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## Building Constructive Relationships With Financial Regulators

*The Editor interviews Jeff Kern, Special Counsel in the Business Trial and White Collar Defense Practice Groups at Sheppard Mullin Richter & Hampton, LLC, a former prosecutor and Senior Regional Counsel at FINRA.*

**Editor:** Jeff, Sheppard Mullin just hosted a unique event for a private law firm, a Financial Regulation and Enforcement Symposium, that brought together prominent regulators and the financial institutions that they regulate. What was the goal of the Symposium?

**Kern:** Well, my colleagues at Sheppard Mullin and I have been on both sides, and there's no doubt in our minds that there's an institutional mutual distrust between the regulators and those whom they regulate. And it only gets worse during financial crises like the one we're still trying to dig out of. We think it's based in large part on the fact that each side doesn't understand what drives the other and doesn't appreciate the pressures that the other operates under.

We wanted to explore this issue. We also wanted to provide our clients with access to their regulators. So we reached out to our contacts in financial regulation and law enforcement, and we worked with the New York External Fraud Committee, the Long Island Fraud and Forgery Committee and the Westchester External Fraud Committee. These committees draw their membership from the ranks of current and former government prosecutors, agents and investigators and include agencies such as the FBI, DEA, the SEC, IRS, Federal Reserve, TARP, Postal Service, U.S. Attorney's Office, and local District Attorney's Offices, who meet once a month to disclose how they can best combat economic fraud.

Our goal was to set up a symposium in the form of a "dialogue" between the two sides that would play itself out in three CLE presentations and a post-presentation cocktail party, where folks could seek each other out and speak informally, which, to be honest, is a great way to form relationships.

We had about 275 folks at the event and received incredibly positive feedback from both sides.

**Editor:** What did the presentations cover?

**Kern:** The first presentation focused on securities enforcement. We had folks from FINRA and the Eastern and Southern District U.S. Attorney's Offices. On the private side, we had in-house counsel from UBS and Bank of America.

Our second presentation focused on the difficulties of financial compliance in what is truly a borderless economy. We had people from FINCEN, the Fed, the Manhattan DA's office and the DEA. On the private side, we had in-house counsel from Morgan Stanley, JP Morgan Chase, and John Hancock.

In between, we had an incredibly provocative PowerPoint presentation by Neil Barofsky, the former Special Inspector General for TARP, who, with detail, clarity and humor, talked about where TARP has succeeded and where it has fallen short.

**Editor:** What were the takeaways from the two panels?

**Kern:** The panels truly were a "dialogue"



Jeff Kern

wherein the folks on the panel actually turned and spoke to one another, sometimes quite passionately.

We asked the regulators questions like "What do you see your role as?"; "How do you view those that you regulate?"; "What are your priorities?"; and "What are some of the things a target can do to make a good impression?" And we asked the industry panelists things like "What is your biggest complaint about your regulator?"; "What is it that you think they don't understand about you and your firm?"; "What are your suggestions of how they could better engage you?" From the first panel, the biggest takeaway was that a lot of the petty disagreements and tension that occurs in the investigative process could be eliminated if there was better and more frequent communication between the two sides.

From the second panel, the dominant idea that emerged was that both sides share the same goal of preventing serious misconduct like insider trading, money laundering and even terrorism, and that when it comes to issues like these, they're actually on the same side. So, the point was, we're all better served if we share information and work together. What was interesting is that the biggest points of disagreement were not between the public and private sectors but between the government agencies that have similar subject matter jurisdiction.

**Editor:** What's your sense of the current state of financial regulation?

**Kern:** Everybody's waiting for the other shoe to drop. Dodd-Frank is one of history's greatest legislative overhauls, but its true impact won't be revealed until the affected federal agencies enact specific rules and regulations. And now, these

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agencies are pushing back and saying they need more time. So, how do you plan for something when you don't know when it's coming and what it's going to look like?

I think law firms are resigned to the probability that whatever is coming is going to be confusing and costly. Beyond Dodd-Frank, you've got regulators stretched to the breaking point trying to do more with fewer resources and personnel while trying to bring big cases to satisfy Congress, the media and the public.

