Broker-Dealers and Financial Services Firms Should Expect Increased Regulatory Scrutiny and Litigation in Light of COVID-19

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COVID-19 has affected our entire economy and the financial markets are no exception. Financial firms continue to face uncertainty and operational challenges, but in these times of crisis, it is important not to overlook changes in regulatory focuses and potential litigation concerns.

Experience tells us that market volatility and economic uncertainty are catalysts for increased regulatory scrutiny and securities litigation. The Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA) and other market regulators have doubled down on policing for fraudulent activity, while securities-related litigation filings are on the rise.

Broker-dealers and other financial institutions therefore need to remain focused and prioritize responding to regulatory changes and potential litigation risks associated with an environment that we expect will continue to be something of a moving target for the foreseeable future.

Regulatory Landscape

The SEC has been working remotely (with limited exceptions) since March 10, 2020, and continues to electronically file lawsuits and conduct on-the-record interviews and testimony. In a March 18, 2020 order, the SEC directed that administrative filings should continue, but electronically.² SEC staff are also signaling that its investigations will keep moving forward via document and information requests, telephone discussions, and virtual meetings. In addition to the regulatory filing and other specified relief, as outlined in its COVID-19 release,³ the SEC’s Office of Compliance Inspections and Examinations (OCIE) plans to conduct its examinations primarily off-site and has agreed to work with firms on the timing of its requests and other exam related matters help to minimize disruptions.⁴

Although FINRA had temporarily limited their routine firm examination requests, those are now back on schedule. In addition to routine examinations, firms can expect FINRA to continue regulatory inquiries regarding credit and margin balances. FINRA is also allowing time extensions for

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regulatory filings or responses to FINRA inquiries and investigations during the current crisis, while reminding firms to bolster their business continuity plans. FINRA also postponed certain Office of Hearing Officers proceedings through April and all of its in-person arbitration and mediation proceedings scheduled to take place through May 31, 2020.

Changes in Regulatory Priorities

The SEC, FINRA, and other market regulators have recently said that they are essentially doubling down on policing for fraudulent activity. More specifically, industry guidance tells us that regulators have sharpened their focus on policing the misuse of material nonpublic information and other fraud-related activities.

- On March 23, 2020, the co-directors of the Division of Enforcement issued a statement emphasizing the importance of protecting against the improper dissemination and use of material nonpublic information in these dynamic circumstances. They explained that, because of the unique circumstances presented by COVID-19, “corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances,” particularly if the virus delays earnings reports or other filings.
- In an April 2, 2020 statement, SEC Chairman Jay Clayton said that the June 30 compliance deadline for compliance with Regulation Best Interest (Reg BI), the “best interest” standard remains in effect, despite the continued impacts of the coronavirus on financial markets.
- In an April 3, 2020 update regarding their COVID-19 response, the SEC indicated that “[t]he agency is actively monitoring our markets for frauds, illicit schemes and other misconduct affecting US investors relating to COVID-19—and as circumstances warrant, will issue trading suspensions and use enforcement tools as appropriate.”

FINRA has indicated that they are also prioritizing matters that they perceive to present the most risk in the current environment. This includes a focus on monitoring for fraud, illicit schemes, and other manipulative activities that seek to illegally benefit from the tumultuous conditions created by the COVID-19 crisis and accompanying market volatility.

In FINRA’s COVID-19 frequently asked questions (FAQs), it also projects a regulatory focus on remote supervision. The FAQs state that FINRA expects member firms to “establish and maintain...
a supervisory system that is reasonably designed to supervise the activities of each associated person while working from an alternative or remote location, and to document changes to its current written supervisory procedures.” FINRA also tells member firms that they should continue testing remote office and telework arrangements to assess their ability to connect to critical firm systems.\textsuperscript{11}

Finally, the US Department of Justice (DOJ) is focusing on combatting COVID-19-related fraud, including Attorney General William Barr’s March 16, 2020 memorandum addressing the need to detect, deter, and punish any COVID-19 related wrongdoing.\textsuperscript{12}

Regulatory Considerations

Regulators have shown a willingness to be somewhat flexible and provide relief to issuers, exchanges, and brokerage firms as they continue to work remotely and adapt to revised filing deadlines. However, they are also strongly communicating that they are paying particular attention to companies’ handling of nonpublic information and that they are increasingly focused on fraud prevention and customer protection.

