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Business Litigation Practice Group
Special Matters and Government Investigations Practice Group

July 12, 2016

The SEC's Customer Protection Rule Initiative and Whistleblower Protection Efforts – What Broker-Dealers Need to Know

On June 23, 2016, the SEC instituted a settled enforcement action against Merrill Lynch, Pierce, Fenner & Smith Inc. and Merrill Lynch Professional Clearing Corp. (collectively, "Merrill"), in which Merrill agreed to pay $415 million in penalties, disgorgement, and prejudgment interest and admit liability for violating Section 15(c)(3) of the Securities Exchange Act of 1934 and Rule 15c3-3 thereunder (the "Customer Protection Rule"), Exchange Act Rule 21F-17 (the "Whistleblower Rule"), as well as other provisions. The Commission also instituted a litigated proceeding against Merrill's former Head of Regulatory Reporting and designated Financial and Operational Principal ("FinOp"), who also served as the firm's acting Chief Financial Officer during part of the relevant period. The FinOp was charged with causing or aiding and abetting certain of Merrill's violations.[1]

At the same time, the Commission announced a two-part Customer Protection Rule Initiative (the "CPR Initiative") intended to encourage registered broker-dealers to self-report violations and alert the industry that the SEC staff will be conducting risk-based exams to assess firms' compliance with the Customer Protection Rule. Below is a summary of the proceedings and key takeaways for Broker-Dealers, Compliance Staff and other Regulated Entities or Public Companies.

The Customer Protection Rule

The Customer Protection Rule requires a registered broker-dealer to safeguard its customers' cash and securities to avoid delay in returning customer securities or shortfalls preventing customers from being made whole if the broker-dealer fails. For customer cash, Rule 15c3-3(e) requires a broker-dealer to maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers. As the SEC's announcement of its CPR Initiative stated, the formula for calculating the amount of cash owed to customers is complex, but the underlying concept is simple: "if a broker-dealer owes more to its customers than its customers owe to it, the broker-dealer must set aside at least an amount equal to that difference so that it is readily available to repay customers."[2]

Rule 15c3-3(c) also requires a broker-dealer to maintain physical possession or control over its customers' fully paid and excess margin securities. The customers' securities must be held free of liens or any other interest that could be exercised by a third-party to secure an obligation owed by the broker-dealer.

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Broker-dealers are required to self-report certain failures to comply with the Customer Protection Rule under Rule 15c3-3(i). Rules promulgated under Section 17(a)(1) of the Exchange Act also require broker-dealers to self-report material weaknesses in their internal controls that could result in a violation of Rule 15c3-3.

The Commission's Enforcement Actions

The Commission's settled order against Merrill found that the firm violated Rule 15c3-3(e) by engaging in a series of "leveraged conversion trades" between 2009 and 2012, which improperly reduced the amount of cash that Merrill was required to hold in its reserve account. While margin loans extended to finance customer positions can properly reduce the amount a broker-dealer is required to hold in its reserve account, the order found that the leveraged conversion trades were riskless, lacked defined terms or economic substance, and were executed with newly-created counterparties set up at Merrill's behest to participate in the trades. The order also found that Merrill improperly reduced its reserve account balance by as much as $5 billion through the leveraged conversion trades, and used these funds to finance its business and trading activities. Merrill was also found to have violated Rule 15c3-3(c) because, from June 2009 to April 2015, it held approximately $60 billion of customer securities in clearing accounts that were subject to liens. Finally, the order found that Merrill violated Exchange Act Rule 21F-17, the Whistleblower Rule, by including language in its policies, procedures, and employment agreements unduly limiting employees from voluntarily disclosing confidential information to the Commission or otherwise limiting the types of information that could be disclosed.

The order, and the SEC's press release announcing it, both stressed that Merrill's violations of the Customer Protection Rule occurred during a time of heightened risk in the market during and after the Financial Crisis, and noted that if Merrill or its parent company had failed during this period, Merrill's customers would have been exposed to a shortfall of cash in the reserve account and been hindered from retrieving their securities. While the order acknowledged Merrill's prompt remediation and substantial cooperation, it also stated that the "significant penalties and other relief … reflect[ed] the seriousness with which the Commission views failures to comply" with the Customer Protection Rule. Although neither the order nor the press release explain why admissions were demanded from Merrill in this case, the Commission apparently determined that the conduct described in the order satisfied some of the criteria that Chair White and the SEC staff previously have laid out, including significant risks to investors and markets arising from the violations.[3]

A separate order instituting litigated proceedings against the FinOp alleged that he was "reckless and negligent" in either aiding and abetting or causing Merrill's "unprecedented" violations relating to the leveraged conversion trades. The order alleged that the FinOp knowingly reduced the amount that Merrill reserved based upon these trades, even though he knew that SEC and FINRA regulators had "significant unanswered questions" about the practice. The FinOp also allegedly failed to accurately disclose the purpose of the trades during a meeting with the SEC and FINRA staff in 2009, and repeatedly ignored requests for information that, if provided to regulators, would have brought about "an abrupt end" to the trades.

