Enforcement and Compliance Priorities and Developments: SEC, FINRA, CFTC and CFPB

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SEC and FINRA Broker-Dealer Examination and Enforcement Priorities
Conflicts of Interest

- Changed how FINRA is addressing its exam priorities and how many broker-dealers firms are reviewing their activities

Report’s focus

- enterprise-level frameworks to identify and manage conflicts
- approaches to handling conflicts in manufacturing and distributing new products
- approaches to compensating brokers
Conflicts of Interest

• FINRA 2015 Priorities letter
  • “Conflicts of interest are a contributing factor to many regulatory actions FINRA (and other regulators) have taken against firms and associated persons.”
• Toys’R’Us® IPO research analyst cases – only conflicts case identified by FINRA.
• Other Conflicts Cases brought since Report
Complex Products

• Starting Point -- FINRA Regulatory Notice 12-03
• This year’s products – 2015 Priorities Letters
  • FINRA - Interest rate-sensitive Fixed Income Securities, Variable Annuities, Alternative Mutual Funds, Non-traded REITs, Exchange-traded Products, Structured Retail Products, - Floating-Rate Bank Loan Funds, Securities-Backed Lines of Credit
  • SEC – Alternative Investment Companies, FI Investment Companies
Complex Products

• Conflicts Report
  • Review committee should analyze suitability, potential conflicts
  • Limit access to certain distributors
  • Prescribe minimum obligations for registered representatives who recommend product
  • Minimize conflicts in compensation structures
  • Use heightened supervision to mitigate remaining conflicts
Complex Products

• di Florio Remarks (October 2014)
  • New product review process
  • Favoring proprietary products
  • Compensation structures

• Instructive Enforcement Actions
  • ETFs
  • Non-traded REITs
  • Private placements
  • RMBS
Investment Advisory Issues

• “Wealth Events” – FINRA priorities letter
• Fee Selection and Reverse Churning – SEC priorities letter
• Fee-based accounts
  • placing a customer in wrap accounts without a reasonable basis or adequate support for the decision
• IRA Rollovers
  • strong suitability and disclosure components to decisions to move 401(k) funds into IRAs
• Relevant Cases
Cybersecurity

• OCIE Report
  • Exams: 88 percent of BDs and 74 percent of the RIAs experienced cyber-attacks
  • Vast majority have written information security policies, with some gaps

• FINRA Report -- Comprehensive

• Examination Priorities
  • Governance structures
  • Processes for conducting risk assessments
  • Data Storage

• Enforcement Actions
Insider Trading

• Broker-dealers
  • Obligated to have policies and procedures to prevent misuse of MNPI
  • FINRA 2015 Examination and Enforcement Priority

• Types of Violations
  • Failure to have adequate policies and procedures
  • Failure to supervise
  • Inadequate large options positions reporting and blue-sheet responses

• Best Compliance Practices
  • Identify red flags
  • Information barriers
  • Monitoring communications
  • Monitoring Trading
  • Watch and restricted lists
CFTC’s Exercise of its Dodd-Frank Authority
CFTC Enforcement Trends

- Significant change at the CFTC over the past year
  - New Chairman, 2 new commissioners, and new Enforcement Director Aitan D. Goelman
- Resource constraints have hampered Enforcement Division to some extent.
- 2014 Enforcement Activity:
  - 67 new enforcement cases, lowest level since 2010, but:
    - Higher penalties: $3.27 billion in monetary sanctions (nearly double previous record of $1.7 billion set in 2013)
    - About 1/2 of this amount was recovered in FX manipulation settlements with 5 major banks
    - Greater focus on complex high-profile, data-intensive cases
Enforcement Areas of Focus 2014

• Benchmark manipulation cases
  • CFTC filed and settled actions against 5 major banks for allegedly attempting to manipulate benchmark FX rates ($1.4 billion in penalties)
  • CFTC also filed 2 settlement orders regarding interest rate benchmarks
• Other Manipulation settlements
  • Moncada (would have been spoofing under Dodd-Frank)
  • Parnon Energy (crude oil)
  • Hunter (natural gas)
• J.P. Morgan “London Whale” manipulation settlement in 2013 involving credit default swaps – first use of the new Dodd-Frank anti-manipulation standard/reckless conduct ($100 million civil penalty)
Enforcement Areas of Focus 2014

- Wash sales – settlement involving a case of a major bank that allegedly engaged in more than 1,000 illegal wash sales, fictitious sales, and non-competitive transactions involving stock futures over a three-year period ($35 million civil penalty)
- Disruptive Trading Practices/Spoofing
  - Coscia criminal prosecution for spoofing (CFTC settled in 2013)
- Position Limits
  - Thrasher ($525,000 penalty)
- False Statements to the CFTC (new Dodd-Frank provision)
  - Obolensky ($250,000 penalty)
  - Stropp ($250,000 penalty)
Enforcement Areas of Focus 2014

• Failure to Supervise:
  • A number of actions were brought against FCMs for violations of CFTC Reg. 166.3, which requires CFTC registrants to “diligently supervise” the activities of its affiliates and employees.
  • These actions involved alleged deficiencies in processing of exchange and clearing fees, maintaining records of segregated funds, and “know your customer” procedures.

• Customer Protection Rules:
  • 5 actions for various violations (e.g., violation of minimum net capital requirements, failure to maintain adequate records of secured and segregated funds) not involving significant customer losses or fraud.