Firms should expect to face questions about their business continuity planning (BCP) processes and procedures, including increased scrutiny regarding the efforts taken by firms to protect material nonpublic information and to prevent improper account access and trading. In addition, regulators are also likely to be focused on:

- Reg BI implementation and testing efforts
- Remote supervision policies and procedures
- Technology testing and cyber security protocols
- Timely customer communications and accurate disclosures

Thus, firms should consider taking steps to remind individuals with access to material nonpublic information of their confidentiality obligations and the prohibitions on insider trading. Likewise, broker-dealers, investment advisors, and other registrants may also want to revisit policies and procedures related to the misuse of material nonpublic information. Broker-dealers should also be wrapping up their Reg BI implementation and testing efforts and be prepared to discuss those efforts with FINRA during upcoming examinations. Finally, firms should continue assessing and documenting BCP supervision and customer communication efforts, and be proactively discussing potential operational concerns and regulatory risks.

Securities Litigation and Arbitration Risk Analysis

In the current environment, there is a logical focus on the potential for litigation involving industries directly experiencing decreased demand because of the measures taken to mitigate the spread of


COVID-19, such as leisure, hospitality, and travel; and also the automotive industry, given the effect of global supply chain disruptions. However, given the crisis's current trajectory, it is likely that litigation risks will spread throughout the economy, including the financial markets. System outages have already sparked class action litigation, challenging corporate fiduciaries’ guidance and decisions in response to this crisis. The SEC also recently filed its first crisis related action against a company and its CEO for alleged COVID-19 related scams. FINRA’s arbitration statistics also show an increase in the number of new cases filed through March of 2020 (946), as compared to the same time last year (831).

In addition, in setting early expectations about securities litigation that may result from the current crisis, we considered it useful to examine post-2008 financial crisis-related litigation. Indeed, both the 2008 and COVID-19 crises have been marked by a significant economic shock and large declines in the stock market. As asset values fall, we may again endure a broad credit crisis. The impact of COVID-19 on related financial litigation will likely be further pronounced due to the preceding years of low interest rates and increased corporate borrowing. Current job losses and output declines are also a reprise of the 2008 financial crisis.

Given these key similarities and shared market declines, we expect to see an increase in securities litigation related to the COVID-19 crisis that somewhat aligns with the increase that occurred following the 2008 crisis.

Private Litigation

A closer analysis of the securities cases related to the 2008 crisis tells us to expect an uptick in private litigation related to fraud, misrepresentation, and breach of fiduciary duty claims. For example, over 50% of crisis-related private litigation cases filed from 2007 through Q2 2013 appear to have been related to fraud or misrepresentation claims (i.e., SEC Rule 10b-5 and Section 11 or 12 of the Securities Act of 1933 violations). Breach of fiduciary duty was also a large portion of the filings (20%).

15 Systems outages spur class action litigation-https://www.law360.com/articles/1250592/robinhood-s-system-outage-spurs-class-action-filed-in-fla-
17 https://www.finra.org/arbitration-mediation/dispute-resolution-statistics#arbitrationstats
While we do not yet know what will comprise the private securities litigation that will follow the COVID-19 crisis, we expect the above claims to present themselves, particularly given some of the economic similarities between the current and 2008 financial crisis.

**Regulatory Actions**

As one might suspect, post-2008 regulatory litigation statistics show an increase in cases involving fraudulent and sales practice related misconduct. Given the SEC’s and FINRA’s current postures regarding potential fraud, and the somewhat similar market volatility and certain economic impacts to the 2008 crisis, we expect regulatory actions in these areas to increase in response to the current crisis.

