Financial Services Industry Year in Review: Regulatory Enforcement and Litigation Trends in 2021 and Beyond

December 27, 2021

Just like the rest of us, the financial services industry wasn't immune from the numerous and unprecedented pandemic-related challenges over the past year. Through our annual Financial Markets Litigation and Enforcement Symposium Series, we were able to take a deeper look at the state of futures, trading, and securities regulatory and enforcement trends.

Along with our guest speakers, we examined the latest in gamification, the role of next-gen traders, the impact of dramatic growth of assets under management, and the regulation of virtual currencies and digital assets. We were also briefed on the significant diversity and inclusion efforts by financial institutions.

In this review, we share our key takeaways, trends to watch, and predictions for the months ahead.

Market Trading: Why Regulator Activity Is Expected to Accelerate

Gamification tactics and investment advice from social media influencers and chat rooms are disruptive technologies and behaviors capturing the attention of regulators in 2021 and forcing them to take a closer look — and react. For the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC), the question becomes how far this new generation of investors should be allowed to take advantage of these new tools, apps, and free trades, and what guardrails need to be in place to protect investors and ensure market integrity? The consensus is that we can expect regulatory guidance to accelerate in 2022.

In discussing developments in best execution and payment for order flow, disruptive technology, a new generation of traders, we highlight five topics to consider.

A New Generation of Investors Are Making Their Mark

In 2020, one clearing firm reported opening six million new accounts, a 137 percent increase over 2019. One million of those new accounts were from Generation Z with an average age of 19 years old. With so many more people interested in market trading, and a significant number of whom are taking guidance from social media, it should be no surprise that 2021 delivered some unexpected developments. Among them was the GameStop trading frenzy fueled by social media platforms and socioeconomic undertones.

On the Reddit internet chat board "WallStreetBets," retail investors reveled in the knowledge that GameStop, a dying breed of brick and mortar video game stores, was shorted heavily in 2020 and vulnerable to a short squeeze. Wanting to "stick it to" hedge funds, Wall Street, and the "1%," these new investors encouraged each other to buy the stock and push it up further. The activity caused a massive price surge — up 928 percent — during the first few weeks of 2021 and effectively forced short sellers, including large hedge funds, to remove their short positions and buy shares. In turn, the run-up led to unprecedented market volatility and resulted in some significant losses for large investors.

In the wake of the GameStop run-up, clearing houses and brokerage firms began pointing fingers at one another. But an October report issued by the SEC after congressional hearings on the matter concluded that the price surge was in fact caused by a large group of individual retail investors taking cues from social media. Although the report did not make specific policy recommendations, regulators are expected to eventually respond.

'Fin-fluencers' Are Getting Mixed Reviews

Following in that same vein, 2021 saw a significant uptick in the number of social media influencers entering the financial space. In general, social media influencers have established credibility in a specific industry, have access to a huge audience, and can persuade others to act based on their recommendations. Though influencers have been around for some time, financial influencers are fairly new.

"Fin-fluencer" social media activity runs the gamut from pitching stocks on the rise and how to get-rich-quick schemes to sharing educational material or personal stories. On the up-side, some believe fin-fluencers fill a gap in financial literacy, despite most lacking formal qualifications. On the downside, there is a lack of transparency regarding risks associated with products and investment strategies they recommend and the potential for pump and dump schemes.

Further, with fin-fluencing growing, more firms are adding them to their marketing mix. There is no better way to reach the new generation of investors than through social media. Firms and broker-dealers are using (and paying) fin-fluencers to talk about stocks and services on their behalf. Regulators are now looking into broker-dealer practices and have issued requests for information, asking for a detailed history of relationships with influencers, how they first identified them, how they are compensated, and any referral agreements they may be engaged in. The inquiry letters also give several pages to privacy concerns regarding sharing client information with influencers. This is certainly a ripe area for more regulation and guidance in the near future.

Gamification Is Playing Havoc With Traditional Regulatory Rules

Closely related to fin-fluencing and chat room investment advice is gamification, also known as digital engagement practices. Similar to a fitness tracker, investment apps using gamification tactics can track the individual's trading activity and encourage trades, sends alerts, use a leaderboard and reward the user with badges when they reach certain milestones. The regulatory issues involved are numerous. For example, is an app that encourages an investor to trade considered a broker recommendation that falls under regulated activity? We expect FINRA and the SEC to issue more guidance on gamification in the near future.

