

Morgan Lewis

webinar

2013 SEC and FINRA Year in Review for Broker Dealers and Investment Advisers

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Agenda

- SEC Enforcement Developments
- SEC Enforcement Statistics
- Selected SEC Enforcement Cases
- SEC Enforcement Priorities
- FINRA Developments
- Conclusion

2013 Highlights: SEC Enforcement Developments

- Change on the Commission and in the senior staff
- Requirement of admissions in certain settlements
- “Broken Windows” strategy
- The SEC’s trial record
- Broker-Dealer Task Force
- Alternative investments and complex products

2013 Highlights: SEC Statistics

- FY 2013: A decline in the number of cases; a record in fines/disgorgements.
 - 686 cases (734 in FY 2012)
 - BD/IA/fund companies: 261 cases
 - Broker-dealers: 121
 - Investment advisers/funds: 140
 - Several financial crisis-related actions
 - 44 insider trading cases (58 in FY 2012)
 - \$3.4 billion in penalties and disgorgement
 - Disgorgement: \$ 2.257 billion
 - Civil penalties: \$ 1.167 billion

2013 Highlights: SEC Statistics (cont'd)



- **686** cases in FY 2013 (734 in FY 2012)
- **140** cases against investment advisers and investment companies (147 in FY 2012)
- **121** cases against broker-dealers (134 in FY 2012)
- Despite decrease in number of cases, \$3.4 billion in disgorgement and penalties was 10% increase vs. FY 2012 and 22% increase vs. FY 2011

2013 Highlights: SEC Statistics (cont'd)

- A “strong pipeline for 2014”
 - 574 Formal Orders of Investigation issued
 - 908 investigations opened last year
 - 1,444 ongoing investigations
- Whistleblower highlights
 - 8% increase in tips, complaints and referrals
 - \$14 million payment to a single whistleblower
 - SEC clarifies that anti-retaliation provision under Dodd-Frank applies regardless of reporting to SEC

2013 Highlights: SEC Cases

- Insider trading
- Municipal securities
- Regulation M – Rule 105
- Market Access Rule – risk controls
- Best execution and soft dollars
- Marketing and representations to clients
- Disclosure of errors
- Compliance reviews, policies and procedures
- Custody rule

2013 Highlights: SEC Enforcement Cases

- **Insider Trading**

- Remains a core focus of Enforcement program with aggressive insider trading actions targeting hedge fund managers, consultants, and corporate insiders
- Investigations and enforcement actions often instituted in tandem with the Department of Justice
- A series of recent cases illustrate that the regulators are heavily focused on firm supervision and culture of compliance

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Municipal Securities**

- Active enforcement and ambitious rulemaking climate continues into 2014
- Enforcement cases demonstrate that the SEC continues to focus on issuer and dealer disclosure obligations:
 - *Further targeted enforcement efforts through a new Cooperation Initiative for municipal issuers and underwriters announced in March 2014*
- SEC is working hand-in-hand with the Municipal Securities Rulemaking Board to enhance municipal market structure in line with its 2012 Report on Municipal Securities and implement the new permanent registration regime for municipal advisors:
 - *Initiatives underway include best execution of transactions in municipal securities, codification of dealer fair pricing obligations, and improving price transparency through markup disclosures for riskless principal transactions*
 - *In September 2013, the SEC adopted its final rule establishing a permanent registration regime for municipal advisors; the MSRB has advanced standards of conduct and a proposed rule on supervisory and compliance obligations of newly regulated municipal advisors*

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Rule 105 of Regulation M**

- SEC is committed to “strategic prosecution of smaller violations” to send a broad deterrent message
- In September 2013, the SEC charged 23 firms with short selling violations
- Many of these cases were instituted despite significant cooperation and self-reporting
- Reflects “zero-tolerance” policy
 - *Disgorgement sought as low as \$4,091*
- In connection with these cases, the SEC Office of Compliance Inspections and Examinations issued Rule 105 Risk Alert
 - *Alert reminds firms of the importance of robust compliance policies and procedures as well as employee training*

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Market Access Risk Management Controls**

- The SEC National Examination Program has identified market access controls as a core risk area for broker-dealers
- The SEC instituted its first enforcement action under the market access rule (Rule 15c3-5 of the Securities Exchange Act) against a firm for failing to have adequate controls and supervisory procedures in place to manage risks related to its use of an automated routing system for equity orders
 - *Firm lacked adequate controls for its order router to prevent the entry of orders that exceeded pre-set capital thresholds, price or size parameters*
 - *These failures resulted in billions of dollars of unwanted long and short positions and significant collateral consequences to other market participants*
- The SEC emphasized the importance of “prudent technology risk management,” including the need for regular and rigorous compliance reviews and investing of appropriate resources in technology, compliance, and supervisory infrastructure