- **SEC Complaints**

  From fiscal years 2007 to 2013, the SEC filed over 4,000 complaints against registered companies and individuals. In 2008, the SEC announced its continued focus on misconduct stemming from the 2008 financial crisis. Post-2008 SEC litigation statistics show an increase in cases involving...
subprime mortgage-related activities, including securities offerings, financial disclosure fraud, insider trading, and investment advisor (sales practice) misconduct.20

Issuer reporting and disclosure filings remained one of the largest categories of SEC enforcement cases, closely followed by securities offerings and investment advisor cases. According to the SEC’s 2008 annual report, the 2008 financial crisis directly caused the increase in securities offering cases, which exposed a large number of Ponzi schemes and other offering frauds. Given the SEC’s recent comments regarding its policing of fraudulent schemes21 and market response similarities to the 2008 crisis, we expect similar enforcement outcomes to the current crisis.

**FINRA Disciplinary Actions**

From January 2007 to December 2013, FINRA filed approximately 500 complaints against member firms, registered representatives, and/or associated persons. While FINRA only specifically mentioned mortgage-backed securities (MBS) in two of these cases and did not mention the 2008 crisis in any complaint, there were a handful that involved fraudulent conduct. Taking into account that FINRA disciplinary actions can also result in settlement, making the filing of a complaint

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unnecessary, we also reviewed the Letters of Acceptance, Waiver and Consent (AWCs) issued by FINRA from 2009 to 2013, of which only 15 mention MBS. Those that did mention MBS were focused on supervision and other conduct related activities.\textsuperscript{22}

This may be an indication that FINRA’s response to the 2008 crisis was a somewhat informal part of its examination process as opposed to formal enforcement actions. While we believe FINRA’s COVID-19 guidance and FAQs are likely projective in terms of its potential examination and investigation focuses, FINRA complaint filings following the 2008 crisis seem to have less predictive value. However, we found the exact opposite to be true for FINRA customer arbitrations.

- **FINRA Arbitrations**

FINRA arbitration statistics are more telling in terms of what we are likely to see from customer complaints, following the current crisis. Our review shows that arbitrations involving customer disputes almost doubled following the 2008 crisis. There was an increase in every type of controversy. The most substantial percentage increases occurred in disputes related to margin calls, unauthorized trading, failure to supervise, negligence, and unsuitability.

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**FINRA Arbitration Filings 2008–2012 by Type of Controversy**

Sources: [FINRA.org](https://www.finra.org)

Notes: An arbitration may include multiple controversy types.

Because of the similarities in terms of market losses and sales practice risks between the 2008 and the current crises, we believe this increase in somewhat predictive of the types of controversies that may result from the COVID-19 crisis.

Relatedly, on April 2, 2020, the SEC’s Investor Advisory Committee hosted a conference call with other regulators and identified potential sales practice issues that could arise following the current crisis. Among them were issues similar to those underlying the spike in arbitration claims following the 2008 crisis, including microcap fraud, private placement scams, misuse of margin, operational issues, and suitability. Thus, firms will likely see an increase in customer arbitrations, similar to the post-2008 financial crisis period.

Securities Litigation Considerations

As a firm’s compliance, operational, and legal teams often work together, collaboration is an essential part of successfully navigating potential COVID-19 related litigation. Key collaborative mitigation strategies for financial firms include:

- Increased attention to coordinated BCP responses to ensure issues are identified quickly and shared among business units
- Quickly addressing and continued testing for BCP-related technology and customer account access interruptions
- Ensuring customer correspondence and disclosures are up-to-date
- Revisiting customer communication and documentation policies with employees
- Boards of directors evaluating if and when COVID-19 poses an enterprise risk, requiring targeted documentation and disclosure

Conclusion

One thing is certain: Broker-dealers and other financial service firms should seek to mitigate the risks associated with the quickly changing regulatory conditions and likely increase in potential securities-related litigation, similar to the increase we saw following the 2008 financial crisis. Further, regulators are highly attuned to the market risks created by the COVID-19 crisis. Companies must be aware of this increased regulatory focus and should document their BCP efforts to be prepared to respond to regulators’ inquiries and investigations. Financial firms that fail to anticipate and respond to these developments may find themselves unprepared for the ongoing litigation risks and regulatory challenges resulting from this crisis.

23 https://www.sec.gov/spotlight/investor-advisory-committee.shtml