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Enforcement Developments Regarding Broker-Dealers

Law360, New York (February 25, 2010) -- The economic crisis of 2008 and the Ponzi scheme of Bernard Madoff led government officials, the public and the media to call for an increase in securities enforcement activity. As a result, 2009 was a year of change at the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority.

The SEC installed new leadership that perceived a mandate to restore investor confidence by aggressively pursuing companies and individuals who engage in wrongdoing affecting the securities markets.

The commission's new leaders instituted a number of organizational and policy changes intended to make its Division of Enforcement more efficient and effective. Many of the metrics used to measure SEC enforcement activity reflect a significant increase compared to 2008.

With its own new CEO in place, FINRA also looked to make changes in its structure and enforcement processes. It did so last year, but perhaps in less noticeable and transformative ways. In 2009, FINRA's caseload increased; it also brought several actions with large fines, in stark contrast to the prior year.

Consistent with its more focused mandate, NYSE Regulation concentrated on trading and transaction reporting in its major cases and instituted fewer actions than the SEC and FINRA.

The SEC

In 2009, the SEC went through enormous change. At the top of the list was the new leadership installed at the commission.

In January 2009, Mary L. Shapiro was appointed and confirmed as the new SEC chairman. Among other senior personnel moves, Chairman Schapiro recruited Robert Khuzami, a former federal prosecutor, to head the Division of Enforcement.

The commission subsequently hired several other former criminal prosecutors to help Mr. Khuzami lead the SEC's enforcement efforts, including a new deputy director and the heads of the commission's New York and Miami regional offices.

Organizationally, the Division of Enforcement announced plans to develop five specialized investigative units, streamline management by eliminating the position of Branch Chief, and create the Office of Market Intelligence.

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First, in an effort to create enhanced specialization, Enforcement introduced five units dedicated to complex areas of the securities laws: (1) the Asset Management Unit; (2) the Market Abuse Unit; (3) the Structured and New Products Unit; (4) the Foreign Corrupt Practices Act Unit; and (5) the Municipal Securities and Public Pensions Unit.

Second, the SEC implemented measures to streamline management and internal processes to improve efficiency, including redeploying Division of Enforcement branch chiefs to conduct investigations.

Third, the commission created an Office of Market Intelligence, which is responsible for collecting, weighing, analyzing and monitoring tips, complaints and referrals received by the SEC each year.

From a statistical perspective, the SEC's fiscal year 2009 was a busy time for enforcement. Among the highlights, the commission:

- Brought 664 cases, down slightly from its 671 actions in the prior year.

- Increased the number of cases brought against broker-dealers to 109 actions from FY 2008's 60 cases, a rise of 82 percent.

- Initiated 37 insider trading cases, a drop of 39 percent from 61 such actions in FY 2008.

- Filed 154 enforcement actions in FY 2009 in coordination with criminal actions brought by the U.S. Department of Justice, representing more than a 30 percent increase over FY 2008.

- Started 944 investigations in FY 2009, up 6 percent from FY 2008, and issued 496 formal orders of investigation, an increase of more than 100% compared to the prior year.

- Closed 716 investigations, down significantly from 1,355 actions closed in the prior year.

- Moved quickly to halt and punish misconduct by seeking 71 emergency orders in FY 2009 — an 82 percent increase from the prior year. The commission also filed 70 percent of its first enforcement actions within two years of starting an investigation or inquiry. That figure represents an 8 percent increase from the prior year.

- Obtained a "favorable" outcome in 92 percent of its cases — the exact same percentage it had achieved in the two prior years.

- Obtained $345 million in civil money penalties (up 35 percent) and $2.09 billion in disgorgement orders (a 170 percent increase).

Keeping with the theme of change at the commission, last year there were a number of new policy developments at the SEC. First, Chairman Schapiro ended the "penalty pilot" program in which staff attorneys had been required to obtain settlement ranges from the commission before starting penalty negotiations with corporate respondents.

Second, the process for obtaining formal orders of investigation was made more efficient by allowing senior Division of Enforcement officials to issue such orders, which allow the staff to subpoena documents and demand testimony under oath.

Third, the SEC began work on several initiatives to foster cooperation by individuals, including developing a public policy statement describing how the commission evaluates a person's cooperation in its investigations.

