Strategies for Broker-Dealers: Moving Forward During Economic Difficulty

View from Inside the FINRA Enforcement Process
Recent Changes, New Priorities, and Practical Advice in Dealing with FINRA

I. Two goals for this presentation

   A. Describe the enforcement priorities of FINRA and the SEC.

   B. Describe key parts of the enforcement process at FINRA.

II. Changes at the SEC

   A. Mary Schapiro has said that she would take the “handcuffs off” of the SEC’s Enforcement Division.

   B. The SEC budget is slated for a 13 percent increase.

   C. Mary Schapiro has announced the end of a two-year pilot program requiring the Enforcement Division to get approval from the Commission before entering into settlement negotiations concerning corporate securities fraud. Schapiro also announced that the process for granting formal orders of investigation would be streamlined.

   D. Robert Khuzami, former prosecutor, named Director of the Division of Enforcement.

   E. The SEC may consider an uptick rule for short sales within the month.

III. 2009 Enforcement and Examination Priorities for FINRA.

   A. Each year FINRA publishes a letter from Bob Errico, Grace Vogel and Tom Gira on examination priorities. The March 9, 2009 letter is on the FINRA website under “Communications to Firms.” FINRA will host an Examination Priorities Webinar on March 18, 2009. The priorities are listed below. Priorities listed with an ** were not on last year’s list.

      1. The 2009 letter starts with a recommendation that firms “carefully consider the impact of headcount reductions in areas such as compliance, finance, and operations, and other control functions to determine that they are commensurate with business-line reductions in those areas.” **

2. A second observation is that as firms consider new income streams "it is imperative that firms proactively review and vet new products or activities, create supervisory procedures and policies specifically addressing new products."
3. FTC's Red Flag Rule (May 1, 2009 implementation date) **
4. Alternative Investments **
5. Cash Alternatives **
6. Supervision
7. Senior Investors [and near Seniors]
8. Anti-Money Laundering
9. Foreign Corrupt Practices Act **
10. Unregistered Sales of Restricted Securities (Including Penny Stock Liquidations) **
11. Variable Annuities
12. Protection of Customer Information and IT Security
13. Outsourcing
14. Information Barriers
15. Back to Basics: Customer Protection **
16. Excess SIPC Protection **
17. Inventory and Collateral Valuations
18. Funding and Liquidity **
19. Counterparty Credit Risk **
20. Intercompany Reconciliations **
21. Bank Sweep Programs
22. Fully Paid Lending Programs **
23. Sales of Equity Securities [Short Sales]
24. Circulation of Rumors **
25. Order-Entry Controls **
26. Marking the Close **
27. Trade Reporting
28. OATS

B. Observations

1. Concerns about new products, alternative investments and cash alternatives share a common focus.

2. The Anti-Money Laundering, FTC Red Flag Rule, Protection of Customer Information and IT Security, and Sales of Unregistered Securities priorities all require firm surveillance of account activity. The Nasdaq sponsored access rule filing has an emphasis on preventative programming. The requirements for firms in these areas are expanding.

3. In light of recent Ponzi schemes, fraud, custody, and similar issues will receive added emphasis.

IV. Enforcement Process at FINRA (Enforcement and Market Regulation)

A. Routine Matters

1. Market Regulation

a. Put the matter in context: How many days did the problem last? How many people were involved in the problem? How many systems were involved in the problem?

b. Detail the firm's efforts to prevent or fix the problem.

c. How hard was it to find the problem? Would the problem have been caught with routine surveillance?

d. Do not underestimate the need to point out, remind, or reiterate self reporting, remediation and corrective measures.

e. Use the Sanction Guidelines to identify relevant facts.

2. The Disciplinary Advisory Committee

a. How it works

b. How it impacts your firm

3. Responding to supervision claims

a. A common misstate made by FINRA staff: Is there really a supervision problem, or just a substantive violation that supervision did not catch.

b. Common mistakes made by firms:

i. Confusing a compliance manual with supervisory procedures. (See FINRA Notice to Members 99-45 and 98-96 which outline four necessary elements of supervisory procedures)

ii. Firms should update their written supervisory procedures to reflect new the FINRA Manual.

iii. When asked to produce written supervisory procedures do not provide just what is in the formal binder. Look for and provide other written materials such as memos and emails. These materials should be provided at the time of the initial request, but these materials will be accepted later in the process.

c. An effective response is to revise the written supervisory procedures immediately and provide them to the staff while clearly noting the date the procedures were revised.