

SEC and FINRA Enforcement in 2009 Year-to-Date: The Handcuffs Are Off¹

May 26, 2009

The market disruptions and alleged large-scale Ponzi schemes that occurred in the second half of 2008 led some government officials and commentators alike to call for increased securities enforcement activity. This year both the SEC and FINRA have new leadership and a mandate to restore investor confidence and aggressively pursue companies and individuals who engage in prohibited conduct. Based on the increased volume of SEC enforcement actions and the high penalty and fine amounts in SEC and FINRA settlements, respectively, thus far in 2009, regulators appear to be taking their mandate seriously, and there is every reason to expect that the uptick in enforcement levels will continue at least throughout the remainder of 2009.

The SEC

On January 20, 2009, President Barack Obama appointed Mary L. Schapiro, formerly an SEC commissioner, chair of the CFTC, and CEO of FINRA, to serve as the 29th chair of the SEC; seven days later, the Senate unanimously confirmed her appointment. Since taking office, Ms. Schapiro has expressed her belief that vigorous enforcement of the securities laws serves the Commission's mission "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."² In testimony before the Senate Banking Committee during her confirmation hearings, Ms. Schapiro explained that she has "never been afraid to go after people who [she] thought violated the public trust," and she vowed that "[o]ne of the first things [she would] do is take the handcuffs off the enforcement division."³

Ms. Schapiro appointed Robert Khuzami to serve as director of the SEC's Division of Enforcement. Mr. Khuzami previously served as General Counsel for the Americas at Deutsche Bank AG, and prior to that spent 11 years working for the U.S. Attorney's Office for the Southern District of New York, serving as chief of that office's Securities and Commodities Fraud Task Force for three of those years. Mr. Khuzami

1. This alert was written by Morgan, Lewis & Bockius LLP partner Michael S. Kraut and associates Robert Scannell and Percy Ross. Morgan Lewis has more than 100 attorneys dedicated to representing financial institutions and issuers in connection with securities law issues. As part of that practice, the firm's Securities Litigation and Enforcement Practice regularly represents investment banks, investment advisers, and mutual funds and their employees in connection with SEC, FINRA, and state securities commission investigations and proceedings. Morgan Lewis also conducts internal investigations for those entities and has acted as independent consultant to firms on issues arising out of regulatory settlements.

2. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://sec.gov/about/whatwedo.shtml#org> (last visited May 11, 2009).

3. Neil Roland, *Schapiro: I'll 'Take the Handcuffs' Off Enforcement*, INVESTMENT NEWS, Jan. 15, 2009, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090115/REG/901159973>.

has vowed to “relentlessly pursue and bring to justice those whose misconduct infects our markets, corrodes investor confidence and has caused so much financial suffering.”⁴ Mr. Khuzami, among others, has publicly lobbied Congress for additional funding to enable the Enforcement staff to “meet its mandate,”⁵ and President Obama responded by proposing an increase in the SEC’s FY2010 budget of nearly 7% to enable the SEC to hire additional staff and enhance its technology.⁶

Ms. Schapiro and Mr. Khuzami inherited an SEC enforcement program that had been criticized for perceived weaknesses, including the reduction of penalty and disgorgement amounts in settlements in recent years and the fact that the SEC did not prevent losses of investors in the Ponzi scheme perpetrated by Bernard Madoff. Regardless of whether subjective criticisms were warranted, it is undeniable that the penalty and disgorgement amounts that the SEC collected in recent years have trended down substantially, as shown in the below table:⁷

Fiscal Year	Civil Money Penalties	Disgorgement
2004	\$1.2 billion	\$1.9 billion
2005	\$1.5 billion	\$1.6 billion
2006	\$975 million	\$2.3 billion
2007	\$507 million	\$1.093 billion
2008	\$256 million	\$774 million

Several factors may have contributed to the reduction in penalties and disgorgement amounts over the last few years, including (1) changes in the makeup of the Commission and the differing views of SEC Commissioners as to how aggressive the enforcement function should be; (2) the settlement of several unusually large cases a few years ago; (3) a decrease in the number of Division of Enforcement investigative attorneys (down 11.5% from 2004 to 2008); and (4) certain internal enforcement policies that have been criticized for slowing down the enforcement process.⁸

