E. Floren	415.442.1391	jfloren@morganlewis.com
Elizabeth A. Frohlich	415.442.1352	efrohlich@morganlewis.com
Los Angeles		
John F. Hartigan	213.612.2630	jhartigan@morganlewis.com
Miami		
Ivan P. Harris	305.415.3398	iharris@morganlewis.com
Irvine		
Scott B. Garner	949.399.7182	sgarner@morganlewis.com
Robert E. Gooding, Jr.	949.399.7181	rgooding@morganlewis.com

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