

Should Broker-Dealers Self-Report?

Law360, New York (May 19, 2010) -- If a firm discovers a problem, should it self-report (assuming no regulatory obligation to do so)? Will it receive sufficient credit for self-reporting or is it just ensuring that it will be the subject of an enforcement action?

In an attempt to answer these questions, the Securities and Exchange Commission in January 2010 announced revisions to its Enforcement Manual and an initiative aimed at encouraging cooperation in investigations or voluntarily disclosure of past or potential violations of the securities laws by companies and individuals.[1] In an effort to make its program more effective and efficient, the SEC's Director of the Division of Enforcement announced these initiatives as "potential game-changers" for its enforcement and investigatory goals.

Previously, in November 2008, FINRA released its policies through Regulatory Notice 08-70, which stated that "extraordinary cooperation" in FINRA investigations would be considered in determining the level of sanctions imposed or disciplinary action taken for violations. The Notice described the types of cooperation FINRA would consider as worthy of credit. At that time, FINRA stated that its goal was to "increase transparency as to the basis for sanctions imposed in cases and to encourage firms to root out, correct and remediate violative behavior." [2]

Considerations for Firms to Decide Whether to Self-Report

Firms considering whether to self-report should probably become familiar with these policies. The decision of whether to report potential violations, what to report, and to whom to make those reports should probably be considered within the context of these pronouncements. Whether credit will be awarded depends on how the SEC and FINRA weigh various facts and circumstances.

In its 2008 Notice, FINRA highlighted four factors it would consider in assessing cooperation including: (1) self-reporting of the violations before regulators were aware of the issue; (2) taking extraordinary steps to correct deficient procedures and systems; (3) taking extraordinary remedial measures; and (4) providing substantial assistance in FINRA's investigations. In return, firms could see possible reduction of fines imposed, complimentary language in settlement agreements, or, in rare cases, complete abandonment of enforcement actions.

Similarly, the SEC's Enforcement Manual provides that credit may be awarded based on: (1) substantial and significant assistance to the commission; (2) the importance of the underlying matter; (3) the interest in holding someone accountable; and (4) the profile of the cooperator, including a history of lawfulness and compliance. Each of these categories includes examples of efforts and conditions to be evaluated. The SEC also announced new tools and cooperation agreements to provide a sense of assurance to further encourage proactive participation.

The following comparison may make it easier to analyze whether to self-report to the SEC, FINRA or possibly neither:

When to self-report?

FINRA's Standards:

--FINRA weighs whether the violation is reported prior to any regulatory inquiry into the conduct at issue.

--FINRA expects more prompt disclosure than that required by various securities regulations. --Self-reporting must be "prompt, detailed, complete and straightforward."

SEC's Standards:

--The SEC will credit cooperators who are "particularly timely" with their reports and will take into account whether the information provided subsequently led to an investigation.

--The SEC looks for the cooperating entity to go beyond regulatory disclosures that are expected and compulsory. -
-The existence of a prior agreement with another agency already requiring disclosure will be taken into account as that type of self-reporting is obligatory.

What if the problem is detected by a regulator before the firm discovers the violation?

FINRA's Standards:

--If FINRA has already uncovered the problem, the firm should take "extraordinary steps" to correct the situation if it wishes to receive credit for cooperation. --FINRA will consider whether the firm's subsequent cooperation and remedial efforts were immediate and proactive or whether they were prompted solely by the possibility of further sanctions.

SEC's Standards:

--Cooperators will be rewarded if they act voluntarily rather than waiting for requests, if they provide information beyond the scope of the SEC's jurisdiction, or if they encourage others to contribute to and cooperate with the investigation.

What type of self-reporting will warrant credit?

FINRA's Standards:

--Self-reporting must be "detailed, complete, and straightforward."

--FINRA's position on the disclosure of privileged information is that the waiver of privilege does not lead directly to the awarding of credit. Rather, FINRA considers the cooperation efforts as a whole in its analysis of whether the assistance is significant enough to warrant credit.

SEC's Standards:

--The SEC analyzes the value and nature of the assistance provided and rewards cooperation based on its overall quality, truthfulness, and completeness. --Providing information that (1) was not requested, (2) may not have been discovered, or (3) was privileged may more likely result in credit.