Despite these challenges, Ms. Schapiro has responded swiftly and decisively in her first few months as chair, particularly with respect to policies that she (and a recent GAO report) viewed as impediments to efficiency. Notably, Ms. Schapiro terminated the “penalty pilot” program initiated by former chair Christopher Cox in 2007 that required SEC Enforcement staff attorneys to obtain settlement ranges from the Commission before commencing corporate penalty negotiations. While the program was designed to increase the consistency and predictability of settlements, critics asserted that it significantly delayed the settlement process and created unnecessary hurdles for the staff.⁹ In addition, Ms. Schapiro eliminated the requirement that all five Commissioners approve the issuance of a formal order of investigation, which is

4. SEC Press Release, *Robert Khuzami Named SEC Director of Enforcement*, Feb. 19, 2009, <http://www.sec.gov/news/press/2009/2009-31.htm>.

5. Robert Khuzami, Testimony Concerning Strengthening the SEC’s Vital Enforcement Responsibilities Before the U.S. Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment (May 7, 2009), <http://sec.gov/news/testimony/2009/ts050709rsk.htm>.

6. Morgan Bettex, *Obama Proposes \$1B SEC Budget for 2010*, SECURITIES LAW360, May 8, 2009, <http://www.law360.com/articles/100518>.

7. Select SEC and Market Data Fiscal 2008, <http://www.sec.gov/about/secstats2008.pdf> (last visited May 11, 2008).

8. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION IN THE DIVISION OF ENFORCEMENT, GAO-09-358, 18, 43-44 (2009).

9. Mary L. Schapiro, Speech by SEC Chairman: Address to Practising Law Institute’s “SEC Speaks in 2009” Program (Feb. 6, 2009), <http://sec.gov/news/speech/2009/spch020609mls.htm>.

a predicate step for staff attorneys to issue subpoenas. Under the revised process, any Commissioner can approve a formal order as a duty officer of the Commission, which should expedite the enforcement process.¹⁰

These changes foreshadowed increased SEC enforcement activity, and the ramp-up is already under way. Between October and December 2008 (the first quarter of the SEC's fiscal year),¹¹ the SEC settled 123 matters. Between January and March 2009 (the second quarter of the SEC's fiscal year), that figure skyrocketed to 182 settlements—an increase of 48% from the prior quarter and a 16% increase from the second quarter of FY2008.¹² While the extent to which the change in leadership caused the increase in enforcement activity remains unclear, it is noteworthy that the pace of SEC settlements in the second quarter of 2009 would annualize to a larger number of cases than the Commission has ever brought in a single year. Moreover, between February and April 2009, the SEC's Enforcement Staff (1) procured 27 temporary restraining orders as compared with just seven during that same period in 2008, (2) initiated 287 investigations (versus 217 during that same period in 2008), and (3) obtained 138 formal orders—a 142% increase over the same period in 2008.¹³

Not only are the number of cases and settlements increasing, the civil penalties paid by respondents to settle those matters have increased substantially as well. In the second quarter of FY2009, SEC settlements with companies involved an average civil penalty of \$12.6 million (compared with an average civil penalty of \$8.4 million in the second quarter of FY2008) and a median settlement of \$1.7 million (compared with a median settlement of \$1.3 million in the second quarter of FY2008).¹⁴

SEC settlements relating to broker-dealers involving large fines that have been announced since Ms. Schapiro became chair of the SEC include the following:

