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# The Regulatory Risks Of A Deregulatory Environment

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**September 19, 2017, 11:49 AM EDT**

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Now that we are several months into an administration with an agenda of financial deregulation, and the investigations related to the financial crisis are fading into the rearview mirror, one might reasonably believe financial institutions are in for several years of relative quiet from financial regulators. For example, in his first public speech as chairman of the U.S. Securities and Exchange Commission this past July, Jay Clayton's remarks on SEC enforcement put a priority on protecting "Main Street" investors, particularly retirees, from perpetrators of affinity, microcap and pump-and-dump frauds.[1]

However, if history provides any lessons, then the next several years could see an unexpected level of regulatory investigations and enforcement activity with a focus on market participants and financial institutions. At least two factors raise the potential risk for a future wave of investigative activity.

First, the rising stock market continues its ninth year — one of the longest bull market runs in history. Increasingly, analysts are noting the inevitability of a market correction.[2] With corrections typically come calls for investigation of the causes and the consequences for those adversely impacted.

Second, state regulators who do not share a deregulatory agenda, but who can have a political agenda of their own, can step in to take a high-profile role in financial enforcement and regulation.

Consider these historical examples. For instance, if the SEC's current focus on protecting elderly retail investors from investment scams sounds familiar, it may be because of its similarity to a speech given 10 years earlier, in 2006, by then Chairman Christopher Cox. In that speech, Cox promoted an initiative with state securities regulators to "curb fraud against America's senior citizens."[3]

At that time, near the end of the last Republican administration, the SEC's focus on investment scams perpetrated against the elderly was short-lived. A year later, the bursting real estate bubble hit Wall Street as investment banks wrote off billions of dollars in mortgage-related assets. In March 2008, Bear Stearns collapsed and the financial crisis, and an era of financial regulation and enforcement, was under way.

Before you think that was an historical anomaly, consider an earlier example from the beginning of the last Republican administration. In October 2001, then SEC Chairman Harvey Pitt delivered one of his first speeches to the American Institute of Certified Public Accountants. Adapting a line originated by the first President George Bush, Pitt noted that the SEC had not always been a “kinder and gentler” place for accountants and articulated a vision for a constructive engagement between the SEC and the accounting profession.[4]

Less than six weeks later, in December 2001, Enron filed for bankruptcy, and ushered in years of accounting investigations, criminal prosecutions and civil enforcement actions. It did not matter that Pitt also advocated for strong enforcement. The media would repeatedly invoke that one line from the speech as symbolic of the need for more aggressive regulatory enforcement.

However, the accounting investigations turned out to be only the beginning of a wave of investigative and enforcement activity. In April 2002, the then-New York attorney general commenced an action against Merrill Lynch challenging conflicts of interest in equity analyst research. The fallout engulfed all major Wall Street broker-dealers in years of intensive investigations and ultimately settlements with the SEC and state regulators that imposed industrywide reforms on sell-side equity research. In September 2003, the New York attorney general announced a settled investigation of a hedge fund that had been engaged in market timing and late trading of mutual fund shares. That action initiated an industrywide investigation by the SEC and state regulators of mutual funds, broker-dealers and hedge funds for rapid trading of mutual fund shares.

One of the characteristics of these cases was the disconnect they revealed between, on one hand, the ordinary-course evolution and adoption of industrywide business practices by financial institutions, and, on the other hand, the way in which those same practices can be turned into populist calls to action against financial institutions by regulators, politicians and the media. In 2003, in the wake of cases involving analyst research and mutual fund market timing, the SEC’s then director of enforcement, Stephen Cutler, called on the SEC registrant community of investment advisers and broker-dealers to undertake a top-to-bottom review of their business operations to identify and address conflicts of interest among clients or between clients and the firm.[5] That invitation led many market participants to take an introspective look at standing business practices with an eye to how they could be viewed through a more critical regulatory or media lens.

Another characteristic of these cases was that it began the regulatory focus on electronic communications as the evidentiary bedrock of investigations and prosecutions. Nearly a generation has passed since those early days of casual, and sometimes careless, use of email. And just as employees have become judicious in their use of company email, a new generation of employees show a tendency to use noncompany means of communication, such as text messages and other smartphone-based messenger applications. Such communications are outside the firm’s surveillance oversight, but nevertheless subject to potential collection and production in an investigation. Yet, in these unofficial means of communication, employees can tend to revert to an informal style that leaves them susceptible to misinterpretation by regulators.

The lesson of history is that one cannot predict where the next regulatory focus will be and cannot take comfort in a deregulatory environment. As businesses evolve, the regulatory risks change. The challenge of compliance is not just managing known risks, but also anticipating, identifying and managing emerging and evolving risks.

A deregulatory environment can present a unique challenge for compliance programs. At times of heightened regulatory scrutiny, enterprises prioritize compliance in both allocation of resources and in the hierarchy of decision-making. When the government is perceived as taking its foot off the regulatory gas pedal, it is easy for enterprises to approach compliance with a diminished sense of urgency. Yet it is precisely the legal and compliance judgments made outside the harsh regulatory spotlight today that will become the focus of investigations tomorrow.

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[1] Speech by Chairman Jay Clayton, Remarks and the Economic Club of New York, July 12, 2017, available at https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[2] See, e.g., “Stock Market Correction Coming? Actually, We Are Already In One,” Rob Isbitts, Forbes, August 22, 2017, available at https://www.forbes.com/sites/robisbitts2/2017/08/22/stock-market-correction-coming-actually-we-are-already-in-one/#51c4f69a779d.

[3] Speech by Chairman Christopher Cox, Remarks at the American Securitization Forum, June 7, 2006, available at https://www.sec.gov/news/speech/2006/spch060706cc.htm.

[4] Speech by SEC Chairman Harvey L. Pitt, Remarks Before the AICPA Governing Council, Oct. 22, 2001, available at https://www.sec.gov/news/speech/spch516.htm.

[5] Speech by Stephen M. Cutler, Director, SEC Division of Enforcement, Remarks Before the National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference, Sept. 9, 2003, available at https://www.sec.gov/news/speech/spch090903smc.htm.

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