Must the firm take steps to correct the problem?

FINRA's Standards:

--FINRA focuses on the correction of deficient procedures and systems. --FINRA will more likely credit correction of procedures prior to regulatory detection than after, but firms may receive credit for post-detection correction measures if the firm "promptly and completely remediated the deficient procedures . . . without prompting by" a regulator.

SEC's Standards:

--Companies should focus on remediation and may consider dismissing or disciplining wrongdoers. --The cooperator may consider disgorgement as a remedial measure or other proactive remediation prior to an order compelling such action.

What is the effect of self-reporting information that can lead to investigations of other firms and violations?

FINRA's Standards:

--FINRA will credit firms that cooperate with regulators to uncover related industry problems if that cooperation is substantial and there is full cooperation.

--FINRA does not specify how it evaluates the character of the investigation, so a firm may not know whether its violation is of the type that will be considered significant.

SEC's Standards:

--The SEC focuses on the importance of the underlying matter and whether it is a Commission priority. --The SEC also will consider whether the violation caused significant harm, had the potential to cause significant harm, or was widespread.

--Reports on significant matters may lead to greater credit.

What is the effect of a lack of disciplinary history?

FINRA's Standards:

--Several FINRA disciplinary cases have stated that a lack of disciplinary history is not a mitigating factor in imposing sanctions. See, e.g., Department of Enforcement v. Fergus, Devine, and Blake, Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3 (NAC May 17, 2001); Department of Enforcement v. Skiba, 2010 FINRA Discip. LEXIS 6 (FINRA April 23, 2010) ("While the existence of a disciplinary history is an aggravating factor when determining appropriate sanctions, its absence is not mitigating").

SEC's Standards:

--The SEC will evaluate the cooperator's personal and professional profile. --A history of compliance, lawfulness, and an acceptance of responsibility may push the scale in favor of credit.

--The likelihood that the violation could occur again may cut against awarding credit.

--Self-reporting companies may receive credit for having a system of “effective compliance procedures and an appropriate tone at the top.”

What if the violation wasn't a technical oversight but actually the result of negligent or culpable behavior?

FINRA's Standards:

--FINRA does not specifically mention how an actor's culpability may weigh other than to reference the “nature of the conduct” as a part of the balancing considerations.

SEC's Standards:

--The SEC weighs culpability in determining how much to credit self-reporting by cooperators.

--The SEC's Seaboard Report[3] takes into consideration how the misconduct occurred – was it an honest mistake or the result of wrongful conduct or willful misconduct? --The SEC will balance cooperation against the severity of the misconduct, the experience of the violator, culpability, and remedial efforts.

What actions should a self-reporting firm take towards investors?

FINRA's Standards:

--Credit may be given for “extraordinary” remedial measures to customers. --FINRA suggests that remedial measures should be immediate and go beyond the scope of FINRA's investigation.

SEC's Standards:

--Cooperation should include “appropriately compensating those adversely affected.” --Self-initiated remedial measures to rectify the situation and repair harms may offset negative factors in the SEC's analysis.

Once the investigation is underway, what should the self-reporting firm do?

FINRA's Standards:

--FINRA may offer credit if the subject of the investigation provides “substantial assistance” such as:

* Providing access to individuals and information outside FINRA's jurisdiction; * Providing extraordinary assistance; and * Undertaking internal investigations and reporting findings to FINRA.

SEC's Standards:

--The Commission may credit a cooperator if the efforts substantially assisted an investigation. --High-quality cooperation is specifically discussed in the framework, and individuals are encouraged to be truthful, complete, and reliable in their reporting.

How sure can a firm be that self-reporting and cooperation efforts are worth the risk?

FINRA's Standards:

--FINRA states that while certain factors will be considered, credit may only be awarded in "appropriate situations." --FINRA's guidance contains a catch-all caveat that "facts and circumstances in each case, including the nature of the conduct, the extent of customer harm, the duration of the misconduct and the existence of disciplinary history, and the extent of a firm's extraordinary cooperation" will weigh into the calculus, but it doesn't explain how.

