SEC AND FINRA: PRIORITIES AND ENFORCEMENT TRENDS

The SEC and FINRA both showed significantly increased enforcement activity in 2011 compared with the two prior years, and the upward trend seems likely to continue in 2012. Future enforcement priorities include issues relating to the financial crisis, insider trading, complex products, and seniors.

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After brief regulatory slowdowns during the midst of the global economic downturn, both the SEC and FINRA have substantially increased enforcement activity in the past two years. Due to market events, varying leadership priorities, and organizational changes, these regulators have emphasized new and different areas of concern and their enforcement priorities continue to evolve. Broker-dealers, investment advisers, and their lawyers may want to diligently analyze the stated priorities of regulators and disciplinary trends if they want to try to avoid the increasing sanctions of these securities regulators. This article seeks to highlight the current areas of focus of the SEC and FINRA, and anticipates what issues may be subject to increased regulatory scrutiny in the future.

RECENT STATISTICS

SEC

In March 2011, Robert Khuzami, the SEC’s Director of Enforcement, announced that fiscal year 2010 (October 2009 to September 2010) was the most active of the past five years, as 681 cases were filed.\(^1\) Despite budgetary uncertainty and funding constraints, fiscal year 2011 (October 2010 to September 2011) dramatically outpaced those 2010 totals. On the heels of


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significant organizational changes in 2009 and 2010, including the creation of five specialized units to make investigations more targeted and efficient, the SEC’s Enforcement Division filed 735 actions in fiscal year 2011, the most in SEC history. SEC Chairman Mary L. Schapiro proudly noted that 2011 set an “unmatched record of holding wrongdoers accountable and returning money to harmed investors.” This included $2.8 billion in penalties and disgorgement in 2011, which was only slightly lower than 2010’s record-breaking fine total of $2.85 billion. There was also a substantial increase in the number of actions filed against regulated entities during the 2011 fiscal year. The SEC brought 146 enforcement actions against investment companies and advisers, which was a 30% increase from 2010’s total and a single-year record for the agency. The Commission also filed 112 enforcement cases related to broker-dealers, which was a 60% increase from 2010.

FINRA

In 2008, with the global financial crisis taking over news headlines, FINRA filed 1,073 disciplinary actions and collected $28 million in fines. The number of disciplinary cases filed in 2009 rose by a modest 8% from 2008. However, the amount of total fines in 2009 almost doubled from 2008’s $28 million to $50 million. The number of enforcement actions filed by FINRA rose significantly in 2010, from 1,090 in 2009 to 1,310 (although there was a $5 million decrease in the total amount of fines). FINRA’s Chief of Enforcement, J. Bradley Bennett, also recently noted that the number of 2011 enforcement actions through September was 10-15% higher than the number of cases filed in the first nine months of 2010. Mr. Bennett indicated that the total amount of 2011 fines was also on pace to surpass 2010’s figures.

The number of suspensions and industry bars has also increased, and Mr. Bennett emphasized that 2011’s restitution levels (as of September) have almost doubled 2010’s total. He stated that these awards are the most effective means of accomplishing FINRA’s ultimate goal of protecting investors because, unlike fines that are paid to a regulator, restitution payments are made directly to investors to help recoup losses allegedly caused by the improper activity at issue.

According to Mr. Bennett, this continuing expansion of regulator activity since 2008 is largely the result of an increase in the number of examinations and investigations FINRA has initiated and 2008 market crash issues that are still being addressed by regulators.

THE REGULATORY PRIORITIES

The SEC’s Stated Enforcement Priorities

Commission officials sometimes reveal in speeches and publications the enforcement issues the SEC will emphasize. In his March 2011 address, Mr. Khuzami highlighted insider trading and financial crisis issues as...
areas of regulatory concern.\textsuperscript{15} A review of the SEC’s recent enforcement actions reflects a greater emphasis on these types of cases. With the recent close of fiscal year 2011, the SEC announced that it filed 57 insider trading actions during the past year, an 8% increase over 2010’s figures.\textsuperscript{16} Notably, the SEC obtained 18 judgments in well-publicized actions relating to the investigation of Raj Rajaratnam, hedge fund manager and founder of Galleon Management, and his extensive insider trading scheme.\textsuperscript{17} For operating a widespread insider trading network, Rajaratnam received a record $92.8 million fine in November 2011, the largest penalty an individual has ever received in an SEC insider trading case.\textsuperscript{18} In addition, in October 2011, the SEC charged Rajat Gupta, a former member of the board of directors for two major companies, with allegedly providing Rajaratnam with inside earnings information about these two companies.\textsuperscript{19} The SEC also filed new insider trading charges against Rajaratnam in this same case for acting upon the information he allegedly received from Gupta.\textsuperscript{20}

