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Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2013 Year in Review

A year of change at the SEC—new enforcement leadership, policies, and areas of focus; at FINRA—an emphasis on "high risk" financial advisers and responding quickly to address fraudulent conduct.

This LawFlash highlights key U.S. Securities and Exchange Commission (SEC or the Commission) and Financial Industry Regulatory Authority (FINRA) enforcement developments and cases regarding broker-dealers, investment advisers, and investment companies during 2013.[1] The full 2013 Year in Review is available at https://www.morganlewis.com/pubs/LIT_2013YearInReview.pdf.

The SEC

2013 was marked by notable changes in the SEC's enforcement program, including new personnel, new policies, and new specialized task forces.

The most notable personnel change came on April 10, 2013, when Mary Jo White was sworn in as Chairman of the Commission. In addition, two new Commissioners were appointed in August 2013: Kara M. Stein and Michael S. Piwowar. The current Commission includes Chair White and four Commissioners: Luis A. Aguilar, Daniel M. Gallagher, Ms. Stein, and Mr. Piwowar.

There were also significant changes in key Staff positions during 2013. In January, Robert Khuzami, Director of the Division of Enforcement, announced his departure after four years in the role. In April, Chair White named George Canellos and Andrew Ceresney as Co-Directors of Enforcement. Mr. Ceresney became the sole Director of Enforcement in 2014, when Mr. Canellos announced that he was leaving the Commission. In 2013, new Chiefs of Enforcement's Asset Management, Municipal Securities and Public Pensions, and Complex Financial Instruments units and a new Chief Litigation Counsel were appointed. Several new leaders in the Office of Compliance Inspections and Examinations (OCIE) were announced in 2013, including a new Director of the National Exam Program, a new National Associate Director for the Investment Adviser/Investment Company Examination Program, and a new National Associate Director for the Broker-Dealer Examination Program. Finally, new Directors were appointed in five of the SEC's 11 Regional Offices.

In FY 2013, the Commission brought 686 enforcement actions, 48 fewer than the 734 initiated in FY 2012; this represents about a 7% decline year over year. Last year's total is the lowest number since FY 2010. According to the Commission, "these numbers do not, however, reflect the outstanding quality of the enforcement actions brought during the year." The Commission noted that 402 of the 686 cases were brought in the last six months of

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the fiscal year. The SEC also trumpeted its "strong pipeline" heading into FY 2014, pointing out that it had opened 908 investigations last year (representing a 13% increase) and issued 574 formal orders of investigation (up 20% on the year). Finally, the SEC reported that it had 1,444 open investigations as of the end of its FY 2013.

Of particular note, reversing a three-year trend, the SEC brought 121 actions against broker-dealers in FY 2013, compared to 134 in FY 2012. This represents about a 10% decrease year over year. Similarly, the SEC also brought fewer actions against investment advisers and investment companies, instituting 140 such cases in FY 2013, seven fewer than filed in the previous year. Nevertheless, taken together, it is clear that the SEC continued to devote significant resources toward investigating regulated entities last year; cases in that area represented about 39% of the Commission's FY 2013 docket.

Interestingly, and in contrast to the amount of headlines garnered, the number of insider trading cases filed by the Commission declined significantly last year. In FY 2013, the SEC brought 44 insider trading cases, 14 fewer than in the prior year. This figure is the lowest since FY 2010 and the third lowest in the last 10 years.

In FY 2013, the SEC obtained orders requiring the payment of $3.4 billion in penalties and disgorgement, a 10% increase from the amounts ordered in FY 2012 and a record for the Commission. Of that amount, approximately $1.167 billion represented orders to pay civil penalties (the highest amount since FY 2005), and about $2.257 billion represented orders for disgorgement of illegal profits.

As the SEC's financial crisis–related investigations began to be potentially affected by the statute of limitations, the Commission's enforcement activity in this area appeared to decline. It appears that, in FY 2013, the SEC initiated only several new cases related to the crisis. Over the last few years, however, the Commission has brought charges against 169 individuals and entities, including 70 CEOs, CFOs, and other senior officers in financial crisis–related cases. These actions have resulted in more than $3.02 billion in penalties and disgorgement.