• Cooperative Enforcement: approximately 95% of major fraud and manipulation cases involved parallel criminal proceedings.
2015 Enforcement

• Focus on Benchmark manipulation likely to continue
• Wider Dodd-Frank compliance scope with focus on swap dealers/financial entities
• More extensive use of post-Dodd Frank anti-manipulation/anti-fraud authority (e.g., CFTC Reg. 180.1)
• Disruptive Trading Practices
• High Frequency Trading
• Position Limits (see Olam case - $3 million penalty (Jan. 2015))
• False Statements
• Greater use of administrative proceedings rather than courts according to Enforcement Director Goelman
• Limited resources likely will remain an issue
• Coordination with FERC in energy cases likely to continue
• Parallel criminal proceedings likely more of the same
CFPB Examination and Enforcement
CFPB Exams

• CFPB examines for compliance with federal consumer financial laws and regulations

• Sourcebook: CFPB Examination Manual
  • Readily available on CFPB website – widely used as a compliance tool for covered institutions
  • Organized by general topics – compliance management, mortgage servicing, mortgage origination, debt collections - and by specific laws (ECOA, RESPA, TILA, UDAAP, etc.

• To date, many institutions, including significant number of depositories, have been examined
  • As with prudential regulators, largest depositories have full-time CFPB examiners on site
  • Non-banks typically don’t have examiners on site, but exams involved more examiners on site and longer exam periods
Types of Exams & Possible Results

- CFPB conducts several types of examinations or reviews
  - Regularly-scheduled company-specific exams, looking into all activities of a particular lender or servicer (common for non-banks)
  - Target reviews, involving a single entity and targeted at particular situation, due to special concern at the Bureau
  - Horizontal reviews, looking across multiple institutions to examine particular products or practices (commonly, involving banks)
  - Limited-scope exams, such as CMS and/or Fair Lending exams
- CFPB reminds the industry that exams not in lieu of investigations in connection with potential enforcement actions – including CID’s, RFI’s, administrative actions & lawsuits
- Now firmly entrenched that CFPB exams lead to enforcement – e.g., CFPB increasingly issuing PARR letters in the course of exams
CFPB Enforcement Powers

• Dodd-Frank Act gives power to CFPB
• For violations of federal consumer financial laws and regulations, and for Unfair, Deceptive, or Abusive Acts or Practices (UDAAPs), CFPB can bring enforcement actions to obtain (among other things):
  • Civil penalties of up to $1,000,000 for each day the violation continues
  • Restitution
  • Refund of moneys or return of real property
  • Damages or other monetary relief (but not punitive damages)
  • Costs of the CFPB in prosecuting the action
• Enforcement actions to date well-publicized and have resulted in $100’s of millions of dollars in civil money penalties and consumer relief/restitution
• Few reported cases, we learn of Bureau priorities through guidelines, issuances and consent orders
Exam & Enforcement Approach

- CFPB public pronouncements (including consent orders, Supervisory Highlights, speeches, testimony) and actions in exams (nonpublic) illustrate the agency’s basic approach
- CFPB is a “numerator” agency – a small number of violations can result in CFPB demands for remediation
  - Real breakpoint from “traditional” prudential regulation (though prudential regulators acting more like the Bureau)
  - Only a few mishandled customer interactions, across portfolios of 1000’s of loans and consumer interactions, get CFPB’s attention & may require remediation
  - CFPB may not be satisfied with good faith self-remediation and process changes – high priority on consumer redress (e.g., refunds), even if only for a few borrowers & small $$$’s
  - Arises in mortgage servicing, student loan servicing, debt collection, credit cards – many consumer interactions and high possibility that consumers are in distress
CFPB Approach cont’d

• In summary, CFPB expects “perfection” across thousands of consumer interactions, from inherently imperfect processes

• What does CFPB focus on?
  • Data transfer, in situations involving boarding and de-boarding of accounts
  • Compliance with rules, with no “gaps”, even for newest rules
  • Communications w/ consumers, not just required disclosures – what did the consumer understand and when did he/she understand it – using a “least sophisticated consumer” standard
  • Any processes & procedures for accounts in actual or imminent default or delinquency - not just inputs, but consumer experience and individual outcomes

• What does the CFPB not focus on?
  • Safety & soundness – not the agency’s job, rather, CFPB’s mission to assess and eliminate “harm to consumers”
  • Actual harm or damage to consumers not required – UDAAP is the common fallback, even if no violations of law or regulation
The Big Stick: UDAAP

- CFPB in nearly every significant exam and enforcement action presses UDAAP claims
- Comes from Dodd-Frank, specifically, §§1031 & 1036
  - Section 1031 defines “unfair, deceptive or abusive acts and practices” (UDAAP)
  - Section 1036 empowers CFPB to enforce the new standard
  - “Unfair” and “deceptive” borrowed from FTC, while “abusive” is new
- A “know it when you see it” standard?
  - Inherently fact-specific, down to the individual borrower
  - Compliance-by-example – difficult to build a compliance regime around lawsuits, administrative actions and consent orders
  - The reverse Nike principle: “Just don’t do it”
- MoFo has written extensively on the subject, including a whitepaper with detailed chart of examples
UDAAP in Play

- CFPB’s most common use is the “deceptive” element, followed by “unfair” – “abusive” thus far has been used sparingly
- CFPB feels it can demonstrate deception and unfairness without going to abusive
- Elements of a UDAAP violation?
  - Violation of law or reg not required – laws/regs as “starting point”
  - Fact-specific
  - Least sophisticated consumer standard
  - Actual harm to consumer need not be shown – the possibility of harm is enough
  - “Harm” can be a consumer’s right to bring lawsuit for violation of laws/regs
  - In lawsuits, admin actions & consent orders, as well as other exam-related guidance, UDAAP not pled or described in detail – CFPB’s “declaratory” approach
- Trendline: more UDAAP, if for no other reason than CFPB’s successes to date
Questions?

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