In the same speech, Mr. Khuzami also emphasized that the SEC’s Enforcement Division would continue to make cases related to the recent financial crisis a top priority. Those results can be seen in the SEC’s 15 actions in fiscal year 2011 relating to the financial crisis, where 16 executives and senior officers were named as defendants.\textsuperscript{21} One such action was a $154 million settlement with a firm for failing to notify investors that the mortgage assets underlying a collateralized debt obligation (CDO) were selected by a hedge fund manager who held short positions in half of the CDO’s portfolio assets.\textsuperscript{22} Two other firms also agreed to a combined $41 million of penalties and disgorgement in separate CDO cases involving misrepresentations and suitability concerns.\textsuperscript{23} Another firm is currently defending an SEC enforcement action involving alleged misrepresentations made during the sale of $200 million of CDO investments.\textsuperscript{24} Including this recent wave of CDO cases, the SEC has filed 36 actions related to the financial crisis against 81 defendants in the past two-and-a-half years, which has already resulted in slightly less than $2 billion in penalties and disgorgement.\textsuperscript{25}

**FINRA’s Stated Enforcement Priorities**

FINRA publishes a Regulatory and Examination Priorities Letter each year that highlights the regulator’s priorities and the types of cases FINRA intends to emphasize and pursue. For example, FINRA’s 2011 Priorities Letter noted that short sales, private placements, municipal securities, electronic communications, and vulnerable investors were all areas of special concern for the regulator.\textsuperscript{26} Past priorities announced in these annual letters, such as trade reporting and suitability issues, have proven to be the subjects of heightened enforcement activity in subsequent years.\textsuperscript{27} Thus, firms may want to continue paying special attention to the topics listed in the 2011 letter, such as private placements and municipal securities. For example, so far in 2011, FINRA has brought at least eight municipal securities cases where it has fined firms at least $100,000 each. Most of these cases involved charges of failing to properly report municipal securities transactions or deliver the requisite paperwork to investors. However, the largest fine ($500,000) was for alleged payments to unaffiliated consultants to solicit nearly $2 million of municipal securities in violation of

\textsuperscript{15} See, e.g., Khuzami, supra note 1.

\textsuperscript{16} Supra note 2.

\textsuperscript{17} Id.


\textsuperscript{20} Id.

\textsuperscript{21} Supra note 2.


\textsuperscript{25} Supra note 2.

\textsuperscript{26} 2011 Annual Regulatory and Examination Priorities Letter, available at http://www.finra.org/web/groups/industry/ip/@reg@guide/documents/industry/p122863.pdf.

\textsuperscript{27} Brian L. Rubin and Andrew M. McCormick, Does FINRA Accurately Seed Enforcement Issues?, LAW360, May 17, 2011.
The Unexpected Enforcement Priorities

Despite a regulator’s stated enforcement priorities, unexpected new issues can emerge, such as the Dodd-Frank legislation or the collapse of the auction rate securities (ARS) market, which force regulators to de-emphasize their original game plans and shift resources to new priorities. For example, since the discovery of the extensive insider trading scheme involving Raj Rajaratnam and Galleon Management, insider trading cases have become a top priority for the SEC. While the SEC filed 37 insider actions in fiscal year 2009, the Commission brought 53 and 57 insider cases in 2010 and 2011, respectively, which represents a 54% increase over 2009. Not only was such a heavy emphasis on insider trading cases by the SEC unexpected prior to the unraveling of the Galleon insider trading scheme, but the Commission’s use of wiretapped phone conversations in these cases was also surprising since the SEC has no wiretapping authority. The Department of Justice played more than 40 secretly recorded phone conversations for the jury in the criminal case against Rajaratnam. Although criminal prosecutors cannot share wiretap evidence in parallel SEC civil cases, the Commission was able to obtain wiretapped conversations in the SEC civil action against Rajaratnam by asking for these materials during discovery. The successful use of wiretapping evidence in this case may lead the SEC to try to increase its use of this evidentiary tool in future enforcement actions.

Advertising concerns and credit default swaps (CDS) are two issues that unexpectedly captured the attention of FINRA in recent years. Although neither of these topics was highlighted in FINRA’s 2007 or 2008 Examination Priorities Letters, they resulted in substantial enforcement fines in 2009 and 2010. While advertising cases yielded the fifth highest amount of FINRA sanctions in 2009 ($5.5 million), they resulted in the largest category of 2010 fines at approximately $4.75 million. A substantial number of these sanctions stemmed from a series of ARS cases involving advertising literature that allegedly failed to disclose certain investment risks. ARS continues to be an area of concern for FINRA, as there have already been five significant actions filed against firms in 2011 for allegedly failing to properly disclose the risks of the ARS market. These cases have resulted in fines of nearly $10 million. CDS cases also rose to the top of FINRA’s enforcement priority list in recent years. Although these cases yielded no fines for FINRA in 2008, they resulted in a combined $7.65 million of sanctions in 2009 and 2010 due to a set of related cases involving improper communications about customers’ proposed brokerage rate reductions in the wholesale CDS market. CDS cases yielded no fines in 2011.

