VENABLE® LLP

SEC Update

October 2013

Broken Windows and Broken Gates: SEC's White Vows to Repair and Clean Up the Securities Market

AUTHORS

Michael J. Rivera

Hillary S. Profita

RELATED PRACTICES

Securities Enforcement and Compliance

Investigations and White Collar Defense

ARCHIVES

2013 2009 2005
2012 2008 2004
2011 2007 2003
2010 2006

At last week's renowned *Securities Enforcement Forum 2013* in Washington, DC, SEC Chairwoman Mary Jo White and her senior Enforcement Division colleagues continued a now familiar drumbeat of aggressive enforcement. These officials reiterated recent warnings that the SEC will seek to deter misconduct by punishing companies, as well as individuals, for major and minor violations of the securities laws that occur across all corners of the securities market.

In the conference's **keynote speech**, Ms. White said investors want the SEC to patrol the markets like a "strong cop on the beat." Ms. White likened the SEC's current enforcement strategy to the "Broken Windows" approach employed by former New York City Mayor Rudolph Guiliani and Police Commissioner Bill Bratton to combat crime in the 1990s. ("Broken Windows" refers to the theory that when a window is broken and later fixed, this signals that disorder will not be tolerated. When a broken window is not fixed, it sends a signal that breaking windows will bear no consequences.) Guiliani and Bratton "essentially declared that no infraction was too small to be uncovered and punished," said Ms. White. She explained that the "same theory can be applied to our securities markets – minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines."

Ms. White also used the occasion to elaborate on comments she made during a speech two weeks earlier regarding her **aggressive enforcement initiatives**. Specifically, Ms. White outlined the SEC's "expanding reach" through initiatives such as the National Exam program, the whistleblower program, the increased technological capabilities, and the targeting of industry "gatekeepers." With respect to the latter, Ms. White said that the public could expect more cases against "critical gatekeepers," such as auditors. And she highlighted the SEC's "Operation Broken Gate" initiative, which targets auditors who have neglected their duties and the required auditing standards.

Ms. White also underscored the more than two dozen **Rule 105 enforcement actions** filed by the SEC on a single day last month, which yielded disgorgements as small as $4,000 and as large as $2.5 million. The $4,000 disgorgement confirmed Ms. White was not exaggerating when she warned that "no amount is too small to escape our attention." Ms. White also announced that the Enforcement Division plans to "step up" its use of technology to detect wrongdoing, through programs such as the Advanced Bluesheet Analysis Program, which identifies suspicious trading in advance of market-moving events and helps to prove relationships between tippees and tippers in insider trading cases. Finally, while she recognized that "the SEC cannot literally be everywhere," Ms. White proclaimed "we will be in more places than ever before."

The *Securities Enforcement Forum* also featured a historic panel of four former Enforcement Division Directors comparing notes with the current Co-Director of Enforcement, Andrew J. Ceresney. The panel discussed the efficacy of requiring admissions of wrongdoing in settlements – a hot topic in recent months. Mr. Ceresney said that while the SEC has identified the types of cases in which the SEC may require admissions, most settlements would continue to include the traditional "no admit/no deny" language. Notably, Mr. Ceresney said that potential collateral consequences resulting from company admissions would *not* be taken into consideration in determining whether to require an admission as part of a settlement. Mr. Ceresney also stated that the SEC would look to bring market structure cases that involve alternative trading systems. (Indeed, one week after making this comment, the **SEC sued Knight Capital** in the agency's first enforcement action under the market access rule – Exchange Act Rule 15c3-5.) In the investment adviser area, Mr. Ceresney said the SEC would pursue traditional fraud cases, use new technology to investigate insider trading, and scrutinize the process by which fund boards approve investment adviser contracts and fees.