Payment for Order Flow Is Drawing Added Scrutiny

PFOF, which over time has survived calls for banning the practice, has faced renewed scrutiny that could result in rule changes or even barring the practice altogether in 2022. The renewed scrutiny followed the market volatility created by the meme-stock frenzy in 2021. In October, SEC Chairman Gensler said that the agency is indeed looking into whether PFOF should be changed or barred, with the objective being to create a more competitive marketplace.

Drawing additional scrutiny in 2021, is the growth in size of payments received by retail brokers for their retail order flow. During the first three quarters of the year, PFOF grew by 41 percent compared to the same period in 2020. A large percentage of that increase is tied to options trading and regulators are concerned brokers are encouraging retail investors to jump into these complex derivative markets without understanding the risk. Commissioner Gensler suggested that the Commission could propose new rules in the near future.

Securities: Four Asset Management Trends Amid Exponential Growth

When the United States Investment Company Act and the Investment Advisers Act of 1940 came into force, assets under management were a mere $1 billion. Sixty years later they topped $20 trillion, and by the end of 2020, they skyrocketed to $110 trillion. Along with the considerable increases in the United States economy and markets, the industry is experiencing dramatic growth and success. In just the past seven years, from 2013 to 2020, the number of registered investment advisors grew by 50 percent.

So, where is this success originating? The answer lies among the increasing popularity of exchange traded funds (ETF), particularly the new Bitcoin futures ETF, the SEC's big wins, and rule changes for asset managers.

Where Growth Is Trending

2020 performance shows that, while still the largest single asset group, hedge funds were static, and private equity funds, once a growing segment, were flat. However, the asset management sector is showing serious growth, primarily from three distinct areas: robo-advisors, separately managed accounts from individuals, and venture capital funds. Overall, private funds comprised approximately $20 trillion of the total $110 trillion in assets under management in 2020.

Globally, registered funds tallied about $60 trillion, with United States registered funds accounting for roughly half that number, holding 30 percent of public company equity, 23 percent of public company debt, and almost 30 percent of municipal bonds. Nearly 61 million Americans now have a substantial percentage of their retirement savings invested in registered investment companies.

Of peculiar note, 2020 saw a pandemic-fueled exodus of people from the Northeast, California and Illinois — home to numerous regulated entities — to states such as Texas and Florida. If this trend continues, we're likely to experience a dramatic sea change in where investment advisors register their principle place of business.

Exchange Traded Funds Take Center Stage

After more than eight years of stops and starts, on October 19, the SEC approved the first-ever Bitcoin-linked ETF, the ProShares Bitcoin Strategy ETF. The launch marked one of the biggest of all time, with the Bitcoin futures ETF accumulating more than $1 billion in assets over the first two days. Notably, the Bitcoin futures ETF gives institutional investors exposure to bitcoin but through the more-regulated futures market — bitcoin futures contracts rather than bitcoin. Proponents of Bitcoin and the cryptocurrency industry, more generally, hope cryptocurrency-linked ETFs will increase the industry's legitimacy through broader exposure and adoption.

While other cryptocurrency-linked ETFs are eager to launch, the SEC indicated it was not ready to approve leveraged Bitcoin ETFs or spot market-based Bitcoin ETFs, largely over concerns that investors may take ill-informed risks and lose significant sums of money. However, because Canada has already approved a spot market-based Bitcoin ETF that has been operating for several months, there is pressure on the SEC to reconsider its approach. Notwithstanding such pressure, the SEC recently rejected yet another application for a spot market-based Bitcoin ETF, this time filed by Cboe BZX Exchange to list and trade the VanEck Bitcoin ETF.

Not to be overshadowed by the Bitcoin futures ETF, both traditional and non-traditional ETFs continue to be attractive for most investors, which are relatively inexpensive and tax efficient. In fact, many analysts believe that the Biden Administration's proposal to increase US capital gains taxes should fuel further interest in ETFs as opposed to mutual funds, with a few caveats. Non-traditional ETF performance over time can be magnified in volatile markets. For firms, regulators continue to pursue disciplinary actions relating to the sale of non-traditional products to retail investors and advise heightened monitoring processes, carefully drafted disclosures, and adequate training for brokers and supervisors regarding risks going forward.

Why The SEC Is Winning

The overall consensus is that the SEC is winning big and advisors can expect more pain next year. Several significant court rulings affirm or increase the SEC's power.