The SEC's whistleblower program completed its third year of operation in FY 2013. Last year, the Office of the Whistleblower received 3,238 tips, complaints, and referrals from whistleblowers, an increase of 237 (or approximately 8%) from the 3,001 received in FY 2012. These notifications came from all 50 states, the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, and 55 foreign countries. The United Kingdom, Canada, and China led the way in referring complaints to the SEC from outside the country last year. Most complaints fell into three categories: corporate disclosure and financials, offering fraud, and manipulation. The SEC reported that it had paid four whistleblowers a combined total of $14,831,965.64. However, that figure includes an award of more than $14 million to a single whistleblower on the last day of the Commission's fiscal year.

In June 2013, in a significant departure from past practice, Chair White announced that the SEC would begin requiring admissions of facts and misconduct from defendants as a condition of settlement in cases where there was a heightened need for public accountability. While she predicted that most cases would continue to settle with the defendants neither admitting nor denying the allegations of wrongdoing, the SEC would begin to require admissions as a condition of settlement in cases involving egregious intentional misconduct, substantial harm to investors, or serious risk to the markets. In FY 2013, the SEC required admissions in two matters.

In her short time at the helm, Chair White has been unequivocal in her pronouncements that the SEC is prepared and willing to take cases to trial. In fact, over the last three years, the SEC has won 80% of the cases it has tried. However, the Commission had mixed results at trial in the latter half of 2013.

In August 2013, the SEC had a highly publicized victory in connection with a jury trial related to the marketing of a collateralized debt obligation by an individual defendant. In contrast, a mere two months later, in October 2013, a jury acquitted an individual on all counts of insider trading in another high-profile SEC trial. Then, in December 2013, the SEC lost two additional cases, each charging individuals with misconduct in connection with financial fraud at public companies. Despite the SEC's mixed record of trial outcomes in recent months, the Commission is likely to continue to take difficult cases to trial, rather than accept what it perceives as weak settlements. Nonetheless, the SEC must contend with the pragmatic reality of limited resources. While it may have the talent and commitment to try cases, the SEC simply does not have the capacity to litigate more than a small percentage of its total caseload.

In July 2013, the SEC announced the creation of a new enforcement initiative in the form of a specialized task force targeting abusive and fraudulent conduct in securities issued by microcap companies, with an emphasis on those that do not regularly report their financial results to the public. The task force will investigate fraud in the issuance, marketing, and trading of microcap securities. In December 2013, the SEC announced that it would be creating a new enforcement task force to increase its focus on the activities of broker-dealers. The task force will focus on current issues and practices within the broker-dealer community and develop national initiatives for potential investigations. The SEC will use this task force, once in place, to coordinate broker-dealer-related initiatives across the agency. The task force will serve to centralize information and expertise concerning industry practices and trends. It will also coordinate with OCIE, and with FINRA, to generate quality referrals and investigations. Although still in the formative stages, the creation of a broker-dealer task force, presumably to be staffed with investigators exclusively dedicated to ferreting out unlawful conduct by broker-dealers, suggests that there will be an increase in enforcement cases brought against broker-dealers and associated market participants.

In October 2013, Chair White reaffirmed the Commission’s commitment to pursuing violations large and small and stated that the SEC would look for violations in all corners of the market. She analogized this enforcement strategy to the so-called “broken windows” strategy employed by former New York Mayor Rudolph Giuliani and made it clear that the SEC would pursue strategic prosecution of smaller violations in an effort to send a broader deterrent message. It remains to be seen whether the “broken windows” approach will result in a significant increase of cases charging less egregious violations of the law. One area where it may be reflected is in an increase of cases charging regulatory lapses initially identified through the SEC’s examination program.

In November 2013, the SEC announced that it had entered into its first deferred prosecution agreement with an individual. This action signals that a majority of the Commissioners are comfortable with the SEC’s use of this cooperation tool with respect to both companies and individuals.

The SEC’s enforcement priorities under Chair White have included an increased emphasis on deterrence, consistent with a robust and effective enforcement program. In 2013, this emphasis on deterrence was reflected in aggressive charging decisions; the pursuit of stronger sanctions, including substantial monetary penalties; creative use of customized remedies, including conduct-based injunctions; the requirement of admissions as a condition of settlement in certain cases; and close coordination with other regulatory and criminal law enforcement agencies, both domestic and international. In the upcoming year, we are likely to see more of the same, together with a renewed focus on cases involving financial fraud and accounting issues, microcap fraud, broker-dealers and investment advisers, and market structure as well as the increased use of data analytics to focus enforcement resources on practices and industries where there is the highest likelihood or risk of misconduct.

