

2010 Year in Review: SEC and SRO Enforcement Developments Regarding Broker-Dealers

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The Morgan Lewis Securities Litigation and Enforcement Practice has published an outline highlighting selected U.S. Securities and Exchange Commission (the SEC or the Commission), Financial Industry Regulatory Authority (FINRA), and NYSE Euronext enforcement actions and developments regarding broker-dealers during 2010.¹

This LawFlash touches on key developments in the enforcement programs of the SEC, FINRA, and NYSE Euronext, including new policies and procedures, the metrics used to measure enforcement activity, and the kinds of cases brought by regulators. It also discusses the Dodd-Frank Wall Street Reform and Consumer Protection Act's (the Dodd-Frank Act's) effect on the SEC's enforcement program. The full 2010 Year in Review, which also includes summaries of approximately 80 cases, is available at http://www.morganlewis.com/pubs/LIT_2010YearInReview.pdf.

The SEC

In 2009, the SEC's Division of Enforcement (Enforcement) began a comprehensive internal review and reorganization. Over the last year, Enforcement worked on implementing many of the changes to its program that resulted from that review.

One of the most far-reaching changes was the creation of five national specialized units within Enforcement. The leaders of those units were announced in January 2010, and the groups have been staffed with attorneys and other experienced personnel throughout the country. The specialized units have identified a number of initiatives and brought significant enforcement actions in their areas of expertise. Examples include several insider trading cases involving rings of tipplers and traders initiated by the Market Abuse Unit, and the Structured and New Products Unit's focus on collateralized debt obligations and other complex financial products.

1. This LawFlash and its accompanying outline were prepared by partners Ben A. Indek, Michael S. Kraut, Kevin T. Rover, and Anne C. Flannery and of counsel Mary M. Dunbar, with substantial assistance from associates Clare M. Cusack, Alex B. Kaplan, Kerry J. Land, Alice L. McCarthy, Julia N. Miller, Sarah S. Nilson, E. Andrew Southerling, and David A. Snider. Certain sections of the outline were drawn from LawFlashes published by the firm. The authors are grateful for the outstanding administrative assistance provided by legal secretary Mary-Elizabeth Denmark. Morgan Lewis served as counsel in certain actions described herein and in the outline. The information in this LawFlash and the outline is current as of January 21, 2011.

Enforcement's restructuring also included the creation and staffing of two new offices: the Office of the Managing Executive and the Office of Market Intelligence. The Office of Market Intelligence is working on an important Commission initiative—the handling, tracking, and distributing of investigation tips, complaints, and referrals received by the SEC. In 2010, an FBI agent was embedded into the Office of Market Intelligence to continue the Commission's coordination with criminal prosecutors to combat financial fraud.

In 2010, Commission officials expressed an intention to evaluate Enforcement's performance based on qualitative, instead of solely quantitative, metrics. Indeed, SEC Chairman Mary Schapiro and Director of Enforcement Robert Khuzami have emphasized that metrics reflect the number of cases brought, but not the effect and impact of those actions. Consistent with that philosophy, the SEC has developed a list of "national priority" or "high impact" actions, which the Commission hopes will be widely covered by the media and affect the future conduct of market participants. At the end of FY 2010, national priority or high impact cases comprised 3.26% of Enforcement's active docket. In FY 2010, 33 such actions were filed.

Several of the metrics traditionally used to measure enforcement activity demonstrate that, in FY 2010, Enforcement actively and aggressively pursued misconduct affecting the U.S. markets.² Some of the key statistics from FY 2010 are described below:

- Enforcement opened 531 formal investigations, compared to 496 new inquiries in FY 2009.
- The SEC brought 681 cases, up slightly from the 664 initiated in the prior year. The number of actions last year is the highest since at least FY 2001.
- The SEC's cases involving broker-dealers declined significantly to 70 actions from 109 in FY 2009. However, when combined with cases against other regulated entities, including investment advisers and mutual funds, it is clear that the SEC continues to closely regulate financial institutions.
- The Commission brought 53 insider trading cases (up from 37 in FY 2009) against 138 defendants (versus 85 in FY 2009).
- There were 139 criminal cases relating to Commission actions, down slightly from FY 2009's 154 cases.
- The SEC reported that it had obtained a "favorable" outcome (including through litigation, settlement, or a default judgment) in 92% of its cases. Interestingly, this is exactly the same percentage the Commission achieved in the prior three fiscal years.
- The SEC recently reported that it had obtained orders requiring the payment of approximately \$1.03 billion in penalties by securities law violators. This is almost three times the amount it obtained in FY 2009. That record reflected a return to the SEC's halcyon years between 2004 and 2006 in terms of its imposition of civil money penalties, although a few large actions account for a substantial portion of last year's billion-dollar figure.

2. The SEC's fiscal year begins on October 1. References to FY 2010 are to the year that commenced on October 1, 2009 and ended on September 30, 2010.

- The Commission also obtained orders requiring disgorgement of \$1.82 billion in illicit gains, a \$189 million drop-off from FY 2009, but in line with the figures in several prior years.
- Finally, case closings were projected to increase 32% over FY 2009.