In October, the US Court of Appeals for the Fifth Circuit upheld a disgorgement order issued by the SEC, marking the first appellate ruling on the topic since the Supreme Court's Liu decision (*Liu v. SEC.*) in 2020. The ruling allows the SEC to continue to seek disgorgement as a remedy in federal courts. The impact of *Liu* is not so much an issue of whether the SEC may obtain disgorgement but under what circumstances it may obtain such relief.

In another 2021 win for the SEC, the Supreme Court denied a petition for a writ of certiorari by a broker dealer involved in an SEC suit for violating anti-money laundering rules, leaving in place the Second Circuit's ruling affirming the authority of the SEC to enforce certain Bank Secrecy Act requirements under the Exchange Act.

Also, in the past year, courts have rejected challenges to the SEC's "gag rule." The SEC's "gag rule" provides that when a party settles an SEC enforcement action, the party cannot deny the allegations after the settlement. The gag order is written into every settlement agreement and the settling party must agree to the gag order. Two recent challenges to the rule failed, all but rendering future challenges to the gag rule dead. In both cases, courts refused to invalidate the gag rule, finding that if the settling party did not like the terms of the settlement, it should not have settled in the first place.

Rule Changes Drive Disclosure Activity

New rules, collectively referred to as the "Marketing Rule," went into effect in May and dramatically change advertising and solicitation practices for investment advisors. Investment advisers have until November 4, 2022 to comply.

Additionally, the SEC approved a Nasdaq listing requirement where public companies must disclose the diversity of their boards. Public companies without a diverse board must explain why. SEC Chairman Gensler is also considering such disclosure requirements for money managers and brokers.

On the ETF front, Rule 6c-11 provides certain ETFs with exemptions from the 1940 Act and also imposes the following conditions: (1) ETFs must provide a daily portfolio transparency on their website; (2) ETFs are permitted to use baskets that do not reflect a pro-rata representation of portfolio funds if they have certain written policies and procedures in place; and (3) ETFs must disclose certain other information on their website, including historical information regarding premiums and discounts and bid-ask spread information.

Futures: Emerging Trends and Enforcement Priorities

Priorities relating to swap dealer matters, exchange enforcement and CFTC enforcement lead discussions, with three takeaways to note.

Enforcement Is 'Business as Usual'

In the wake of Covid-19, enforcement actions across the financial markets were surprisingly "business as usual." The focus continues to be on preserving market integrity. Despite some ebb and flow, 2021 saw the usual numbers and types of cases, including actions involving: swaps market manipulation; spoofing; wash trades; insider trades; and swap reporting failures. With respect to swaps reporting failures in particular, the CFTC brought and settled five swaps manipulation enforcement cases in 2021. Supervisory practices and digital currencies continued to garner attention from regulators in 2021.

Rounding out the state of enforcement activity in 2021, efforts to coordinate investigations across agencies and exchanges continue. Although each regulator and exchange has a different mission, communicating on joint investigations and resolutions benefits all. Similarly, the CFTC and others continue to enhance regulatory outreach and education, and as well as improving internal capabilities to flag suspicious activities for further investigation.

Swap Reporting Failures Continue to Be a Top Enforcement Priority for the CFTC

While the CFTC understands that no reporting party will accurately and timely report swap data to a swap data repository 100 percent of the time, the CFTC's recent swap reporting enforcement actions against several swap dealers and — for the first time — a swap execution facility, highlight the fact that the CFTC continues to view swap reporting failures as a top enforcement priority. The CFTC has repeatedly noted that swap reporting is essential to its swap market oversight function. For that reason, swap reporting parties need to continue to assess and improve their swap data reporting systems, compliance framework and governance.

Not all swap reporting failures tend to become the subject of enforcement actions. Analyzing the facts of the CFTC's various swap reporting cases over the last eight years reveals that certain failures may likely result in an enforcement action. These failures include: the same or substantially similar root cause failure being repeated over a multiple-year period; substantially late reporting; missing data fields that the CFTC considers critical (i.e., creation data); the lack of (or a deficient) supervisory and governance framework focused on swap data reporting; and high volumes of reporting failures overall (i.e., in terms of a gross number) or as a percentage of the reporting party's total number of swaps reported.