A panel on trends involving the Foreign Corrupt Practices Act (FCPA) featured an extensive discussion

on the potential benefits of self-reporting possible violations to the SEC. Kara Novaco Brockmeyer, Chief of the SEC Enforcement Division's FCPA Unit, said that the SEC's treatment of a self-reporting company depends on the magnitude of the problem being reported. If the potential misconduct is detected by the company in its nascent stages and the magnitude of the problem is small, the SEC will most likely allow the company to complete its own investigation. However, if the misconduct has progressed significantly, Ms. Brockmeyer said the SEC would unlikely ask the company to complete its own review. Nonetheless, Brockmeyer said that companies that self-report "always end up better" than those that do not. Importantly, Ms. Brockmeyer noted there have been at least six instances in the last six months where companies had self-reported potential FCPA violations and the SEC declined to initiate an enforcement action. Ms. Brockmeyer also rejected the notion that the SEC would automatically seek to impose a monitor on any company that self-reported an FCPA violation. Indeed, commented Ms. Brockmeyer, a company's own discovery of an FCPA problem suggests that its compliance procedures are effective.

Joseph Brenner, Chief Counsel for the SEC's Enforcement Division, speaking on a panel regarding SEC and FINRA investigations, commented that: (i) the SEC is renewing its use of Exchange Act Section 21 (a) reports of investigation, noting that three have been issued this year; and (ii) there is renewed focus on supervisory responsibilities at regulated entities, noting that supervisors who delegate compliance functions must "follow-up" to ensure the delegate is performing them. Mr. Brenner identified the following additional areas of interest with respect to investment advisers and broker dealers: best execution; investment adviser conflicts; the custody rule (Advisers Act Rule 206(4)-2); fee calculations; insufficient policies and procedures generally; and failures to implement recommendations identified in deficiency letters issued by OCIE. Associate Director of Enforcement Stephen J. Cohen noted during a panel on financial reporting and accounting fraud that there is a "great hunger" for accounting fraud cases at the Department of Justice, with whom the SEC continues to work closely on such matters.

The following additional comments of interest were made by other panelists and speakers at the *Securities Enforcement Forum*:

- Former SEC Commissioner Troy A. Paredes opined that the SEC's resources are best allocated to cases involving the greatest level of culpability and the most significant harm to investors. Mr. Paredes added that it is not the best use of SEC resources to sue over technical violations and other infractions not requiring scienter. (This view contrasts with Ms. White's effort to employ a "Broken Windows" enforcement strategy.)
- The Honorable Stanley J. Sporkin, a former SEC Enforcement Director, shared his view that the SEC would be best served by focusing on proactively gaining more market intelligence, perhaps by leveraging internal resources such as the Division of Corporate Finance, which is best placed to search for trends in the market. Judge Sporkin also recommended that the SEC staff eliminate the new practice of requiring admissions in cases and suggested that the SEC issue more investigative reports under Section 21(a) of the Exchange Act to convey information and issues the Staff wants to publicize.
- Claudius B. Modesti, Director of the Public Company Accounting Oversight Board (PCAOB) Division of Enforcement and Investigations, highlighted various emerging areas of focus for his division, including foreign-based audits and cases against individuals who do not cooperate with the PCAOB enforcement process.
- Emily P. Gordy, Senior Vice President, Chief of Staff and Deputy of FINRA's Department of Enforcement, stated that: (i) FINRA is more frequently using its temporary cease-and-desist authority to halt improper activities (Gordy noted that FINRA has used this power four times in the past ten months, after not using it since 2004); (ii) FINRA is initiating more expedited proceedings to force members to cooperate with investigations and resolve situations involving significant delays by members (FINRA can suspend a member for such a failure to cooperate); (iii) FINRA has issued a **framework for its rulemaking approach** to conducting economic impact assessments to ensure that its rules better protect the investing public and maintain market integrity while minimizing unnecessary burdens; and (iv) FINRA would issue a report shortly on conflicts of interest in the broker-dealer industry to highlight effective conflicts management practices (FINRA subsequently issued the **report** on October 14).

*For more information regarding this alert, please contact **Michael J. Rivera** or **Hillary S. Profita**. Mr. Rivera is Chair of Venable's **Securities Enforcement and Compliance Practice Group**.*