Key CPR Initiative Takeaways for Registered Broker-Dealers

Both the significant sanctions imposed against Merrill (notwithstanding its cooperation and extensive remediation) and the accompanying announcement of the CPR Initiative demonstrate the Commission's serious focus on enforcement of the Customer Protection Rule. The CPR Initiative appears to be modeled on the Enforcement Division's recent Municipalities Continuing Disclosure Cooperation ("MCDC") Initiative, which encouraged municipal issuers and underwriters to self-report violations of their continuing disclosure obligations, and ultimately led to dozens of settled enforcement actions.[4]

The CPR Initiative utilizes both "carrots" and "sticks" to achieve its goals. It holds out the carrot of more favorable settlement terms for those broker-dealers that self-report violations of the Customer Protection Rule before November 1,

2016. Under the CPR Initiative, if the Division of Enforcement decides to recommend an enforcement action for any self-reported violation, it will recommend that the Commission accept a settlement with the following terms:

- The action would be brought through a cease-and-desist proceeding;
- The broker-dealer would neither admit nor deny the findings in the Commission's order;
- The settled order would find that the broker-dealer violated Rule 15c3-3 and any applicable books and records and reporting charges;
- The broker-dealer would undertake to (a) establish appropriate policies and procedures and conduct training; (b) cooperate with any investigation related to the violation, including of the roles of individuals and other parties; and (c) if warranted, retain an independent consultant to conduct a compliance review; and
- The broker-dealer would pay disgorgement and penalties, but "meaningful cooperation credit, including in the form of reduced penalties, will be given."

The CPR Initiative also includes two significant sticks to encourage self-reporting. First, the Division of Enforcement, the Division of Trading and Markets, and the Office of Compliance Inspections and Examinations will jointly conduct a risk-based sweep of certain broker-dealers to assess their compliance with the Customer Protection Rule. As a result, any broker-dealer that elects not to self-report violations faces a greater likelihood that these violations will be discovered as part of the sweep.

Second, the SEC's announcement of the CPR Initiative makes clear that a broker-dealer that elects not to take advantage of the chance to self-report will face more significant sanctions if violations are discovered during the sweep. Notably, Merrill did not self-report its violations and was ordered to pay a $358 million penalty and admit liability, even though the settled order acknowledged its substantial cooperation and prompt remedial steps.

Consequently, given the availability of significant credit for self-reporting, the preexisting Rules requiring self-reporting and the impending sweep, broker-dealers should consider proactively reviewing for any violations of the Customer Protection Rule and weigh the benefits of participating in the Initiative.

Key CPR Initiative Takeaways for Compliance Officials and other Associated Persons

The situation of Compliance staff remains uncertain in the wake of the litigated action against Merrill's FinOp, which highlights the SEC's focus on bringing cases against individuals, including compliance professionals. In several recent speeches, senior SEC officials have outlined the factors the Enforcement Division and Commission consider when determining whether to bring enforcement actions against Chief Compliance Officers ("CCOs") and other compliance employees. In a November 2015 speech, Enforcement Director Andrew Ceresney reiterated that enforcement actions against compliance officers would be infrequent, but noted that the Commission would consider bringing cases in situations where the CCO (1) was affirmatively involved in misconduct unrelated to his or her compliance function, (2) engaged in efforts to obstruct or mislead the Commission staff, or (3) "exhibited a wholesale failure to carry out his or her responsibilities."[5]

Here, the Enforcement staff and Commission apparently viewed the FinOp's alleged conduct as falling into one or more of these three categories, but the fact that the action against him includes negligence-based "causing" charges shows that it remains difficult to determine where the Commission will draw the line between what appears to be egregious misconduct and what may be the exercise of good faith judgment that in hindsight turns out to have been a mistake. Furthermore, the CPR Initiative explicitly applies only to broker-dealers, and not to individuals associated with those entities.[6] Consequently, while there may be tangible benefits to the firm, there is a risk that compliance professionals or other associated persons may be subject to individual liability, including for negligence-based charges, if a broker-dealer self-reports violations of the Customer Protection Rule. Compliance employees will be better-positioned to

answer questions about their own conduct if they can demonstrate that they proactively investigated, reasonably analyzed, and appropriately addressed any potential violations of the rule.