On a conceptual level, in the Madoff aftermath, the trendy phrase is "risk-based" regulation, which theoretically means that instead of casting a wide net, regulators will focus on particular issues and problem players. But we have not seen any evidence of this new approach, so again, we don't know what it's going to look like. We are also seeing more innovation and aggression on the part of regulators, like federal prosecutors using wire taps to investigate insider trading and non-criminal regulators moving toward prosecutorial models that entail things like whistleblower programs, "credit-for-cooperation" incentives, and unannounced on-site visits. So, there's a lot going on out there.

**Editor: What are the potential implications of these developments?**

**Kern:** Well, again, regulation is going to become more costly and time consuming, for sure. The biggest fear is that the pressure to produce is going to cause regulators to become less flexible, more suspicious and more prone to rushing to judgment. And then the mutual mistrust meter is going to rise.

**Editor: That sounds pretty dire.**

**Kern:** It is and isn't. I've talked about some worst case scenarios. We've been through cycles like this before and everybody on both sides eventually adjusts.

What gives me some optimism is my belief that, despite the pressures we've talked about, most regulators, from field examiners to agency heads, are proud of what they do, and they want to do the right thing and achieve the right result. They like wearing the white hat. In fact, it is because these pressures exist that the more forward-thinking regulators are beginning to see the value in taking a

cooperative approach as a way to conserve resources and still get the same result. The key on our side is proactive and constructive engagement. And that goes for all regulated industries.

**Editor: So, as someone who defends and counsels financial institutions facing regulatory inquiries, how do you constructively engage the regulator?**

**Kern:** Well, it's easier said than done because some of these inquiries are inherently adversarial, which is why having good relationships is so important. But constructive engagement actually starts before your client gets the phone call, letter or subpoena.

It starts with creating a resume of good corporate citizenship. As a result, by the time a regulator gets around to the firm and into the inquiry, he or she will realize that the allegation is inconsistent with the established culture of the firm.

So, having clear and unambiguous policies and procedures that speak aggressively against wrongdoing is important. So is hiring managers, compliance personnel and brokers, traders, researchers, etc. with no customer complaints or industry discipline and keeping easy-to-access and accurate books and records. Having things like hotlines, internal investigative capabilities, and employee educational programs help a lot. Sponsorship or participation in industry events or panels dedicated to compliance is another good way. Essentially, you want to be able to point to concrete examples that your client has long been dedicated to running a clean operation.

**Editor: And when the client gets that phone call, letter or subpoena? How do you constructively engage the regulator?**

**Kern:** A lot of it is common sense. Treat the regulator like you would want to be treated if you were in his or her position. In general, never fail to be courteous, professional and responsive.

On a specific level, once you are contacted by a regulator, pick up the phone as soon as you get your bearings and speak to him or her. During the call, acknowledge receipt of the inquiry and pledge your best efforts to respond completely and in a timely manner. Provide the name and contact information of one primary and at least one backup point person. Make sure to meet production deadlines

and, if you can't, make sure to apprise the regulator as far in advance as you possibly can so that he or she can adjust. It's really about presenting yourself for accountability. The regulator views both in-house counsel and outside counsel as the face of the firm. So, how you conduct yourself really matters.

**Editor: What happens if the regulatory inquiry does become adversarial?**

**Kern:** One common mistake I've seen is that at the first sign of disagreement, counsel goes on the offensive by questioning the investigator's motives or work, insisting on elevating the case to a higher level, or falling back on clichéd arguments that the regulator's efforts could be better spent on pursuing "real" misconduct. These tactics rarely work and will only serve to antagonize the regulator or increase his or her suspicion. In the event that things get rocky, you have to maintain your cool and resist the initial impulse to strike back, especially by insisting on speaking to a supervisor. Elevating a case up the chain should be reserved for extreme cases or when you have no other choice. One thing that I've found to work fairly well is to acknowledge the seriousness of the underlying allegation without necessarily conceding any ground. I've also found it helpful to "educate" a regulator in a non-condescending way (of course) about the nuances or unique features of your client's operations.

**Editor: OK, let's keep going. What happens if the regulatory inquiry doesn't go well for your client and a regulator decides to move forward with a case?**

**Kern:** It's important to remember that a regulator's decision to "go formal" is not the end of the case; it's actually, in a real sense, a new beginning. So, you don't change your approach. Until there's a decision by a tribunal, there's always a chance for resolution. And now that the proceedings have become officially adversarial, there's a new audience watching how you operate: the trier of fact, whether it be a judge, jury, administrative tribunal or hearing panel. So, again, it's important to be courteous, professional, and cooperative. Always, always represent your firm in a constructive, positive light.