- On March 11, 2009, Merrill Lynch, Pierce Fenner & Smith Inc. (Merrill Lynch) settled charges that the firm lacked adequate policies and procedures designed to control access to information concerning its institutional customers' orders. Between 2002 and 2004, certain Merrill Lynch retail brokers allegedly allowed their customers, including day traders, to listen to Merrill Lynch's intercom or "squawk box" and trade ahead of Merrill Lynch's institutional customers. Merrill Lynch consented to a censure, a cease-and-desist order, and a \$7 million civil penalty. Certain individuals whose conduct gave rise to this matter were criminally charged by federal prosecutors, and on April 22, 2009, a jury convicted three brokers and three day traders of one count each of conspiracy to commit securities fraud.
- On February 18, 2009, the SEC settled an enforcement action with UBS AG alleging that the firm acted as an unregistered broker-dealer and investment adviser. The SEC complaint alleged that UBS permitted certain U.S. clients to maintain undisclosed Swiss bank accounts, thereby enabling clients to avoid tax payments. The complaint further alleged that UBS acted as an unregistered broker-dealer and investment adviser for between 11,000 and 14,000 clients, generating revenues for the firm between \$120 million and \$140 million. UBS allegedly

10. *Id.*

11. The SEC's fiscal year begins on October 1. References to FY 2008 refer to the year that began on October 1, 2007 and ended on September 30, 2008.

12. Jan Larsen with Dr. Elaine Buckberg and Dr. Baruch Levy, *SEC Settlements Trends: 1Q09 Update Settlement Activity Increases as Change Comes to the SEC*, Apr. 9, 2009, http://www.nera.co.uk/image/PUB_Settlements_Update_0409.pdf.

13. Mary L. Schapiro, Speech by SEC Chairman: Building a Stable and Efficient Financial System (May 8, 2009), <http://sec.gov/news/speech/2009/spch050809mls.htm>; see also Khuzami, *supra* note 5.

14. See Larsen, *supra* note 12.

attempted to conceal the business that it conducted within the jurisdiction of the United States and trained its advisers on how to avoid detection by the U.S. authorities. UBS agreed to disgorge \$200 million (in addition to payments of \$180 million for disgorgement and \$400 million for taxes that UBS will make to settle a related U.S. Department of Justice investigation).

- On March 4, 2009, the SEC announced that it filed charges against 14 specialist firms alleging that these firms traded ahead of customer orders or interpositioned the firms' proprietary trades between customer orders. Collectively, the specialist firms paid almost \$70 million in disgorgement and penalties to settle these charges. This case follows similar charges that the SEC and NYSE Regulation have brought against specialists in recent years.

FINRA

2008 marked the first full year since NASD Regulation and NYSE Regulation merged to form FINRA in July 2007. The number of cases that FINRA resolved in 2008 (1,007) reflected a reduction of 100 cases from FINRA/NASD's 2007 levels (1,107) and a reduction of more than 200 cases from the number of cases resolved by the NASD alone in each of 2005 and 2006.¹⁵ Despite the fact that FINRA received 19% more investor complaints in 2008 than in 2007, FINRA filed fewer disciplinary actions and resolved fewer formal actions in 2008 than FINRA/NASD did during the prior year (although the number of individuals barred and the number of individuals suspended increased in 2008 by 7% and 11%, respectively). The amount of FINRA fines also has been trending down steadily over the last few years from a high in 2005 of \$125.4 million to approximately \$28 million in 2008.

On February 24, 2009, the Board of Governors of FINRA announced that Richard G. Ketchum had been appointed FINRA's CEO, replacing Mary Schapiro. Prior to his appointment, Mr. Ketchum served as CEO of NYSE Regulation and as chairman of FINRA's Board of Governors, although he continues to hold the latter position.

Since becoming FINRA's CEO, Mr. Ketchum has publicly expressed several of his agenda items, including filling gaps in regulatory oversight that result from the SEC's, FINRA's, and state securities regulators' possession of different jurisdictions. In particular, Mr. Ketchum has expressed a belief that investment advisers should be subject to additional regulations, and he believes that "FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently."¹⁶

Mr. Ketchum inherits an enforcement program that also has been criticized for the reduction in its "big dollar" enforcement matters. In 2008, FINRA settled only three cases with fines of \$1 million or more (including one case with a fine of exactly \$1 million). However, by the first business day of 2009, FINRA was one-third of the way toward matching that figure when it announced a \$1 million settlement with E*Trade Securities (E*Trade) relating to the firm's alleged failure to monitor for possible money laundering transactions that did not involve cash movement. As shown in the following table, however, the E*Trade matter was only the first in a series of FINRA settlements thus far in 2009 that reflect a substantial increase in high fine levels:¹⁷

