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compliance i briefing series
#1 enforcement

Raising the Issue

Researched and written by Complinet’s in-house team of former regulators, attorneys and industry practitioners, this iBriefing series will provide insight into current key regulatory topics that educate compliance staff, inform business lines and escalate dialogue with senior managers.

Raising the Issue

Complinet's iBriefings provide a summary of current key regulatory topics that are under consideration for fundamental regulatory reform or a significant shift in approach in the aftermath of the recent financial crisis. The series aims to provide a focused update on the main issues, talking points, status quo, trends and potential developments that will impact the compliance teams at financial services firms globally. The commentary will cover the situations in the EU and North America, and will also include any relevant perspectives from APAC and the Middle East if these are divergent.

Researched and written by Complinet's in-house team of practitioners, the iBriefings are meant to educate compliance staff, inform business lines and initiate dialogue with senior managers. More than ever, now is the time to establish a culture of compliance throughout the firm. The iBriefing series provides relevant analysis to demonstrate the issues and convey compliance concepts to all levels of management.

Executive summary

Enforcement is going to increase in its frequency and intensity; this is going to be a global phenomenon and the process will be expedited as far as that is possible. The more developed the financial services market, the more intense this will be. Tolerance for future regulatory failure and fraud is minimal in the current climate; regulators desperately need to restore the reputation of the markets as generally safe, and convince investors again that they remain the principal investment arena for capital growth, income generation and long-term finance and investment, in both a retail and institutional sense. This reputation is in tatters after seismic market failure, and this has recently been compounded by the large-scale investment frauds that had remained uncovered during the bull-run.

The US Securities and Exchange Commission has already signalled that it will be adopting a much more aggressive approach to enforcement than was in place during the previous Administration. Mary Schapiro, the new SEC chairman, has stated that 'the agency is seeking to establish a more centralized process that will more effectively identify valuable leads for potential enforcement action as well as areas of high risk for compliance examinations. As we continue to reinvigorate our enforcement efforts as an agency, it's vitally important that we move very aggressively to improve staff's use of tips and complaints from investors and whistleblowers. The SEC is looking for ways to help identify from among the various streams of information we receive and those that the staff has developed independently, the systemic risks and emerging trends that need investigation'.

This sea-change in attitude is being replicated across the EU. The UK Financial Services Authority has pronounced recently that it is no longer 'not an enforcement-led regulator'. The double negative is curious but reflects a marked change in approach.

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The FSA has previously used a mantra of 'credible deterrence' in the hope that its selective approach to enforcement would 'change behavior' and 'bring about compliance with the standards we expect'. FSA has best defined credible deterrence in this way: 'it means bringing enough cases of the right sort and getting the right outcomes so that people sit up and pay attention. It's about making people realize that they'll suffer significant and meaningful consequences if they break our requirements and if they fail to improve standards of behavior.'

Hector Sants, FSA's Chief Executive, has also been unusually combative recently, saying 'there is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA.' Asked whether the former senior management of failed institutions should be frightened, Mr Sants said, 'we take our obligations very seriously. We will look at significant failure to see if there is action to take in relation to senior managers.' He added rather ominously, 'a principles-based approach does not work with individuals who have no principles.' The FSA has been eager to stress its need to see the right 'outcomes' at firms whether complying with principles or more prescriptive rules; the message is clear that the wrong outcomes could very well lead to enforcement.

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Background

It could be argued that enforcement in the financial services market has been lax globally over the last three years, despite the fact that the statistics released by regulators suggest they are handing out increasingly larger fines and doing this more frequently. However, this increase in enforcement has been outpaced proportionately by the considerable global growth in the financial services market.

The approach of many of the regulators has lately been questioned in terms of the quality of the enforcement; as an example, recent revelations from the SEC show that it had previously evaluated its enforcement program against the number of cases brought in, rather than the severity or difficulty of the action behind each case. Enforcement performance was measured against quantity, not quality.

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There are differing reasons for this lighter touch depending on the region being analyzed, but much can be attributed to pure politics and aggressive competition for market share among international financial centers that encouraged regulatory arbitrage. In the last eight years, governments have been pushing to deregulate and be responsive to lobbying by financial services firms demanding reductions in the burden and cost of compliance.

Another key reason for a more selective approach by regulators to enforcement is increasing evidence of the inadequacy and outdated nature of the legal systems and tools available to the regulators and other enforcers; this has been accentuated by a widening gap between the market and the regulators (in terms of sophistication, technology, market practice and knowledge of increasingly complex financial products). This was further compounded by the staffing policies within regulators where it is now widely accepted that there is a huge need for supervisors and enforcement staff with more relevant skill sets, market experience and overall seniority.

