

SECURITIES LAW ALERT

DECEMBER 2009

Highlights From SIFMA Compliance And Legal Seminar New York City, November 18, 2009

On November 18, 2009, the Compliance and Legal Division of the Securities Industry and Financial Markets Association (SIFMA) hosted its New York Fall Compliance and Legal Seminar, "Securities Regulation in the New World Order." The all-day seminar featured panel discussions addressing recent developments in securities enforcement and litigation in the post-financial crisis and Madoff era; hot topics in institutional sales and trading; retail brokerage and advisory issues; current exam issues and regulatory priorities; and the current financial reform proposals circulating in Washington D.C. Although Madoff is behind bars where he belongs, the Seminar made clear that his legacy is contributing to significant structural and tactical adjustments being implemented by the regulators.

The opening seminar, which focused on enforcement and litigation, provided insight on new initiatives and goals of both the SEC and FINRA. The panel included Lorin Reisner, Deputy Director of Enforcement of the SEC; and Susan Merrill, Chief of Enforcement of FINRA.

Mr. Reisner highlighted recent initiatives as well as current programmatic goals and priorities of the SEC's Enforcement Division. At the forefront of Enforcement Division projects is its structural reorganization, pursuant to which it will develop five specialized units, each headed by a unit chief and staffed by experts in their respective focus areas. The units and their

goals are: 1) **Asset Management**, which will focus on disclosure and due diligence, among other responsibilities, of investment advisors, hedge funds and private equity groups; 2) **Market Abuse**, which plans to work with SROs to identify suspicious trading activity and detect patterns that could indicate abuse; 3) **Structured and New Products**, whose mission is to penetrate the complexity of new or uncommon products that may otherwise be difficult for customers to understand; 4) **Foreign Corrupt Practices Act**, which will be charged with finding strategic ways to monitor and enforce FCPA compliance; and 5) **Municipal Securities and Public Pension Funds**, whose members will examine issues in these areas ranging from underfunded liabilities to "pay to play" and other conflicts. The five new units, which will comprise approximately 20% of Enforcement's staff, will serve as key resources for Enforcement's core mission in fighting financial fraud and insider trading, which will remain priorities for the division. The reorganization plan contemplates that these specialized units will handle investigations in their respective areas, and also help educate the Enforcement staff with respect to such issues.

Mr. Reisner also discussed the SEC's aim to streamline the Enforcement Division, by shifting some management personnel to "front line" positions to enhance the Division's responses to matters at their beginning stages. This aspect of the reorganization augments previously-announced changes which authorized the

Director of Enforcement to issue subpoenas and issue formal orders of investigation without specific Commission approval. In addition, the Enforcement Division hired its first Chief Operating Officer in order to increase departmental efficiency and is launching its Office of Market Intelligence, intended to be charged with taking a broad look at market trends and developments.

Reiterating remarks made by George Canellos, the recently-named director of the SEC's New York Regional Office, at an October 2009 SIFMA luncheon, Mr. Reisner discussed the Enforcement Division's initiative to develop a policy statement on cooperation for individuals such as had been done in connection with the Commission's "Seaboard" Report. The SEC is considering the use of cooperation agreements similar to those used by the Department of Justice as well as deferred prosecution agreements.

Susan Merrill also discussed structural and philosophical changes underway at FINRA. With respect to the former, FINRA has established the Office of the Whistleblower (www.finra.org/Industry/Whistleblower/index.htm) with an eye toward centralizing whistleblower allegations. Under FINRA policies, all whistleblower allegations must be escalated in order to ensure that an experienced professional reviews all such cases. The Office of the Whistleblower is housed in the newly formed Fraud Detection and Market Intelligence Unit, which is charged with investigating allegations of fraud, including those based upon examination results or customer complaints.