15. FINRA Statistics, <http://www.finra.org/Newsroom/Statistics/index.htm> (last visited May 11, 2009).

16. Richard G. Ketchum, FINRA Chairman & Chief Executive Officer, Remarks from the SIFMA Compliance & Legal Division's Annual Seminar (Mar. 23, 2009), <http://www.finra.org/Newsroom/Speeches/Ketchum/P118256>.

17. The information in the table was collected based on our review of FINRA's monthly "Disciplinary and Other FINRA Actions" publications and FINRA news releases.

Fine Range	2008 (Jan. – Dec.)	2009 (Jan. – Apr.)
\$100,001 to \$250,000	45	9
\$250,001 to \$500,000	10	9
\$500,001 to \$750,000	4	2
\$750,001 to \$1,000,000	2	2
\$1,000,001 to \$1,500,000	2	1
\$1,500,001 or more	0	4

As shown in the above table, FINRA has already brought four cases with fines of more than \$1.5 million in the first four months of 2009 as compared with none in all of 2008. Also, in the first third of 2009 FINRA has already brought more cases with fines greater than \$500,000 than it did in all of 2008.

The following summaries briefly describe the four FINRA settlements in 2009 that involved fines of at least \$1.5 million:

- On February 12, 2009, FINRA announced that it had settled a matter with two Wachovia subsidiaries relating to their alleged failure to (1) provide investors with breakpoint, sales charge discounts, and the benefit of net asset value transfer programs in connection with mutual fund and/or unit investment trust trading; and (2) consider whether customers who purchased class B and C mutual fund shares would have benefited from the purchase of class A shares instead. The respondents agreed to pay fines totaling more than \$4.5 million and to disgorge more than \$5.4 million.
- On March 17, 2009, FINRA announced that Citigroup Global Markets agreed to pay a \$2 million fine to settle a matter referred to FINRA by the NASDAQ Marketwatch Department. The fine relates to allegations that the firm failed to comply with FINRA rules involving trade reporting and order displays. Notably, FINRA alleged that Citigroup failed to properly monitor its systems on June 17, 2005, a Quadruple Witch Expiration Friday (i.e., the day on which “stock index futures, index options, stock options, and options on stock index futures simultaneously expire”).¹⁸ This failure resulted in the erroneous publication of nearly 7,000 “non-bona fide transactions.” Other firms relied on the erroneous published information and executed transactions that they subsequently were required to cancel.
- On March 25, 2009, FINRA announced that Morgan Stanley agreed to settle a matter involving allegations that the firm failed to supervise two former Rochester-based registered representatives that persuaded more than 184 customers to elect early retirement and permit the representatives to manage their retirement funds. The brokers promised unrealistic returns that would permit consistent withdrawals, which led some firm clients to endure substantial financial hardship. In addition, one of these representatives allegedly falsified client records and provided gifts to try to obtain companies’ confidential employment records so that he could identify new leads. Morgan Stanley consented to pay a \$3 million fine and \$4.2 million in restitution to affected clients.
- On April 14, 2009, FINRA announced that it had fined Fifth Third Securities (FTS) \$1.75 million for violations involving variable annuity sales and exchanges. FINRA found that

18. News Release, *FINRA Fines Citigroup Global Markets \$2 Million for Range of Trade Reporting Violations*, Mar. 17, 2009, <http://www.finra.org/Newsroom/NewsReleases/2009/P118157>.

during a nearly two-year period, FTS representatives engaged in more than 250 unsuitable sales for clients. FINRA ordered FTS to pay more than \$260,000 in restitution for losses resulting from surrender charges that the firm's clients paid in these transactions. In addition, FINRA also required the firm to offer nearly 200 customers the opportunity to rescind transactions.

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