FUTURE ENFORCEMENT PRIORITIES

As discussed above, the SEC and FINRA appear to be steadily returning to their peak levels of regulatory activity despite budgetary and resource restraints. The financial industry can expect a likely increase in enforcement actions so long as the effects of the 2008 financial crisis continue to be felt. In the speeches previously noted, Messrs. Bennett and Khuzami have emphasized that there are many problematic issues relating to the financial crisis that still need to be addressed, including those relating to ARS and CDO securities. As discussed above, the SEC and FINRA have each actively pursued firms for misrepresenting or

32 Heilizer, supra note 7, at 1.
37 Supra notes 1 and 11.
omitting the risks associated with these securities in recent years and will likely continue to do so in 2012.

In addition, although most of the topics listed below did not result in substantial disciplinary sanctions for the SEC and FINRA in 2009 or 2010, they will likely be priorities for regulators in the coming years. Regulators such as Mr. Bennett and Susan Axelrod, the Executive Vice President of FINRA’s Member Regulation Sales Practice, have emphasized the following 10 specific areas of concern in FINRA’s Examination Priorities letters or in recent speaking engagements:

1) Form U4 and U5 reporting; 2) structured products; 3) complex investments; 4) vulnerable investors; 5) non-traded REITs; 6) anti-money laundering; 7) fraud; 8) municipal securities; 9) issues relating to the financial crisis; and 10) attorney misconduct. 38

Ms. Axelrod has specifically expressed a concern about complex products and whether registered representatives truly understand these types of investments and their suitability for their clients. 39 A recent FINRA investor alert also warned that investors should carefully evaluate and review potential non-traded REIT investments. 40 As a result, broker-dealers and their representatives may want to take steps to ensure that REITs, CDOs, and other complex products are adequately explained to investors and that these investments are suitable for their customers.

The dawn of the retirement of the baby boom generation has brought with it a strong regulatory focus on older investors. In a November 2011 Regulatory Notice, FINRA again expressed its increased interest in ensuring that firms are dealing fairly with seniors, who are seen as vulnerable investors by regulators. 41 Senior issues were highlighted as an area of concern in FINRA’s 2011 Enforcement Priorities Letter, 42 and this recent Notice specifically reminded firms when it is appropriate to designate a representative as an expert in senior investments. 43 Since complex products and senior issues have both been repeatedly emphasized by regulators as priorities, firms may want to review their policies and supervision concerning senior designations and the suitability of recommendations to elderly investors.

Given that the 10 issues listed above have been cited as special concerns by the top enforcement regulators at the SEC and FINRA, firms have a road map that may guide internal review of the relevant regulatory rules, firm procedures, and supervisory controls concerning these topics. These issues, including complex investments and concerns about vulnerable investors, are likely to be the subject of enforcement actions in the next few years.

CONCLUSION

No one can predict with complete accuracy the issues that the SEC or FINRA will choose to emphasize going forward. Financial firms and their representatives can prepare themselves, however, by focusing on the publicly stated enforcement priorities of these regulators. Efforts to review or improve firm policies, procedures, and supervisory controls related to these priorities may pay dividends in the future by minimizing or avoiding potential issues and liabilities. Firms also may be able to protect themselves by carefully reviewing FINRA’s published outcomes of its recent enforcement actions each month, which may reveal regulatory trends and areas of emphasis. Further, attending seminars and conferences about the enforcement priorities of the SEC and FINRA, and reading journals like The Review of Securities & Commodities Regulation, may help firms anticipate enforcement trends and be better prepared to respond proactively to both stated and changing regulatory priorities. Firms may want to pay close attention to disciplinary trends and the enforcement priorities highlighted by regulators since these will likely be the subjects of significant regulatory attention in the near future. All of these steps may help firms avoid substantial disciplinary actions.

38 Id.; Susan Axelrod, Executive Vice President, Member Regulation Sales Practice, FINRA, Conversation with the Head of FINRA’s Member Regulation Sales Practice Area, at the ALI-ABA course “The Financial Services Regulatory Revolution” (Sept. 23, 2011).

39 Axelrod, supra note 38.


43 Supra note 41.