

# Today's Regulatory and Enforcement Environment: Practical Considerations for Your Organization

## ICI Legal Forum

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May 5, 2011

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# Introduction

- We are facing the aftermath of the financial crisis and the Madoff scandal.
- The SEC was harshly criticized for its role in the financial crisis and for its handling of tips about Madoff.
- Congress responded with Dodd-Frank, which gives the SEC increased enforcement powers and rulemaking authority.
- The SEC appears determined to enhance its image as an aggressive enforcer of the federal securities laws.

# Enhanced SEC Enforcement – Powers Granted by Dodd-Frank

- Dodd-Frank expands the SEC's enforcement powers:
  - New authority to seek civil money penalties in administrative cases and against a wider array of persons, including officers and directors.
  - New authority to bring aiding and abetting cases under the 1933 Act, Advisers Act, and 1940 Act.
  - Expands scope of collateral bars.
  - Expands the SEC's jurisdictional reach.
  - Mandates payment of awards to whistleblowers.

# Enhanced SEC Enforcement – Asset Management Unit

- Currently the largest Unit in Enforcement.
- Focuses on the industry as a whole:
  - Registered investment companies
  - Hedge funds
  - Investment advisers
- Taking a data-driven approach, with input from the SEC's new analytical unit.
- OCIE is a pipeline of referrals to the Unit.
- Already starting to see an increase in cases, which is consistent with the significant resource commitment to the Unit.

# Enhanced SEC Enforcement – Asset Management Unit

- Key priorities of the Unit include:
  - Inconsistencies between strategies and disclosures.
  - Misleading valuations and performance data.
  - Oversight by mutual fund boards of directors.
  - Personal trading and conflicts of interest.
  - High-risk products marketed to retail investors.
- The mutual fund industry is clearly within the Unit's mandate.

# Enhanced SEC Enforcement – Key Initiatives

- Mutual Fund Fees, including Subadviser Fees.
- Bond Funds
- Problem Advisers
  - Focusing on education/experience, past performance, conflicts of interest, and insider trading (e.g., David Baldt/Schroders Muni Fund).
- Recent actions could suggest nature of future cases (e.g., State Street, Schwab Yield Plus, AXA Rosenberg).

# Enhanced SEC Enforcement – Whistleblower Program

- Dodd-Frank requires the SEC to pay W/Bs awards equal to 10% - 30% of monetary sanctions collected.
- The increased size of monetary sanctions creates a powerful incentive for W/Bs to come forward.
  - Xerox (2002): \$10 million
  - Goldman Sachs (2010): \$550 million
- Dodd-Frank also includes anti-retaliation measures to protect W/Bs, and W/Bs may provide information anonymously.
- The SEC's whistleblower program will be another pipeline for Enforcement cases.

# Enhanced SEC Enforcement – Whistleblower Program

- To be eligible to receive an award under the SEC’s proposal, a W/B must:
  - Voluntarily provide
  - Original information
  - Leading to a successful enforcement action
  - In which the SEC obtains monetary sanctions totaling more than \$1 million.
- Covers violations of any of the federal securities laws.
- Dodd-Frank also creates a W/B regime for the CFTC and gives W/B protections to employees of firms subject to the jurisdiction of the new Consumer Financial Protection Bureau.

# Enhanced SEC Enforcement – Whistleblower Program

- Remediation without self-reporting may now be less attractive or realistic.
- Internal reviews and self-reporting decisions could be rushed by the concern that an employee may tip the SEC.
- Where a W/B tip has been made, organizations are likely to be scrutinized for whether they appropriately dealt with the underlying allegations.
  - Did they self-report in a reasonable time?
  - Did they proceed in bad faith?

# Enhanced SEC Enforcement – Practical Considerations

- Start with first principles:
  - What is the fiduciary culture at the firm?
  - What is the tone at the top?
  - Do you hire good people?
  - Is there a culture of compliance?
  - What steps can be taken to reinforce the culture?
  - How effective are the firm's training programs?
  - What conflicts of interest are inherent in the firm's business, and how can they be eliminated or mitigated?
- Consider the human resources element – is there an atmosphere of collegiality and respect?

# Enhanced SEC Enforcement – Practical Considerations

- Ask fundamental questions about the business:
  - Are fees reasonable?
  - Do products and services make sense?
  - Do products themselves and their structure promote the interests of clients?
- Review basic operational matters:
  - Do disclosure documents accurately reflect current strategies and risks?
  - Are valuation procedures appropriate for the instruments involved, and are they followed consistently?
  - Are funds and other client accounts managed in keeping with fundamental policies and stated strategies?

# Enhanced SEC Enforcement – Practical Considerations

- Assess whether the organization can respond effectively in light of the new whistleblower regime:
  - Is there a robust process for determining whether and when to self-report, and are all key stakeholders involved?
  - Is there a significant commitment of resources to conduct internal reviews in a timely fashion?
  - Are there problem areas that could be addressed with increased resources or focused remediation?
  - Are internal policies consistent with the anti-retaliation provisions of Dodd-Frank?

## “Pay to Play” Rule – Background

- The Rule was not mandated by Dodd-Frank, but was adopted in the post-crisis environment.
- Mutual fund advisers weren't the reason for the Rule but are caught by it anyway.
  - E.g., funds in which government entities or plans invest.
- The Rule poses substantial risks of self-inflicted wounds.
  - Two-year “time out” on advisory fees.
  - Reputational risks of non-compliance, however accidental.
  - Employment actions.

# “Pay to Play” Rule – Basic Provisions

- The Rule prohibits a firm and its “covered associates” from:
  - Providing investment advisory services for compensation to a government entity within two years after making a political contribution to an official of the government entity.
  - Paying any person to solicit a government entity for investment advisory services (with limited exceptions).
  - Coordinating or soliciting contributions to an official of a government entity to which the firm provides or seeks to provide advisory services.
  - Coordinating or soliciting payments to a political party of a state or locality where the firm is providing or seeking to provide advisory services to a government entity.
- Imposes extensive recordkeeping requirements.

# “Pay to Play” Rule – Implementation Considerations

- Exceptions to the two-year “time out” pose practical challenges and uncertainty.
- There may be real obstacles to establishing a satisfactory compliance record.
  - Pre-clearance and certifications may not be 100% reliable.
  - Outright ban may be practically appealing, but difficult to enforce.
- Prohibition on “indirect” violations expands scope of compliance responsibilities.

# “Pay to Play” Rule – Implementation Considerations

- Procedures must be implemented with an eye on future potential business.
- Recordkeeping requirements may present operational challenges.
- There is a potential for significant employment issues.
  - Allegations that hire/fire decisions were based on political preferences.
  - Allegations that policies infringe on individual rights.
- Extensive employee training and follow-up are likely outgrowths of these new requirements.

# Takeaways

- This is not a time for firms to downplay compliance, even if they are facing constrained resources.
- A close focus on new requirements is appropriate, but organizations may also wish to assess their overall business:
  - Fiduciary culture and tone at the top
  - Products, services, and potential conflicts of interest
  - Compliance resources
- While more effort will be required to deal with the aftermath of the last crisis, firms should not forget to look out for future hazards.

# Thank you



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