

New and Continuing Developments in the SEC's Examination and Enforcement Programs (With FINRA Following Suit)

by Sylvia M. Scott

As we all know, the SEC and FINRA are under tremendous pressure in the wake of the financial crisis to probe every nook and cranny to eradicate fraud and any other conduct that they believe threatens investors and the integrity of the marketplace. As the SEC and FINRA perform these intense probes, anything they find along the way is 'fair game' for a deficiency letter or enforcement action. Both the SEC and FINRA have adopted multiple reforms to ramp up their examination and enforcement programs. In short, the pendulum has swung decisively in the direction of heavy regulation and zero tolerance enforcement.

Enduring these tough regulatory times is about "survival of the fittest" from a compliance perspective. While a "survival of the *fit enough*" approach sufficed in the past, this approach is not powerful enough in the current regulatory environment.



vs.



Today's Standard (ok, a bit of an exaggeration)

Old Standard

A visit to the enforcement sections of the SEC's or FINRA's websites sends a clear message that treating compliance like a neglected stepchild can mean the demise of even a profitable firm. The SEC and FINRA are bringing more enforcement actions than ever before and are coordinating efforts through referrals to one another and by sharing information and expertise.

Sylvia Scott is a partner at the Los Angeles-based law firm *Freeman, Freeman & Smiley, LLP* and a former enforcement attorney with the SEC and NASD (nka FINRA).

While the SEC's (and FINRA's) tougher policies can have catastrophic consequences for industry participants, firms should have nothing to fear if they have the "fittest" compliance programs, stay up-to-date on regulatory developments and know how to handle regulatory examinations. The goal of this article is to address 1) new and evolving changes in examination approaches and techniques, 2) the new enforcement landscape, and 3) how firms should respond to all of these new and continuing changes. My last article in the September/October 2009 Currents issue provided guidance on maintaining an evergreen compliance program and handling a regulatory examination, also critical elements for surviving these tough regulatory times.

Changes In Examination Approaches and Techniques

Since the Madoff and other financial scandals, the SEC's examination program has undergone significant changes and will continue to change as newly appointed OCIE Director Carlo di Florio settles into his new position. Additionally, the SEC recently established the Division of Risk, Strategy and Financial Innovation (or "RiskFin") as a type of "think tank" that will likely influence continuing changes in the SEC's examination program. In short, the examination program is like a moving target that firms must constantly monitor. A good watchword for firms in these times is vigilance. Summarized below are some additional changes in exam approaches and techniques, along with identifiable consequences and implications:

1. Greater collaboration between the SEC's BD and IA examination programs. Consequences:

- Broader and longer examinations, requiring even more firm resources (and patience).
 - Dual BDs/IAs and affiliated BDs/IAs will be particularly impacted. Conflicts (requiring disclosure) will be more readily identified. More enforcement actions.
2. Greater collaboration among the regulators. Consequences:
- SEC will increase referrals of smaller BD cases to FINRA. FINRA will refer IA cases to the SEC.
 - More enforcement actions.
3. Conducting risk-based examinations. Consequences:
- Firms need to ramp up their risk management department and work closely with compliance in this area.
 - More enforcement actions.
4. Enhanced "Human Intelligence" at the SEC – i.e., hire specialists, provide more staff training, etc. Consequences:
- "Smarter" and more focused examinations.
 - More sweeps in potential problem areas identified by specialists.
 - More enforcement actions.
5. Longer document requests, with shorter deadlines and less flexibility in granting extensions. Consequences:
- Obvious strain on the firm and its staff.
 - Shorter timeframe for bringing enforcement actions.
6. Examiners working more closely with enforcement staff to analyze potential violative conduct and move quickly if necessary. Consequences:
- Firms must take all exams very seriously; no more casual approaches, whether or not you believe you have nothing to hide. See my prior article for handling regulatory exams.
 - More emergency enforcement actions.

The common thread that runs through all of these changes is that

they are intended to bring more enforcement actions. Because the SEC oversees FINRA, similar changes at FINRA are being adopted, with the goal of bringing more enforcement actions. This effort is being aided by the addition of new staff and the reduction of certain senior staff so that more investigators and examiners can be hired.

What this means for all firms (including small firms) is that they can no longer take a casual approach to exams and investigations, under any circumstances. All firms must adopt formal procedures for handling regulatory exams, sweeps and cause investigations. For example, firms should not permit their employees to submit to “casual,” impromptu interviews by regulators. All firms should have a knowledgeable and professional point person to receive and handle all regulatory requests. This is particularly important as the regulators integrate specialists and experts into the examination process.

