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SEC To Financial Firms: Cut Costs At Your Peril

Law360, New York (February 06, 2009) -- The financial industry is in turmoil. In 2008, financial pressures of enormous magnitude forced seismic changes in the industry.

Street stalwarts such as Merrill Lynch, Bear Stearns and Wachovia have consented to acquisitions, and Lehman Brothers filed for bankruptcy protection.

Citigroup, Goldman Sachs and Morgan Stanley suffered massive reductions in their market capitalizations. Hedge and mutual funds experienced unprecedented withdrawals and redemption requests.

The financial industry suffered the loss of approximately 130,000 industry jobs, and this number is likely to increase as year end totals are finalized.

Commentators project that job losses in the industry will likely continue, and up to 250,000 financial workers, perhaps even more, could find themselves out of work by the second quarter of 2009.

The U.S. Securities and Exchange Commission (SEC), which oversees approximately 11,300 investment advisers, 950 mutual fund complexes, 5,600 broker-dealers and 410 transfer agents, is being blamed for much of the current market turmoil. SEC regulatory and enforcement efforts over the past decade are being sharply criticized as "abysmal".[1]

Critics say that the SEC does not proactively prevent problems, but merely acts as a policeman for blatant violations well after they have occurred.

As one critic argued, the SEC "hasn't been leading the charge, as much as they've been following it. The house burns down, and then they do a really good job to say, 'Whose fault is that?'"[2]

In the face of mounting financial pressure on industry participants, and despite the criticisms leveled against the SEC, the SEC seems to be sending a clear message to

the street: cut costs if necessary, but do not cut so as to impair the efficacy of your compliance programs.

At the end of November, Linda Thomsen, the Director of the SEC's Division of Enforcement, stressed that the Division remains focused on "covering the waterfront," and it remains "business as usual" at the Commission.[3]

Around the same time, the Chairman of the SEC, Christopher Cox, publicly warned against cost-cutting measures by companies in the current climate, stating:

"In a profit and loss driven world, there is always a risk that companies facing an uncertain economic future may choose to cut compliance expenses as a shortsighted way to save money.

"But experience has taught us again and again that giving short shrift to regulatory compliance subjects a company's investors, employees, management, directors and every other stakeholder to unacceptable risks ... [n]ow more than ever, companies need to take a long-term view on compliance and realize that their fiduciary responsibility requires a constant commitment to investors.

"That means sustaining their support for compliance during this market turmoil, and beyond as well."[4]

Cox further cautioned against compliance cuts, stating, "When a company cuts compliance, violations will occur. And if violations occur, punitive actions should and will be taken ... [t]here will be no favor granted because a company made a cost-cutting decision to minimize their compliance budget."

The warnings continued in December in a statement by the SEC's director of compliance, inspections and examinations.

Lori Richards issued an open letter to chief executive officers of SEC-registered firms, including broker-dealers, investment advisers, investment companies and transfer agents, to remind them of the critical role played by their firms' compliance programs in assuring that their operations comply with the federal securities laws and rules for industry participation and to ensure that the interests of customers or clients are protected.

Richards specifically addressed compliance in the context of the financial crisis, stating, "While many firms are considering reductions and cost-cutting measures, we remind you of your firm's legal obligation to maintain an adequate compliance program reasonably designed to achieve compliance with the law."[5]

The SEC is putting the financial industry on notice. Current compliance cost-saving efforts may result in enforcement-related consequences.

The exposure of firms to the institution of SEC enforcement proceedings, and to the imposition of greater sanctions in those proceedings, will be increased if the SEC staff concludes that the underlying enforcement issue was either caused by a firm's reduction of resources devoted to its compliance program, or likely would have been prevented absent such reduction. This is the message from the SEC, and it is unmistakable.

As financial firms review their budgets and make the difficult judgments required in allocating resources, it is imperative to bear this point in mind. Failure to do so may result in the realization of near-term savings, at the price of much greater long-term expense resulting from a lengthy SEC investigation.

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Richard E. Brodsky, "Solving the SEC's Ills Won't be Easy," Miami Daily Business Review, Jan. 5, 2009, p. A5.

[2] Theo Francis, "SEC's Cox Catches Blame for Financial Crisis," BusinessWeek Online, Sept. 22, 2008.

[3] "Dialogue with the SEC Enforcement Staff," sponsored by the American Bar association's Sub-Committee on Civil Litigation, Nov. 21, 2008.

[4] Christopher Cox, Chairman of the U.S. Securities and Exchange Commission, Address to the 2008 CCO Outreach Seminar (Nov. 13, 2008), www.sec.gov/news/speech/2008/spch111308cc.htm

[5] Lori A. Richards, Director of the SEC's Office of Compliance Inspections and Examinations, Open Letter to CEOs of SEC-Registered Firms (Dec. 2, 2008), ftp.sec.gov/about/offices/ocie/ceoletter.htm.