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Best Execution and Soft Dollars**

- Reflects increasing focus on dual registrants and selection of affiliates for brokerage transactions
- Failure to adopt or implement best execution policies or to conduct a sufficient analysis to determine whether the adviser properly sought best execution for trades executed on behalf of advisory clients
- Failure to evaluate brokerage options for advisory accounts in a manner consistent with Form ADV disclosures
- Excess commissions on ETFs and selection of higher cost mutual fund share classes to generate 12b-1 fees
- Use of soft dollar credits from client commission arrangements for personal and other undisclosed and unauthorized purposes (and failure of broker-dealer to act on red flags associated with the payments)

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Marketing and Representations to Clients**

- False representations to mutual fund board of trustees in violation of Section 15(c) of the Investment Company Act
- Misleading advertisements that overstated the firm's performance and falsely claimed compliance with GIPS and false statements regarding pending regulatory investigations
- Falsifying fund financial statements and making false misrepresentations regarding redemption rights
- Representations that increase in value of holdings were attributable to performance instead of a change in valuation methodology

- **Disclosure of Errors**

- Failure to disclose and promptly correct coding errors

2013 Highlights: SEC Enforcement Cases (cont'd)

- **Compliance Reviews and Policies and Procedures**

- Continued focus on failure to adopt and implement compliance policies or to conduct annual compliance reviews under Advisers Act Rule 206(4)-7
- Chief compliance officers with minimal compliance experience or training
- Failure to comply with SEC examination comments regarding compliance failures and to take sufficient steps to remediate compliance improvements that the CCO identified
- Misleading fund CCO in violation of Investment Company Act Rule 38a-1(c)

- **Custody Rule**

- Focus on compliance with Advisers Act Rule 206(4)-2 (Custody Rule)
- Alleged failure to maintain client assets with a qualified custodian, engage an independent public accountant to conduct surprise examinations or deliver audited financial statements to private fund investors

2013 Highlights: SEC Enforcement Priorities

- **Sales Practices/Fraud**

- Unsuitable recommendations of higher yield and complex products (e.g., leveraged ETFs and structured products), as well as the adequacy of due diligence
- Suitability, representations, advertising or churning when recommending the movement of assets from a retirement plan to an IRA rollover account
- Suitability/disclosures around variable annuity buyback offers
- Micro-cap fraud and pump and dump schemes
- Affinity fraud targeting seniors or other groups
- Unregistered entities engaged in the sale or promotion of unregistered offerings or other unusual capital raising activities

2013 Highlights: SEC Enforcement Priorities (cont'd)

- **Trading**

- Best execution
- Use of technology, with focus on algorithmic and high frequency trading
- Information leakage and cyber security
- Market manipulation (practices such as marking the close, parking, spoofing, and excessive markups and markdowns)
- Relationships between broker-dealers and Alternative Trading Systems (“ATs”)
- Application of the Market Access Rule (15c3-5) to proprietary trading

2013 Highlights: SEC Enforcement Priorities (cont'd)

- **Internal Controls**

- Effectiveness of key control functions (liquidity, credit, and market risk management practices);
- Internal audit function;
- Valuation practices; and
- Overall compliance function.

- **Anti-Money Laundering**

- Focus on AML programs of proprietary trading firms that allow customers direct access to the markets from higher risk jurisdictions.

2013 Highlights: SEC Enforcement Priorities (cont'd)

- **Fixed Income Market**

- The structure and transparency of the market and its effect on the quality of executions;
- Use of filters by market participants to control what is displayed by fixed income ATSs; and
- Focus on transparency in the municipal securities market.

2013 Highlights: FINRA Statistics

- 1,535 new disciplinary actions
- 1,307 formal actions resolved
- 24 firms expelled
- 429 individuals barred
- 670 individuals suspended
- \$65 million in fines levied
- \$9.5 million in restitution to investors

2013 Highlights: FINRA Developments

- Personnel Changes
- “High Risk” broker enforcement program
- Responding quickly to fraudulent misconduct
- Credit for extraordinary cooperation
- Targeted examination letters and sweeps

2013 Highlights: FINRA Cases

- FINRA Actions:
 - AML: Failure to Monitor Suspicious Securities Trades
 - Operational Failures: Trade and Position Reporting, Customer Confirmations and Reports
 - Retention and Review of Electronic Communications
 - Sale of Unsuitable and Complex Products to Retail Investors
 - Reg SHO and Illegal Short Selling



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