SEC's Standards:

--The SEC announced new tools to encourage cooperation including:

* Proffer Agreements: Written agreements promising individuals that statements made to the SEC will not be used against the individual in a subsequent proceeding even if the SEC later uses those statements for impeachment purposes or as leads to other discovery; * Cooperation Agreements: Formal written agreements between the SEC's Enforcement Division and the cooperator whereby the Division agrees to recommend that the cooperator receive credit for substantial assistance in investigations; * Deferred Prosecution Agreements: Written agreements in which the SEC agrees to forego an enforcement action if the cooperator agrees to, among other things, cooperate fully and truthfully and comply with express prohibitions and undertakings during a period of deferred prosecution; and * Non-prosecution Agreements: Formal written agreements in which the SEC agrees not to pursue an enforcement action if the cooperator agrees to certain undertakings, remedial measures, and to cooperate fully.

--The SEC streamlined its process for submitting requests to the Justice Department for witness immunity where the witness has the capacity to provide significant assistance.

Conclusion

So, should a firm self-report? When deciding whether to self-report, the firm may want to consider whether the SEC and/or FINRA will learn about the issue in any event (from another source, such as complaining customers or whistleblowers) and how the regulator will react to the failure to self-report. On the other hand, if the firm does self-report, will the firm receive credit and, if so, how much? Both regulators have noted in settlement agreements that they have provided credit for self-reporting,^[4] but the amount of credit appears unpredictable and dependent on various facts and circumstances.

To provide some certainty, the SEC has begun to focus on this issue.^[5] The SEC's current framework contains greater detail and examples of what the commission will take into account in evaluating cooperation compared to FINRA's earlier framework. While FINRA focused mainly on the self-reporting and cooperation efforts themselves, the SEC takes into account the profile of the cooperator, its knowledge and experience, and its track records of compliance, while providing would-be whistleblowers and cooperators the guarantees of the Cooperation Agreements.

Unfortunately, it is impossible to know, under either framework, whether credit will be awarded, and if so, what that credit will be. Nonetheless, because the SEC and FINRA will sometimes provide some credit, firms may want to carefully review the regulatory guidance (including prior settlements) and weigh the advantages and disadvantages of self-reporting.

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1 Robert S. Khuzami, Director, Division of Enforcement, Securities and Exchange Commission, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders (January 13, 2010) (available at <http://www.sec.gov/news/speech/2010/spch011310rsk.htm>); Press Release, Securities and Exchange Commission, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (January 13, 2010) (available at <http://www.sec.gov/news/press/2010/2010-6.htm>); Securities and Exchange Commission, Division of Enforcement, Enforcement Manual (January 13, 2010) (available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>).

2 FINRA Regulatory Notice No. 08-70 (November 2008) (available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117452.pdf>).

3 SEC Release No. 34-44969 (Oct. 23, 2001) (available at <http://www.sec.gov/litigation/investreport/34-44969.htm>).

4 See, e.g., NASD Letter of Acceptance, Waiver and Consent, No. CE305002 (Feb. 22, 2005) ("This type of self-examination and self-reporting ... benefits NASD's enforcement program and investors by allowing for cost-effective enforcement and timely remedial action, and was taken into account in assessing sanctions against Piper Jaffray"); "SEC Charges Six Former Officers of Putnam Fiduciary Trust Company with Defrauding Clients of \$4 Million," SEC Lit. Rel. No. 19517 (Jan. 3, 2006) (reporting that, despite charges of fraud against six former officers of a fiduciary trust company, no enforcement action would be brought against the company itself because of its "swift, extensive and extraordinary cooperation," including self-reporting the fraudulent acts, conducting an independent internal investigation, sharing results of the internal investigation with the SEC, waiving applicable privileges, and taking certain remedial measures); SEC v. Royal Ahold, 2004 SEC LEXIS 2330 (Oct. 13, 2004) (noting Ahold's "extensive cooperation" and self-reporting as among reasons for not seeking penalties in the enforcement action).

5 Compliance Reporter, SEC Enforcer Assures on Cooperation Deals (February 26, 2010) (available at <http://www.compliancereporter.com/Article.aspx?ArticleID=2401636>) (noting efforts to bridge parallel cooperation agreements with other enforcement agencies).