Last year, the SEC brought broker-dealer cases in several traditional areas, including registration, commissions and markups, and insider trading. The Commission continued its efforts in the mortgage-backed securities area and opened new fronts involving the Market Access Rule and municipal securities. The SEC also brought several financial crisis–related actions as the events of 2008 reached their five-year anniversary. In the asset management space, it continued to focus on several practices, including best execution, compliance reviews and policies and procedures, trade allocation, and representations to investors.

FINRA

Last year, there were several notable personnel changes in FINRA’s senior staff. Susan Axelrod was promoted to Executive Vice President of Regulatory Operations. In this role, Ms. Axelrod oversees Enforcement, the Office of Fraud Detection and Market Intelligence, and Member Regulation (which includes Sales Practice, Risk Oversight and Operational Regulation, and Shared Services). Carlo di Florio joined FINRA from the SEC as the Executive Vice President for Risk and Strategy. In his new role at FINRA, Mr. di Florio is responsible for assessing the most significant risks to investors and market integrity and developing ways to lessen, manage, and monitor those risks and trends in the industry. Finally, Mike Rufino was promoted to Head of Member Regulation Sales Practice, and

Bill Wollman was elevated to the role of Head of Member Regulation Risk Oversight and Operational Regulation.

In 2013, FINRA brought 1,535 new disciplinary actions, a slight decline from the record 1,541 cases initiated in 2012. FINRA resolved 1,307 formal actions last year; 363 fewer cases than it had in the prior year. Last year, FINRA expelled 24 firms from its membership (compared to 30 in the prior year), barred 429 people (versus 294 in 2012), and suspended 670 individuals (an increase over the 549 such actions in the prior year).

In 2013, FINRA posted only three Targeted Examination letters on its website, versus five in the prior year. Last year's letters focused on Alternative Trading Systems, social media communications, and firms' controls and processes in connection with the development and use of trading algorithms and automated trading technology.

There were several FINRA enforcement developments of note last year, including the following:

- First, in late 2013, FINRA publicly described its efforts to monitor certain "high risk" brokers and the firms that hire such individuals. According to FINRA, two of the primary tools used in this area are its Broker Migration Model and Problem Broker Model. The Broker Migration Model tracks the movement of certain registered representatives from firm to firm using a variety of risk metrics. The information developed is used by FINRA's Staff to prioritize its surveillance, examination, and enforcement resources, enabling it to conduct targeted examinations and enforcement actions. The Problem Broker Model identifies and monitors registered representatives who have significant regulatory disclosures. FINRA also uses the information derived from this model to target brokers in its surveillance, examination, and enforcement activities. In its 2014 letter setting forth its regulatory and examination priorities, FINRA indicated that it will expand its "high risk" program and establish a dedicated team within the Department of Enforcement to prosecute such cases.
- Second, FINRA issued Regulatory Notice 13-27 announcing amendments to Rule 8313, which governs the publicity of its disciplinary actions. Key changes include the elimination of the publicity thresholds in the rule, the establishment of general standards for the release of disciplinary information, and clarity on the scope of information subject to Rule 8313. Of particular note, the prior monetary sanction threshold of $10,000 for publication of disciplinary actions has been eliminated. Effective December 16, 2013, disciplinary complaints and decisions, independent of the sanction amount, will be shared with the public. Moreover, the amendments also changed the scope of the information FINRA will share with the public regarding many types of disciplinary matters.
- Third, senior FINRA officials emphasized that the agency was focused on responding quickly to address fraudulent conduct. As examples of this effort, in at least two matters in 2013, FINRA filed for Temporary Cease-and-Desist Orders when it learned of alleged fraudulent conduct.

Based upon our review of currently available public information, we believe that FINRA's top enforcement priorities include the following: (i) structured and complex products sold to retail clients; (ii) single registered representative cases involving various types of significant misconduct; (iii) fraud and insider trading; (iv) sales to senior investors; (v) the use of social media to interact with retail investors; (vi) excessive commissions and markups/markdowns; (vii) cyber security and data breaches and losses; (viii) the Market Access Rule; (ix) anti-money laundering; (x) systems- and operations-related supervisory failures; (xi) microcap and penny stock fraud; and (xii) audit trail integrity, including Large Options Positions Reporting and options order marking capacity.

Last year, FINRA brought a number of actions in its traditional areas of focus, including the anti-money laundering, best execution, record retention, suitability, and trade reporting areas. It also continued its recent trends with cases regarding leveraged and inverse exchange-traded funds and private placements. Finally, FINRA initiated actions in new areas such as Direct Market Access and the retention of certain records in the required electronic format.

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