Ten Questions Key to the Current Regulatory Climate

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BAKER BOTTS

Current State of Financial Regulation

- SEC penalties down 66% year over year
- FINRA enforcement numbers also declining from record 2016
- SEC and FINRA leadership focusing on retail investor protection
  - Ponzi schemes, boiler rooms, penny stocks, affinity fraud, sales practice abuse
- These areas will remain the priorities until overtaken by events or political change
- Expect a decline in non-scienter and supervision-based actions
- Regulators and Congress aligned in the focus on fraud and intentional misconduct
- State attorney generals remain active and unpredictable
- Class actions on a record pace, driven by qualitative materiality theories
- Customer arbitration claims at record low levels

Particular Challenges Facing FINRA

- Migration of assets to advisory accounts/fiduciary duty rule/lack of jurisdiction over advisory accounts
- Rise of index investing and fintech
- Decline in taxable trading volumes
- Failure to win CAT processor/viability of RSA business
- Decline in broker-dealers
  - 80 percent or more of registered representatives work for 20 largest firms
  - Number of B/D's still exceeds historical levels
- Absence of political support for larger role
- Unpredictable cash flow streams
- FINRA 360 Review designed to identify risks and opportunities
  - combination of duplicative enforcement and examination functions
  - right size organization to its revenue stream

SEC Chair Clayton's Enforcement Philosophy

- Limited record:
  - confirmation testimony
  - speech to the Economic Club of New York, July 12, 2017
  - limited number of enforcement actions
- Strong focus on retail investor protection "Mr. & Mrs. 401(k)"
- Vigorous pursuit of those who "lie, cheat and steal"
- Skeptical of systems and supervision cases
- Compliance costs versus benefits to investors
  - AML, control architecture failures
- Individual accountability provides the greatest deterrence
- Penalties tied to shareholder benefit, shareholder loss, existence of a "real" victim, and level of intent

Question 1: Is it safer to operate in gray areas?

- **No**
- Neither the SEC nor the Department of Justice has much of an appetite for pursing negligence-based cases where there is no benefit to shareholders or identifiable victims, but there is every indication that intentional violations of criminal and civil statutes governing business conduct will be vigorously pursued.
- Company would be foolish to court disaster by cutting back on systems or compliance or taking more aggressive positions on its financial reporting in hopes that regulators will not pursue the conduct.
- No indication that willful blindness will be tolerated in such high penalty areas as the Foreign Corrupt Practices Act, the Securities Act of 1933 and the Securities and Exchange Act of 1934, insider trading, or mail and wire fraud.

Question 2: Do individuals have a lower risk of prosecution?

- **No**
- The Holy Grail of corporate enforcement actions remains the prosecution of responsible individuals.
- One of the first statements offered by Chair Clayton during his confirmation was that nothing provides deterrence like the vigorous prosecution of individuals.
- The Department of Justice procedures are explicit in requiring prosecutors to justify the failure to name individual corporate employees if they propose settling a corporate prosecution with an action solely against the corporation.
- Per AG Sessions "the Department of Justice will continue to emphasize the importance of holding individuals accountable for corporate misconduct. It is not merely companies, but specific individuals, who break the law."
- FINRA also focused on naming individuals, particularly in high risk areas

Question 3: Has whistleblower risk declined?

- **<u>No</u>**
- No indication that whistleblower activity is driven by enforcement policies
- Vast majority of the whistleblower complaints received by the SEC are filed by lawyers on behalf of clients seeking bounty payments
- Whistleblower complaints have also become a key strategic lever in employment disputes, often in an effort to gain the protection of anti-retaliation provisions
- Other motivating factors are the absence of internal reporting mechanisms, distrust of the corporate culture, and a genuine feeling that the employee has been aggrieved
- SEC expanding the pool of eligible whistleblowers to include state and local government personnel in non-enforcement positions and those participating in the wrongdoing

Question 4: Can we expect lower fines and penalties?

- **<u>Yes</u>**, unless there is compelling evidence of fraud
- SEC returning to the *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Release 2006-4 (January 4, 2006)
- Key drivers are (1) the presence or absence of a direct benefit to the corporation as a result of the violation; (2) the degree to which the penalty will recompense or further harm injured shareholders; (3) the need to deter the particular type of offense; (4) whether complicity was widespread throughout the corporation; (5) the level of intent of the perpetrators; (6) the degree of difficulty in detecting the particular type of offense; (7) the presence of remedial steps; and (8) the extent of cooperation with law enforcement.
- Applied literally, drastic reduction of penalties in complex systems and supervision cases as by definition the conduct in these matters does not involve intentional wrongdoing, complicity, or a benefit to shareholders, and the vast majority of systems failures are remediated by the corporation.

Question 5: Will the benefits of self-reporting become more apparent?

- <u>**Yes**</u>
- SEC appears to be looking for ways to visibly reward companies who self-report misconduct.
- Recent enforcement actions suggest that fines will be lower for those companies who self-report and provide meaningful cooperation.
- FINRA, stressing restitution over penalties and rewarding the firms who find and fix their own problems.
- FINRA has been among the most aggressive in rewarding self-reporting despite the fact that Finra Rule 4530 requires firms to self-report material issues
- <u>**Even if you do not find the issue, prompt remedial action will be credited by the regulators**</u>

Question 6: What will be the effect of *Kokesh v. U.S.* on the SEC Enforcement Program?

- Limited practical effect on financial remedies in SEC actions
- Footnote 3 of the Opinion invites a challenge to the use of the disgorgement remedy as a penalty unauthorized by statute
- SEC can always add what they would have gotten as disgorgement to the penalty amount.
- Will increase the use of tolling agreements
- Will pressure SEC to complete cases in five years

Question 7: Is there more flexibility in disciplining senior employees?

- **<u>Probably not</u>**
- Individual discipline is one of the most compelling ways in which a corporation communicates to regulators that it “gets it”.
- Also consistent with effective remediation
- Market expects that the corporation will take meaningful steps to move beyond the issue

Question 8: Will SEC and FINRA investigations become less exhaustive and expensive?

- **<u>No, if case turns on intent and individual liability</u>**
- Toughest challenge for investigators in complex cases is proving intent and identifying culpable individuals
- Diffusion of responsibilities requires more testimony and email review
- Settlement of fraud charges without an individual defendant will be more rare
- Companies should careful review extent of indemnification obligations and insurance coverage
- No targeting of legal and compliance personnel, particularly in supervision cases

Question 9: What is the effect of Finra's combination of enforcement functions?

- "Speed camera" trade reporting and data entry cases should decline
- More thorough vetting of Market Regulation cases should lead to more logical outcomes
- Role of RSA clients in enforcement matters may decline
- Opens the door for a broad range of work stream improvements
- Accretive with other changes likely to come out of FINRA 360
- Expect significant turnover of longstanding staff
- Closer coordination with SEC to avoid regulatory duplication

Question 10: Have the standards changed for when to launch an internal investigation?

- **Yes**.
- Red flags, hot line reports, and alleged violations of corporate policies and codes of conduct must be resolved in the ordinary course pursuant to established WSPs.
- There is more leeway in crafting an incremental and risk-based response to allegations.
- The use of internal mechanisms, such as in-house lawyers, internal auditors, and corporate compliance personnel in the initial stages is quite reasonable where the allegations do not implicate a material business line or senior corporate officers.
- Documentation of the review, the preservation of relevant evidence, the use of personnel whose conduct is not at issue, and strong reporting lines are key, as is the willingness to change the investigative plan if the evidence suggests broader issues or a more significant reputational risk.

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