The major policy change to Enforcement's program in 2010 was the announcement and implementation of a series of new measures designed to encourage individuals and companies to cooperate in investigations and actions. In January 2010, the SEC issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. At the same time, the Commission authorized the use of a number of new "cooperation tools" designed to establish incentives for individuals and companies to cooperate with Enforcement. These tools include formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements with individuals and companies. In the last year, Enforcement entered into approximately 15 cooperation agreements. Moreover, in December 2010, the Commission announced that it had entered into the first nonprosecution agreement under its new initiative.

In 2010, the SEC brought cases in the insider trading, fraudulent sales practice, and supervisory areas, each of which reflects the kinds of cases that the Commission initiates against broker-dealers or their employees. Moreover, the SEC's efforts to investigate issues surfacing from the financial crisis bore fruit in cases involving the marketing and sales of collateralized debt obligations, subprime mortgage holdings, and net asset value. Finally, the SEC once again brought cases involving anti-money laundering, municipal bond transactions, and Regulation SHO.

Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Act. This landmark legislation contains a number of measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.

Specifically, the Dodd-Frank Act enhances the SEC's ability to prosecute aiding and abetting and control person cases. The legislation also extends the statute of limitations for securities laws violations and expands the application of the antifraud provisions and the jurisdiction of federal courts in actions brought by the SEC in certain cases. With the new legislation in place, the SEC has several enhanced remedies, including the ability to impose collateral bars and the authority to impose civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. The incentives and protections afforded to securities whistleblowers have been significantly increased by, among other changes, permitting the SEC to pay between 10% and 30% of monetary sanctions exceeding \$1 million to whistleblowers who voluntarily provide original information in cases involving any violation of the securities laws. New Commission whistleblower regulations implementing the Dodd-Frank provisions should be promulgated later this year.

Finally, the Dodd-Frank Act contains certain procedural modifications relating to SEC enforcement actions, including granting the Commission nationwide subpoena power in connection with civil actions filed in federal courts and requiring the SEC to file an enforcement action within 180 days of the Wells notice in certain cases or to notify the affected party of the intent not to file an action.

FINRA

Two significant personnel changes occurred at FINRA in 2010. In July, Susan Axelrod, a longtime NYSE Regulation attorney and senior FINRA official, was appointed Executive Vice President – Head of the Member Regulation Sales Practice Area. In October, FINRA announced that it had appointed J. Bradley Bennett, a lawyer in private practice, as its new Head of Enforcement, effective January 1, 2011.

Similar to comments made by the SEC concerning the use of statistics, FINRA officials have indicated that its enforcement program should not be evaluated solely on the fines it levies on firms and individuals. Rather, the number of cases filed each year, the types of misconduct under investigation, and the size and financial wherewithal of the broker-dealers involved should also be taken into account.

Notwithstanding its efforts to downplay the statistics, year-over-year metrics reflect that, in 2010, FINRA's Department of Enforcement staff was active in filing and resolving disciplinary actions. Last year, FINRA filed 1,310 new disciplinary actions—an increase of 13% from the prior year. FINRA also resolved 1,178 formal actions last year; in 2009, it concluded 1,090 such cases.

FINRA's total fines in 2010 appear to have declined when compared to the prior year, but represent a large increase versus 2008. Through November 2010, FINRA reported that it had levied fines of \$41.1 million. That figure represents a decline from the \$47.6 million in fine revenue in the prior year, but a significant increase from the \$25.9 million in revenue from fines FINRA garnered in 2008. In line with the decline in its overall fine levels, the number of cases with significant penalties dropped sharply in 2010 when compared to 2009. In 2010, FINRA's largest cases (i.e., those with penalties over \$1 million) dropped by 70%.

FINRA appears to have significantly slowed its use of targeted examination letters, as only four such letters were posted on FINRA's website in 2010. These inquiries related to noninvestment company exchange traded products, direct market access, private placement agents soliciting and/or obtaining business with municipalities and public pension funds, and broker-dealer services involving customers of financial institutions. The lack of "targeted examination letters" may merely be semantics because the Department of Enforcement also launched several task forces to investigate certain issues, including Regulation D offerings, municipal securities transactions, and day trading.

Last year, FINRA's Department of Enforcement brought cases in a number of traditional areas, including anti-money laundering, email retention, financial reporting, research report disclosures, Regulation SHO, sales material disclosures, and supervision. FINRA also returned to such topics as auction rate securities, day trading, and credit default swap brokerage rates. Finally, the staff opened new fronts by bringing cases involving high-frequency trading, mortgage-backed securities, and retail sales of collateralized mortgage obligations and reverse convertible notes.

NYSE Euronext

In June 2010, FINRA and NYSE Euronext announced that they had completed the implementation of a previously announced agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Under the agreement, FINRA assumed the regulatory functions for three exchanges: the New York Stock Exchange LLC, NYSE Arca, Inc., and NYSE Amex LLC. NYSE Euronext, through its subsidiary NYSE Regulation, remains ultimately responsible for overseeing FINRA's performance.

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