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In mid-January 2010, these efforts came to fruition with the publication of a formal statement concerning cooperation by individuals.

The Division of Enforcement also added several sections to its Enforcement Manual concerning new "cooperation tools" relating to both individuals and corporations, such as Cooperation Agreements, Deferred Prosecution Agreements, and Non-Prosecution Agreements.

In November 2009, the SEC joined President Obama's interagency Financial Fraud Enforcement Task Force, which is designed to strengthen the country's efforts to combat financial crime. This initiative is yet another example of the commission's efforts to coordinate its activities closely with criminal authorities.

Finally, in December 2009, the U.S. House of Representatives passed The Wall Street Reform and Consumer Protection Act of 2009.

If approved by the Senate in its current form, the bill would enhance the SEC's enforcement powers by providing it with access to grand jury materials in certain instances, establishing a new whistleblower bounty program, and authorizing the commission to obtain penalties in cease-and-desist administrative proceedings.

The legislation would also force the SEC to either commence an action or close an investigation within 180 days of a Wells notice in most cases.

FINRA

Last year marked the second full year since NASD Regulation and NYSE Regulation merged to form FINRA in July 2007.

On Feb. 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, and he continues to hold the latter position.

Since becoming FINRA's CEO, Mr. Ketchum has, among other things, focused on the importance of restoring investors' trust in the financial markets and the regulatory system and promised that FINRA's Department of Enforcement will have the resources it needs to investigate and discipline firms or individuals that harm investors.

The changes at FINRA last year, while not as striking as at the SEC, are noteworthy. To begin, in March 2009, FINRA created the Office of the Whistleblower to accelerate the review and analysis by senior FINRA staff of important tips and to assure a prompt response to meritorious investigative leads.

In October 2009, FINRA created the Office of Fraud Detection and Market Intelligence, which is responsible for analyzing allegations of fraud brought to the staff's attention either through its own internal processes or external sources.

The new Office encompasses several existing groups within the Departments of Market Regulation and Enforcement, but fraud cases will generally continue to be investigated in the field by examiners and enforcement staff.

The Department of Enforcement also spent time last year reviewing its case identification, opening, and investigative processes with the aim of being more "nimble and quick."

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Of note, it is likely that FINRA will increase its use of "onsite" enforcement investigations based upon the success it had with this technique in its 2008 ARS investigations.

Last year, FINRA significantly increased its use of sweeps, canvassing member firms on at least eight topics ranging from transactions with retail customers in various products to hedge fund advertising and sales literature to research and trading "huddles." This activity caused FINRA's chief of enforcement, Susan Merrill, to state that "sweeps are back in vogue."

FINRA resolved 1,103 cases last year, up 9.5 percent from the 1,007 such actions in 2008. It also appears that the fines imposed by FINRA in 2009 will exceed substantially the prior year's totals. Moreover, in 2009, FINRA announced six cases with fines of more than $1.5 million; there were no such actions publicized in 2008.

NYSE Regulation

Notwithstanding the creation of FINRA in 2007, NYSE Regulation retained independent oversight and enforcement responsibility for trading violations occurring on the NYSE's systems and facilities. Pursuant to a regulatory services agreement, NYSE Regulation also regulates the trading on NYSE Arca and NYSE Amex.

Not surprising, given its reduced mandate, the number of cases brought by NYSE Regulation in 2009 dropped substantially from prior years. NYSE Regulation released approximately 25 Hearing Board Decisions that have a 2009 case number (four of which relate to a single case involving four affiliates of one firm).

In 2009, NYSE Regulation announced about 46 decisions relating to its oversight of NYSE Arca and NYSE Amex.

--By Ben A. Indek (pictured) and Michael S. Kraut, Morgan Lewis & Bockius LLP

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] The SEC's fiscal year begins on Oct. 1. References to FY 2009 refer to the year that began on Oct. 1, 2008, and ended on Sept. 30, 2009.

[2] This article is based on The Year in Review, written by a Morgan Lewis & Bockius team that also included partners Anne C. Flannery and Kevin T. Rover and associates Julia Miller and John Shin, with assistance from associates Clare M. Cusack, Kerry J. Land, Alice L. McCarthy, Melissa J. Mitchell, Kurt W. Rademacher and David A. Snider. The authors were also assisted by legal secretary Mary-Elizabeth Denmark.

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