To avoid a reporting failure turning into a potential CFTC enforcement action, reporting parties should: promptly identify and remediate any reporting failures through reconciliation and review of swap data at each SDR to which the reporting party reports; after any remediation, follow-up to ensure that any past failures do not resurface; and maintain a comprehensive swap data reporting compliance framework that includes active governance. Where significant reporting failures are identified, a reporting party should consider whether self-reporting to the CFTC would be appropriate.

Who Oversees Virtual Currencies, Digital Assets and Decentralized Finance (DeFi)

Jurisdiction and enforcement cases regarding virtual currency markets continues as a hot topic among regulators and participants. The Commission, which brought its first crypto-related enforcement action in 2015, handled several important crypto-related enforcement cases in 2021, including the first manipulation case — a pump and dump scheme — that used Twitter to tout a certain cryptocurrency. The CFTC also brought or settled various actions alleging the entities offered margined retail commodity transactions or binary options in digital assets without properly registering with the CFTC.

Regulator jurisdiction with respect to decentralized finance, or DeFi, a blockchain-based form of finance is being examined by regulators such as the CFTC and SEC. CFTC efforts to become more knowledgeable in the digital asset space continue. The agencies can be expected to proceed if one of them concludes that an appropriate enforcement case has arisen.

In November, the President's Working Group on Financial Markets issued an interagency report urging Congress to pass legislation to make stablecoins, a class of cryptocurrencies that attempt to offer price stability and are backed by a reserve asset, to be subject to federal banking laws. The regulators also asserted that they would use their current jurisdictional authorities to monitor the stablecoin market. The report also described the growing market for stablecoins and also discussed DeFi-related issues.

We expect the CFTC and exchanges to continue to be active in all of these areas in the future. We also expect 2022 to deliver more collaboration to foster responsible innovation, promote consistent regulatory approaches, and identify and address potential risks that arise from digital trading and financial assets.

D&I Update: What Financial Institutions Are Doing to Move the Needle on Diversity

In 2020, during the midst of the Covid-19 pandemic, a rapid succession of events forced Americans to take a hard look in the mirror regarding systemic racism. Profound national conversations ensued. Many in the financial services industry published statements emphasizing their commitment to diversity and inclusion, but few statements did what 12 general counsels were able to accomplish in September 2020.

In an open letter addressed to the legal community, general counsels of some of the world's largest financial institutions came together to not only discuss the violence against the Black community and their commitment to diversity and inclusion, but more importantly, to set an example by providing an action-driven statement.

Law firms and financial institutions in the United States have made progress with respect to women and people of color representation, but these populations remain starkly underrepresented, particularly in senior level positions. For example, women and people of color make up approximately 47.5 percent and 26.5 percent of law firm associates in US law firms, respectively, according to a McKinsey & Company study in 2021. However, Black women and Latinx women each represent less than 1 percent of all partners in US law firms, the National Association for Law Placement reports. In a study of 44 of America's largest banks, minorities made up approximately 42 percent of the banks' workforce in 2018. That representation dropped precipitously at the executive and senior level positions for the banks — the study found that minorities accounted for only 19 percent of executive and senior level employees. This significant drop in representation at senior levels is also seen among women in the financial services industry.

During our FMLE Symposium, four representatives of the open letter's 12 signatories weighed in on initiatives implemented and lessons learned over the last year in the context of the financial services industry's commitment to three pillars: (1) internal actions, (2) external supplier engagements and (3) social action efforts to increase diverse representation and retention. The candid discussion covered initiatives and actionable steps that can be implemented by the financial services industry and legal profession to continue to increase diverse representation in the financial services and legal profession.

Pillar 1: Internal Action — recruitment, retention and promotion of diverse attorneys

Recognizing that diverse representation cannot happen without meaningful consideration of qualified diverse candidates at the recruitment stage, law firms and companies have increasingly begun to formally expand their consideration of a broader pool of candidates. For example, the Mansfield Rule, which was created to increase diversity in law firm recruitment and promotion, requires that law firms seeking to achieve certification under the rule to consider women and attorneys of color for at least 30 percent of leadership and governance roles, equity partner promotions and senior lateral positions. In the more general corporate context, the Nasdaq Board Diversity Rules, approved in August, require Nasdaq-listed companies to publicly disclose statistics concerning board diversity and, most notably, to have, or publicly disclose why they do not have, at least two diverse directors.