Firms should also strive to get ahead of problems and diffuse them should they surface. This may lessen the chance of an enforcement referral or a referral to another regulator. When faced with a never-ending document request that seems to ask for every piece of paper ever generated by your firm, the firm’s point person may have some success in negotiating an extension if there truly is such a need. For example, with smaller firms, it might be physically impossible to meet the deadline. Usually the staff will grant an extension in limited circumstances provided the firm can detail a reasonable basis for the request. If the staff refuses to grant what appears to be a reasonable request, this can be a signal that the staff believes that they have identified a potential emergency that might require an emergency enforcement action. If this is the case, the firm should immediately contact its counsel. If however you genuinely believe that the staff is not behaving

reasonably, you should consider escalating the matter to a supervisor, or you can call the SEC’s Examination Hotline (202.551-EXAM) as a last resort.

The New Enforcement Landscape

The SEC’s enforcement program, like its examination program, has been the subject of many new reforms and continues to evolve as new senior managers settle into their positions. To begin with, the SEC recently established five specialized units to address SEC priority areas:

1. Asset Management — This unit is led by Co-Chiefs Bruce Karpati and Robert B. Kaplan and focuses on investigations involving Investment Advisors, Investment Companies, Hedge Funds, and Private Equity Funds.

2. Market Abuse — This unit is led by Daniel M. Hawke and will focus on investigations involving large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others.

3. Structured and New Products — This unit is led by Kenneth R. Lench and focuses on complex derivatives and financial products, including credit default swaps, collateralized debt obligations, and securitized products.

4. Foreign Corrupt Practices — This unit will be led by Cheryl J. Scarborough and focuses on violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies from bribing foreign officials for government contracts and other business.

5. Municipal Securities and Public Pensions — This unit is led by Elaine C. Greenberg and focuses on misconduct in the municipal securities market and in connection with public pension funds including offering and disclosure fraud; tax or arbitrage-driven fraud; pay-to-play and public corruption violations; public pension accounting and disclosure violations; and valuation and pricing fraud.

Because the SEC has made these

areas its priorities, firms should do likewise to the extent their business models are reasonably likely to overlap in these areas. You can bet that the examination program is coordinating with these new enforcement units to develop new examination approaches to find enforcement cases in these areas. The SEC’s enforcement program is also increasing its resources and streamlining management (including the reassignment of first-line managers as staff investigators). Existing management has also seen a substantial increase in its authority. The Commission has delegated to the Enforcement Division Director and other senior officers the authority to issue formal orders of investigation, which gives the staff the power to issue subpoenas. This means that a firm’s failure, or perceived failure, to cooperate will be swiftly followed by a subpoena possibly as soon as the following day.

Additionally, certain senior officers below the rank of Deputy Director now have the authority to make “routine” case decisions like issuing a “Wells” notice (i.e., notifying the subject(s) of an investigation that the staff intends to recommend enforcement action). Enforcement Division Director Robert Khuzami also announced the creation of the Office of Market Intelligence, which was formed to evaluate the many tips, complaints and referrals received by enforcement.

Most recently, in a further effort to unearth fraudulent activity, the Enforcement Division has adopted a number of policies to encourage individuals and companies to cooperate with SEC enforcement actions and investigations. The SEC Enforcement Manual (posted on the SEC’s website) lays out the criteria for evaluating cooperation and the extent to which persons might receive “credit” for their cooperation.

(Continued on page 12)

ENFORCEMENT PROGRAMS*(Continued from page 11)*

Each situation will involve a highly fact-intensive analysis, and the effectiveness of this new initiative remains to be seen.

FINRA's enforcement program, for its part, is mimicking many of the SEC's trends like increasing resources, streamlining management and designating specialists. Additionally, FINRA's examination and enforcement staff coordinate efforts on large cases and sweeps.

While all of these regulatory reforms are bewildering to firms, there are a number of tried and true measures that firms can employ to survive all of this regulatory scrutiny. First, make sure your compliance fundamentals are solid and evergreen. Second, make the SEC's priority areas your firm's priority areas, where applicable. Third, make the new stars of your firm the compliance staff and foster an environment of good compliance. Fourth, foster an environment of open communication so that potential whistleblowers will go to your firm's compliance department before they go to the regulators. Fifth, think of ways to provide incentives for encouraging good compliance (not just punishing "bad" behavior). For example, branches that receive exceptional audit results might receive special bonuses.

In sum, by having a fit compliance program and a healthy compliance environment, firms should have nothing to fear but should nonetheless remain vigilant and careful should the regulators come calling.

YOUR QUESTIONS ANSWERED

Your compliance
questions answered
through the collective
wisdom of NSCP's
membership community.

Available to members only.

www.nscpfforums.com