Large firms with dedicated compliance and legal teams had become adept at diverting the regulators' attention away from the more contentious issues. While there was a feeling that the regulators had become proficient in issuing 'parking tickets' to deficient firms, it was felt that it was unlikely that an enforcement action would be particularly punitive unless the miscreant had done something very bad or very blatant (or a combination of both). In fact, some very large and allegedly reputable market players were so blasé about enforcement, they calculated cynically that the costs of remediation, litigation, reputational damage and enforcement were dwarfed by the profits available from certain strains of deliberately non-compliant business.

Many of the technological advances in the market have remained largely 'untouchable' by regulatory authorities, either because detection methods are weak or the relevant law/regulation is too outdated or ambiguous to make enforcement likely to be successful. Evidence is often circumstantial, there is rarely 'a smoking gun', criminal and fraud cases are not jury-friendly, and many are settled prior to full public enforcement.

Market players have also managed to exploit loopholes and regulatory gaps despite best efforts from regulators to extend their remit (e.g. through principles-based regulation), as well as extensions to their powers (or calls for such extensions) via civil/criminal actions and plea-bargaining. Market participants of varying types and size have also not been afraid to challenge aggressive enforcement moves by regulators, and some have done this with notable success.

Regulators have been roundly criticized for some time for failing to properly enforce against individuals, especially members of senior management where negligence is alleged or market failure has been evident. Since the financial crisis and global recession have taken grip, and with the political environment having changed enormously in the last six months, the demand for enforcement at the highest levels of management, it would seem, can no longer be ignored. The UK FSA has notably started actions against individuals at the same time as it has initiated proceedings against their employing firms; previously firms were pursued first before any thought was given to disciplining or prosecuting individuals.

Prosecution and indictments have been particularly hard to pursue with respect to individuals, and this is why a move to civil actions has been fostered in some jurisdictions. Perhaps the most effective route for regulators to take is to ensure that where negligence, fraud or incompetence can be proven, such individuals will be banned from employment in the industry forever. The UK FSA recently secured a permanent industry ban and fine against hedge fund manager Loic Albert Antoine Montserret for mismarking positions to disguise losses in his trading book – this was the first time the FSA has banned and fined an individual for mismarking trading positions. FSA said the behavior fell short of the standards expected of a registered person and showed a lack of integrity and honesty.

A footnote to this is the interesting link between the enforcement divisions of regulators, and their examination or inspection/supervision teams. The enforcement teams at regulators seem to have taken more than their fair share of criticism for some of the more notorious regulatory failures that

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have come to light as the bull market petered out (mainly due to evidence that a process without any form of prioritization or senior supervision was used to assess complaints from whistle-blowers - be they former employees or competitors - though the press has conveniently avoided publishing just how many false positives get reported to regulators each year and the huge cost that investigation of each would entail). The focus at regulators is now being turned towards better resourcing of the examinations and supervision teams so that they are in a better position to spot some of the larger regulatory abuses that have emerged in the downturn.

Regulatory change (recent and potential)

Already this new approach to enforcement is taking hold and having a marked impact. The US has started to pursue more criminal actions that run parallel to alleged failures that are being pursued by the regulators. Examples over the last 18 months include: action against two managers of failed Bear Stearns hedge funds for wire and securities fraud and conspiracy; the pursuit of two Credit Suisse directors for securities and wire fraud related to sales of auction rate securities; a criminal inquiry into the role of three senior executives at AIG in relation to misleading representations made to auditors and investors about its credit derivatives business (related to sub-prime CDOs). In addition, House Speaker Nancy Pelosi announced in April that she will form a special commission to investigate 'what happened on Wall Street to cause the economic collapse', along the lines of President Franklin Roosevelt's 'Pecora Commission'. The Pecora Commission's dramatic hearings unearthed many of the frauds, abuses and schemes that led to the 1929 crash.

An interesting recent development in the UK was the first successful use of FSA's criminal prosecution powers (powers received in 2007) to pursue an action related to market manipulation or insider trading (Mr C. McQuoid and Mr J.W.Melbourne: an insider trading case decided in March). FSA has warned that it has a number of other similar actions ready for trial and has stated the following: 'we're convinced that the threat of a criminal sanction — a criminal conviction and a custodial sentence — is a powerful deterrent. We are prepared, ready and able to take on challenging criminal prosecutions'. There have been calls by some prominent regulators in the US for similar powers to be made available to the likes of the SEC and the CFTC but no groundswell has yet developed behind these requests to suggest this is a change that is likely, and such power is less required in the US where insider trading and market manipulation cases are often referred to the Justice Department for criminal prosecution as a matter of routine.