Ms. Merrill went on to address the changes in focus FINRA is adopting regarding the investigation of new cases. FINRA is placing an emphasis on speed in opening

and conducting examinations, thereby encouraging staff to take early testimony and obtain the facts at the outset of an investigation. While unannounced, "for-cause" examinations will remain relatively rare, they will be employed and Enforcement lawyers may be included on exam teams. FINRA staff plans to be more attentive to potential rule violations, evaluating not only red flags, but "pink flags" in order to scrutinize activity that would require regulatory action. In particular, third-party due diligence providers, the outsourcing of work normally done by broker-dealers and stock loan disclosures will be scrutinized. Additionally, Ms. Merrill touched on the Metlife Securities case announced on November 18, 2009, to illustrate her warning that a brokerage firm's insufficient email review standards can lead to a failure to detect and prevent abuse practices – in this case a \$6 million misappropriation scheme.

Additional items discussed at the enforcement and litigation session included regulatory actions aimed at insider trading, including SEC actions against Galleon Management LP, Mark Cuban and Oleksandr Dorozhko. These cases reveal key unsettled legal issues in the insider trading realm, including whether a fiduciary duty is a required element of case based upon the alleged use of a deceptive device. The panelists also addressed the SEC's case against Bank of America stemming from Bank of America's acquisition of Merrill Lynch, currently pending before Judge Rakoff in the Southern District of New York. As was widely publicized, Judge Rakoff rejected the proposed settlement between BofA and Merrill. Conceding that it was entirely proper for Judge Rakoff to scrutinize the potential settlement, Mr.

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Lorin also noted that the case's outcome could have a significant impact on future settlements and how their overall fairness to shareholders will be evaluated, as well as significant implications for company directors and officers faced with thorny disclosure issues. Indeed, it will be interesting to see whether Judge Rakoff's decision leads the SEC to pursue administrative resolutions in cases in which they otherwise would have sought judicial consent orders.

Other highlights from the Seminar include:

- Institutional Sales and Trading
 - Grace Vogel (FINRA Executive Vice President, Member Regulation) reported substantial progress in firms' compliance with Rule 204 and that fails have been declining as a result.
 - The new Prime Broker Letter is expected to be completed sometime after the new year, although no new details emerged about its content.
 - The impact of the emergency short sale rules is still being evaluated to determine whether the market volatility in 2008 was the result of short selling.
 - Ms. Vogel indicated that she did not think a hard borrow requirement was imminent and that such a requirement may go "too far."
 - Alternative Trading Systems (Dark Pools) will continue to

attract considerable regulatory attention, including in the areas of what constitutes an "actionable indication of interest."

- Controls and risks related to sponsored access (which Ms. Vogel described as "really scary") were discussed.
- Regulatory attention will continue to focus on so-called "trading huddles" following reports on these gatherings in the WSJ.
- Regulatory Exams and Priorities
 - John Walsh (SEC, Acting Director, Office of Compliance and Inspections), Hans Reich (Senior Vice President, FINRA), and Joy Weber (Executive Director, Deputy General Counsel, UBS) noted that regulatory exam deadlines are going to be more strictly followed. While the Staff will maintain some flexibility, "deadlines are deadlines."
 - Mr. Reich identified 7 topics that arise with some frequency in FINRA exams: (1) a lack of supervisory controls, including failures to designate responsible persons and a lack of testing of applicable procedures and controls; (2) written supervisory procedures that don't adequately address the "who, what, when and why" or otherwise lack clarity; (3) failure to test AML procedures and safeguards; (4) inadequate review of outsourcing issues in the Reg S-P context; (5) failures to update

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business continuity plans; (6) failure to test electronic communications systems and lack of controls with respect to social networks and instant messaging; and (7) continuing research issues, including failures to approve research by qualified individuals.

- Mr. Walsh said that OCIE would be focused on improving its technical and market expertise; that it would

work to break down the broker-dealer/investment advisory silos that may have hindered good information flows and; in response to some of the Madoff inspector general findings, intimidation of Staff by market participants would be addressed through strong identification; and escalation procedures within OCIE. ■

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