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Time To Focus On Compliance Programs Again: SEC Enforcement Actions And Sanctions Are On The Rise

Probably to no one's surprise, given the SEC's much publicized enforcement efforts, the Commission has announced that it filed a record number of enforcement actions over the last three fiscal years and secured record payouts in penalties and disgorgements.[1] Over this period, the SEC has taken aim at a broad spectrum of conduct in the securities markets and targeted a diverse range of market actors.

Although the SEC has divided its focus across a range of different areas, three themes have emerged from its increased enforcement activity. First, the SEC has aggressively targeted lapses in regulatory compliance and risk controls over a broad spectrum of conduct and industries. Second, the SEC has increasingly relied on technology to detect such misconduct. And third, the SEC has made substantial awards to whistleblowers for providing information that has led to successful enforcement actions.

Considering this increase in enforcement activity, companies and individuals engaged in business relating to the financial industry need to be prepared to meet the SEC's heightened scrutiny. With this in mind, it is a good time to revisit compliance programs, policies and procedures to assure they are up-to-date and focus on the concerns of the SEC and requirements of the securities laws.

According to a recent press release, the Commission reported that it had filed a record high of 755 enforcement actions in Fiscal Year ("FY") 2014. Along with those actions was another high mark: orders for

penalties and disgorgement in the amount of \$4.16 billion. That reflects a 22% increase in penalties and disgorgement as a result of SEC enforcement actions over last year. In FY 2013, the Commission filed 686 enforcement actions and obtained orders totaling \$3.4 billion in disgorgement and penalties. In FY 2012, the Commission filed 734 enforcement actions and obtained orders totaling \$3.1 billion in disgorgement and penalties.

The SEC continued to crack down on traditional financial fraud, charging more than 135 parties with violations relating to reporting and disclosure. At the same time, it continued its focus on misconduct relating to complex financial instruments such as mortgage-backed securities and collateralized debt obligations, and it brought several novel actions targeting deficient compliance and control practices. For example, the SEC successfully held global investment bank and brokerage firm Jefferies LLC responsible for its failure to properly supervise trading on its mortgage-backed securities desk. The SEC also brought actions, for the first time, under a rule requiring firms to establish adequate risk controls before providing customers with market access. It imposed the largest penalty ever for net capital rule violations in a case against a high frequency trading firm and a former senior executive. And it also filed enforcement actions against the New York Stock Exchange and brokerage subsidiaries for their failure to comply with exchange rules, and Wells Fargo Advisors LLC in the Commission's first case against a broker-dealer for failing to protect a customer's material nonpublic information.

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The compliance and control practices and procedures of private equity firms, investment advisers and investment companies were also in the SEC's line of sight. According to the Commission, it brought its first-ever action under the investment adviser "pay-to-play" rule. The SEC also filed its first action arising from a focus on fees and expenses charged by private equity firms. It also instituted an action against a private equity firm and its president, alleging fraud in the allocation of expenses to the firm's funds. Finally, the Commission charged three investment advisory firms with failure to maintain adequate controls on the custody of customer accounts.

Accountants, attorneys and compliance professionals also found themselves contending with SEC enforcement actions this past year. In one matter, the SEC filed an action against Ernst & Young LLP relating to auditor independence rules. In another, the SEC filed an action against an audit firm and four of its auditors for their roles in the failed audits of three China-based companies. The Commission charged two Florida-based attorneys, a transfer agent and its CEO for their roles in an offering fraud involving improper distributions of billions of shares of unregistered stock. Finally, in a fraud case, the Commission charged a company's audit committee chair, who learned of the misconduct in question and failed to take meaningful action to investigate it or disclose it to investors.

The SEC also touted its success in using new technologies to detect market misconduct over the last three years. SEC Chair Mary Jo White stated that "[t]he innovative use of technology – enhanced use of data and quantitative analysis – was instrumental in detecting misconduct and contributed to the Enforcement Division's

success in bringing quality actions that resulted in stiff monetary sanctions." The SEC successfully used quantitative analytics to identify especially high rates of filing deficiencies and brought coordinated charges against 34 individuals and companies for violating laws requiring them to promptly report information about their holdings and transactions in company stock. The SEC pursued wrongdoing by asset managers through proprietary analytics that identify hedge funds with suspicious returns. It also employed "next generation analytical tools to help identify patterns of suspicious trading" in its continued efforts to eliminate trading on the basis of inside information. Over the last three years, the SEC charged 80 people in connection with insider trading and, among those charged are a former hedge fund trader, a portfolio manager, the co-chairman of a board, an investment banker, an investor relations executive, an accountant, husbands who traded on information they learned from their wives, and a group of golf buddies and other friends. There is every reason to expect that the continued use of these techniques will lead to more enforcement actions across a broad spectrum of market conduct.

Lastly, the SEC's record payout of awards to whistleblowers is bound to incentivize whistleblowers to come forward and may lead to more prosecutions of individuals. In FY 2014, nine whistleblowers received awards totaling approximately \$35 million, including one that was more than \$30 million for a whistleblower who provided key original information that led to a successful enforcement action. That award was the largest-ever whistleblower award. The Commission also demonstrated its commitment to protect whistleblowers in that it brought its first charges under new authority to bring anti-retaliation

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enforcement actions. In that case, the SEC charged a hedge fund advisory firm with engaging in prohibited principal transactions and then retaliating against the employee who reported the trading activity to the Commission. It also charged the firm's owner in connection with the principal transactions.

In terms of actions against individuals in addition to companies, as U.S. Attorney General Eric Holder recently remarked, cases against individuals are more easily brought when there is a witness who is able to provide evidence of a corporate executive's knowledge of and intent to participate in wrongdoing.^[2] Those witnesses are more incentivized to come forward when there is a robust whistleblower program. Undoubtedly, the recent provision of substantial awards to whistleblowers will provide such incentive for people to come forward when they are aware of possible illegal conduct and may lead to increasingly vigorous investigation and enforcement activity against not only companies but also individuals.

According to Chair White over the last three years, "[a]ggressive enforcement against wrongdoers who harm investors and threaten our financial markets remains a top priority, and we brought and will continue to bring creative and important enforcement actions across a broad range of the securities markets."

As Chair White's and the Commission's statements reflect, the SEC is committed to using modern data analytics and investigative techniques to monitor the securities markets and enforce the securities laws. Further, whistleblower awards and legal mechanisms designed to

protect whistleblowers from retaliation by their employers have made it more likely that people in possession of information relating to possible wrongdoing will report it to law enforcement authorities and both corporations and individuals will be prosecuted on the basis of that information. Moreover, the SEC continues to hone in on firms' deficient compliance and control practices through bringing novel actions charging companies with violating various laws and rules.

Thus, companies and individuals engaged in business relating to the financial industry should expect to encounter even more aggressive enforcement of the securities laws from the SEC. Going forward, a company's compliance programs, policies and procedures will likely be subject to heightened scrutiny by the SEC. With this in mind, now is a good time to re-evaluate compliance programs and internal controls to assure that they are up-to-date, that best practices have been adopted and are being followed, and that, importantly, they adequately address the SEC's concerns.

[1] <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660>

[2] <http://www.justice.gov/opa/speech/attorney-general-holder-remarks-financial-fraud-prosecutions-nyu-school-law>

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