Key Whistleblower Protection Takeaways for All Regulated Entities and Public Companies

In addition to the Customer Protection Rule violations, Merrill was found to have violated the Whistleblower Rule by imposing confidentiality obligations in severance agreements that the Commission viewed as an impediment to a former employees' ability to voluntarily provide information to the Commission. Exchange Act Rule 21F-17 provides in part that, "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."

The order found that Merrill used language in certain severance agreements that prohibited former employees from disclosing the confidential information or trade secrets of Merrill to any person outside the firm, except pursuant to formal legal process or with the permission of an authorized Merrill representative. Although the agreement permitted departing employees to disclose confidential information if compelled by a court, administrative agency, or other authority, it did not permit former employees to voluntarily disclose such information to these entities. In 2014, Merrill added language to its standard severance agreement stating that a departing employee was permitted to initiate communications directly with the SEC or other authorities, but limited the type of information that could be shared to (a) information relating to the severance agreement itself or (b) the "underlying facts and circumstances" relating to the agreement.

Merrill was charged with violating Rule 21F-17 even though the Commission's order made clear there was no evidence that any Merrill employee actually was prevented from communicating with the Commission staff, or that Merrill actually took any action to enforce the confidentiality provisions so as to prevent an employee from doing so. The order also cited Merrill's substantial remedial acts, which included modifying the confidentiality provisions in its policies, procedures, and agreements. The new language clarifies that, with the exception of information that is protected from disclosure by an applicable law or privilege, nothing in Merrill's updated language prohibits an employee from sharing information with the Commission. In addition, Merrill now requires employees to undergo annual training concerning their rights to: (a) report possible violations of law to the Commission or other authorities without permission or notice to Merrill; (b) report possible violations anonymously; and (c) cooperate voluntarily with or respond to any inquiry from the Commission or other authorities.

The Whistleblower Protection charge against Merrill is the latest of several SEC actions enforcing this rule,[7] and demonstrates that the Commission will seek to enforce Rule 21F-17 based simply on confidentiality provisions with the potential to chill communications with Commission staff about securities law violations. Pursuant to the Commission's current position, it is not necessary to show that a person actually was chilled from engaging in such communications, or that the entity took affirmative steps to enforce a confidentiality agreement in order to impede a person from doing so.

Accordingly, all regulated entities or public companies should consider conducting a review of their employment and severance agreements, policies, and procedures to determine whether the Commission staff could interpret the applicable language as potentially impeding current or former employees from communicating with the SEC staff about potential securities law violations. Such entities also should consider whether to implement some or all of the remedial changes that Merrill made to its whistleblower agreements, policies, procedures, and internal training.

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This briefing provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

[1] *Merrill Lynch to Pay $415 Million for Misusing Customer Cash and Putting Customer Securities at Risk*, SEC Press Release (June 23, 2016)(available at https://www.sec.gov/news/pressrelease/2016-128.html).

[2] *Customer Protection Rule Initiative*, SEC Divisions of Trading & Markets and Enforcement (June 23, 2016)(available at https://www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml).

[3] The SEC in 2014, 41st Annual Securities Regulation Institute - Coronado, CA, Chair Mary Jo White (January 27, 2014)(available at https://www.sec.gov/News/Speech/Detail/Speech/1370540677500); *Remarks to the American Bar Association's Business Law Section Fall Meeting*¸ Andrew Ceresney, Director, Division of Enforcement (November 21, 2014)(available at https://www.sec.gov/News/Speech/Detail/Speech/1370543515297).

[4] *SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters*, SEC Press Release (March 10, 2014)(available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828).

[5] *2015 National Society of Compliance Professionals, National Conference: Keynote Address,* Andrew Ceresney, Director, Division of Enforcement (November 4, 2015)(available at https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseney.html).

[6] *Customer Protection Rule Initiative*, SEC Divisions of Trading & Markets and Enforcement (June 23, 2016)(available at https://www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml)("The CPR Initiative covers only broker-dealers. The Division of Enforcement provides no assurance that individuals associated with those entities will be offered similar terms if they have engaged in violations of the federal securities laws. The Division of Enforcement may recommend an enforcement action against such individuals and may seek remedies beyond those available through the CPR Initiative. Assessing whether to recommend an enforcement action against an individual for violations of the federal securities laws necessarily involves a case-by-case assessment of specific facts and circumstances, including evidence regarding the level of intent and other factors such as cooperation by the individual.").

[7] *In the Matter of KBR, Inc.*, SEC Release No. 34-74619 (April 1, 2015)(settled order); *SEC v. Kenneth W. Crumbley*, Civil Action No. 3:16-CV-00172 (N.D. Tex.)(January 27, 2016)(litigated action).