The UK FSA will also increase its enforcement scope over banks, building societies and credit unions when the previously voluntary Banking Code Standards Board code of conduct becomes statutory regulation in November. Unfair treatment of consumers could result in significant enforcement.

In summary, the broad themes and areas of enforcement that have been indicated and are evident, both retrospectively and for the near future, include: market abuse and manipulation (short selling infractions while restrictions were placed on short sales at the end of 2008 and start

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of 2009 plus ongoing restrictions); systems and control failures; supervisory failures; securities fraud (disclosure and misrepresentation); mortgage and lending fraud; insider trading; senior management failure (fraud, negligence, incompetence, lack of integrity, culpable misconduct); privacy and data protection failure; weak governance and ethics (e.g. Foreign Corrupt Practices Act violations); lax custody arrangements and lack of control over client assets.

Impact for the Compliance Department

The future looks very challenging, especially for firms that have a sham or non-existent compliance culture. How effective the regulators become in their increased enforcement effort remains to be seen, but the pressure from the politicians and the public for enforcement, both future and retrospective, will see the compliance workload and natural paranoia within firms increase markedly. Compliance officers, whether accessories to regulatory failure or not, will inevitably at best be tainted in some way, or at worst seriously implicated, by such enforcement. On this basis, it may be time for compliance people that work for organizations with historically poor disciplinary records and a 'bare minimum' attitude to compliance to demand a very different approach championed by senior management across their firm in a very short timeframe; the only alternative would be to seek more compliant employers if such changes do not materialize.

It will also be vital for compliance departments to keep abreast of the enforcement priorities of relevant regulators. News concerning regulatory sweeps, examination priorities and the regular hints emanating from speeches by key staff at each regulator will guide senior compliance managers as to the areas within their business most likely to face scrutiny.

Impact for Business Lines and Senior Management

A raft of retrospective enforcement is likely to be initiated over the next 24 months from the existing crisis. As the recession deepens and resentment increases, a modern-day witch-hunt is developing, though it still remains to be seen how effective this will be in terms of ultimate prosecution. Political players will give their electoral hopes a valuable boost by pursuing senior financial services executives that have already been deemed culpable in the eyes of the public, irrespective of the merits of such actions. Civil suits, industry bans and career-ending damage to reputations may be the only real result in this respect.

More interesting is the regulatory reform that emerges to ensure that future abuses and failures can be pursued more aggressively. The spotlight is being turned more on those with significant influence and those in positions of responsibility that can control risk, success and failure at regulated institutions. These individuals will need to be acutely aware of what is and is not acceptable behavior in the eyes of the regulator, and the likely consequences if

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there are transgressions.

Enforcement trends over the last decade have changed considerably as sentiment towards certain activities that were previously deemed market practice become less acceptable and even subject to enforcement (a good example is alleged front-running by NYSE floor specialists that lead to considerable settlements and saw criminal action against various specialists with unpredictable results differing from guilty pleas and convictions to acquittals). Management will need to keep a very close eye on regulatory enforcement, and have access to very competent compliance advisers to ensure they are on the right side of the line.

Regulator relations and focus

It has never been more important to keep close to the regulators and to ensure a regular and open relationship wherever possible. This will become tougher as the new regime takes hold and the regulators become more distant, confrontational and less cooperative in an attempt to improve their reputations and demonstrate less tolerance. Critics have pointed out that 'self-regulation' should be scrapped and that some of the most glaring failures have resulted from the conflicts that arose where industry participants have been involved with committees at regulators and have abused these positions of trust.

The regulated are best advised to attempt to disclose their approach to new regulation whenever possible, collaborate with the regulator wherever possible, and demonstrate the competency of their management and the efficacy of their systems and controls at every turn. Where a regulated firm or bank identifies a regulatory infraction itself, it would be well advised to declare this at the earliest opportunity at the same time as explaining its actions for remediation, and to look to cut a deal with the regulator to reduce the size of the penalty. Deciding to ignore or cover up such infractions in the hope that these will not be spotted by the regulator will be an increasingly risky strategy, and could prove extremely costly if they are identified by the regulator at a later stage.

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Conclusion

It is hard to determine exactly where the enforcement effort will be concentrated at this stage except where regulators have already stated their intentions. The given is that there will be much more enforcement in terms of volume, size and frequency and the consequences of it will be more severe where it is successful; even where it is not, reputations may be damaged in the process and costs will be considerable. Individuals especially will be more accountable than ever, will be targeted more frequently and will have higher standards to abide by.

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