In order to ensure that such consideration of diverse candidates translates to the hiring of more diverse employees, law firms and financial institutions can implement various initiatives. For example, strong diverse candidates who are not hired for a current opening, can become part of a pool of candidates considered for future openings. Law firms and financial institutions can take it one step further by shifting their respective organizations' perspective on hiring. Instead of rejecting a candidate, particularly a diverse candidate, because they do not possess the exact qualifications needed for an open position, an organization can foster an apprenticeship environment to train and improve candidates' skills in required areas. This approach, can not only increase the recruitment of diverse candidates, but also their retention, by ensuring high-level leaders are involved in the training of diverse employees and providing them opportunities to build cross departmental skills and relationships.

Pillar 2: External Action — Measuring staffing, advancement and leadership of diverse employees

The impact that in-house attorneys at global and local companies can have on diverse representation present at their law firm partners cannot be understated. Setting the expectation that the staffing of diverse associates is a critical consideration when selecting law firms, along with other criteria, can drive law firms to ensure diverse associates are involved in all aspects of new matters. Some organizations review various metrics and other information to assess representation and engagement of diverse associates in law firms, such as requesting their law firm partners to conduct self-evaluations of their internal culture and community outreach efforts to ensure that diverse associates included on the team have substantive roles in the engagement.

When law firm partners are underperforming with respect to the diversity efforts in staffing, promotion and retention of diverse associates, some organizations have committed resources to help them improve. Indeed, as law firms improve their efforts concerning diversity and inclusion, their success can be shared and drive others to adopt their best practices.

In-house attorneys can also create connections between their organization and diverse associates in law firms to increase opportunities for diverse associates to develop client relationships. Some institutions are developing mentorship programs that match mentors from their organization with diverse associate mentees from their law firm partners, to assist diverse associates in navigating career challenges.

Pillar 3: Social Action — pro bono, racial injustice and community initiatives

In order to significantly increase diverse representation in the financial services industry, law firms and in-house counsel cannot merely focus on the recruitment of diverse law school candidates, but instead must drive interest and engagement among students from diverse backgrounds at an earlier stage. Some organizations have created internships and programs that expose diverse students in high school or earlier to the financial services industry to demystify financial markets, products and other unfamiliar legal topics. These programs further instill in diverse students, at an early age, that diverse attorneys can and do succeed in the financial services industry.

In terms of recruitment and engagement, law firms and in-house legal counsel need to continually evaluate the types of colleges and universities they consider for positions. For example, institutions can meaningfully consider diverse candidates from Historically Black Colleges and Universities, for mentoring, recruitment and other programs. Expanding the field of applicants that are considered, will foster an environment in which diverse employees in law firms and in-house legal departments feel welcome and valued, ultimately increasing representation and retention of diverse employees in the financial services profession.

The impact of the pandemic has also created an increased need for communities, especially among ethnic and immigrant communities, for pro bono legal assistance. Being able to provide pro bono legal services remotely, via various platforms and programs, has allowed in-house counsel and law firms to expand their reach to the communities they are able to serve. In particular, in light of recent events, some organizations have also focused their pro bono efforts on racial injustice and providing resource pipelines to underrepresented groups.

What's ahead?

Looking to the future, we can expect in-house counsel to continue to make diverse staffing and representation, at the pitch stage and throughout the engagement, a priority in selecting law firms for new matters. Institutions can also continue to focus on discrete areas concerning diversity and inclusion, including taking a more intentional approach to their internal development of diverse employees and continuing to train on implicit bias and management skills. As institutions improve their diversity and inclusion efforts, other institutions need not recreate the wheel, but instead can adopt the successful initiatives in their own organizations, to create widespread improvement in the financial services industry.

Editor's Note: This advisory is an edited compilation of our coverage of Katten's 2021 Annual Financial Markets Litigation and Enforcement Symposium Series.

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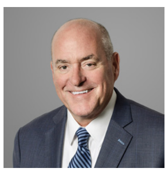

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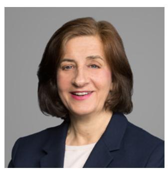

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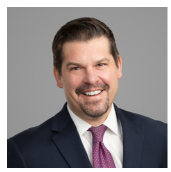

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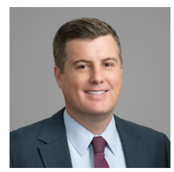

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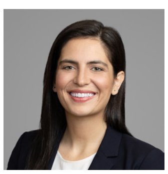

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12/27/21