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## **FINRA Priorities And FINRA Results**

*Law360, New York (March 17, 2010)* -- On March 1, 2010, the Financial Industry Regulatory Authority published its examination priorities letter for the coming year.[1] This year's letter is 16 pages long and covers not only examination priorities, but also new developments, and areas of heightened importance to FINRA's Department of Enforcement.

For several years FINRA has been sending a letter to all of its member firms outlining FINRA's examination priorities. Starting in 2008, FINRA published the letter on its Communications to Firms Web site.

The 2010 letter notes that FINRA's examination program is "risk based" meaning that the frequency, content and scope of a firm's examination will depend on the risk, scale and nature of the firm's operation.

In addition to identifying areas of concern, this year's letter includes extensive guidance with respect to subject areas, including numerous citations to prior publications.

### **New Developments**

Among the new developments cited in the letter are the creation of the Office of Fraud Detection and Market Intelligence, the expansion of BrokerCheck and permanent disclosure of regulatory actions against former brokers, the rule consolidation process, and the deployment of the eFocus Filing Platform.

The new Office of Fraud Detection and Market Intelligence is headed by Cam Funkhouser and provides a centralized point of contact for fraud issues, subject matter expertise, and reflects an effort to "promote proactive fraud prevention and detection."

### **Regulatory and Business Considerations**

The 2010 letter lays out 15 areas of regulatory concern: new products, merged or acquired firms, direct market access/sponsored access, life settlements, member private offerings, hiring and compensation practices, municipal securities, supervision of transmittals and withdrawals of customer assets, new FINRA financial and operational rules, liquidity, cross-market surveillance, circulation of rumors, fair pricing and best execution of fixed income securities, and OATS reporting.

The letter specifically mentions FINRA's concern about three types of securities: principal protected notes, reverse convertible notes and member private offerings.

With respect to OATS FINRA is now publishing a preliminary report card and provides an email notice to firms identified as having "compliance rates outside their peer group norms."

## Examination Priorities

The 2010 letter also identifies the following 16 areas of examination priorities: fraud detection, information barriers, variable annuities, protection of customer information and IT/cyber security, anti-money laundering (“AML”), pandemic preparedness/business continuity planning, branch office supervision, outsourcing, inventory and collateral valuation, customer margin debits and collateralization by nonmarketable securities, accounting and spreadsheet controls, day-trading margin, fully paid lending programs, an options examination program, short sales and regulation SHO, and algorithmic trading controls.

For variable annuities, the focus will be on recommendations to exchange annuities. The letter notes that FINRA has updated its small firm template for AML to include new red flags that firms of all sizes should consider.

With regard to branch office supervision, the emphasis will be on registered representatives with multiple customer complaints and sales practice disclosures, and statutorily disqualified persons. With respect to inventory and collateral valuation, the examinations will focus on “procedures for escalating pricing differences to management.”

## Published Disciplinary Actions in 2009

In 2009 FINRA resolved 1090 formal actions.[2] While FINRA reports the total number of cases resolved each year, it does not provide a break down of actions by subject area. FINRA does publish a monthly summary of disciplinary actions that meet the publication criteria established in FINRA Rule 8313.

In general, disciplinary actions with monetary sanctions of \$10,000 or more (including fines, restitution, and interest), actions imposing an expulsion, cancellation, suspension or bar, and actions involving certain “Designated Rules” are described on FINRA’s monthly and quarterly “Disciplinary Actions” webpage.[3]

The summary descriptions of disciplinary actions identify the sanctioned parties, the sanctions, and provide a textual description of the findings. The descriptions generally do not cite to the section of law, federal securities regulation, or FINRA rule violated.

Thus it is impossible to derive a precise breakdown of the rules being enforced in FINRA disciplinary actions from the 385 pages of published disciplinary actions for 2009.

Just as a word cloud[4] can provide interesting insights into a message, a review of the most commonly used words in FINRA’s Disciplinary Actions can provide us with a rough approximation of the violations most frequently brought by FINRA.

A word search of the monthly and quarterly FINRA Disciplinary Actions Web pages for 2009 revealed the most prevalent words associated with rule violations. It should be noted that there is not a one-to-one correction between the use of a word and the number of actions involving that issue.

For example, the brief description of a single action may refer to supervision several times in describing the conduct, findings and sanctions. Furthermore, a single description will often include words associated with the same conduct, such as “inaccurate”, “misleading”, and “false”, or “discretionary” and “unauthorized.”

Descriptions of cases involving significant fines or novel policy issues tend to be longer. These word counts provide a general, but not precise or finely calibrated, indication of the types of actions taken by FINRA.

The most frequently cited term, “supervision”, and related words such as supervise, occurred 593 times indicating the key role that supervision plays in FINRA’s enforcement program, regardless of the underlying problem.

The next most frequent term identified with violations was “disclosure” which appeared 259 times. Disclosure was associated with obvious issues such as forms U-4, but also with placements of auction rate securities, margin disclosure and other requirements.

The next two most common terms associated with rule violations were “OATS” (172 occurrences) and “short” (147 occurrences). The number of actions with these two terms reflects the robust, multifaceted, and efficient enforcement programs maintained by FINRA’s Market Regulation Department in the OATS, short sale and short interest reporting areas.

The OATS references cited above also do not include the significant number of unpublicized OATS actions that involve fines of less than \$10,000. The next most frequent term is “outside” (140 occurrences), usually associated violations involving outside activities and outside accounts.

Another cluster of often overlapping terms shows FINRA’s efforts to protect investors from basic dishonesty and inaccurate information: “inaccurate” (125), “misleading” (68), “false” (93), “forgery” (64) and “fraud” (23).

The relatively infrequent use of the term “fraud” illustrates the limitation of this analysis. Undoubtedly, there were more than 23 cases finding fraud, however, the brief descriptions of the conduct focus more on the facts and rarely on legal conclusions about the conduct such as whether it was fraudulent.

Other terms with a significant number of references were: “TRACE” (103), “U-4” (96), “AML” (78), “net capital” (64), and “e-mail” (45). Conversely, “Regulation S-P” was only used eight times, “business continuity” four times, and “Regulation NMS” and “information barrier” were not used at all.

The word search also noted the following product categories received significant regulatory attention in 2009: “ARS” (166 occurrences)[5], “variable” (113) (referring to both variable annuities and variable life insurance), “mutual fund” (107) and “real estate” (30).

In light of FINRA’s increased emphasis in 2008 and 2009 on protecting seniors, near seniors and retirees, the term “elderly” was used 34 times in 2009 while being used only two times in the rest of the decade.

The two prior uses of the term elderly certainly do not represent all FINRA cases involving the elderly prior to 2009. A portion of the increase in the use of the term “elderly” must reflect a conscious effort by FINRA to not only bring cases which protect the elderly, but to identify those cases.

## **Conclusion**

FINRA’s statement of examination and enforcement priorities adds transparency and is a helpful tool to promote compliance through education. The difference between what FINRA sets forth as priorities and the results disclosed in the Disciplinary Actions publication could be the result of several factors.

First, there is a time lag between the initiation of examinations and investigations pursuant to the priorities established by FINRA and the resolution of such cases.

Second, long-standing protocols for cause of examinations and sweeps will produce significant numbers of important cases that are not necessarily reflected in the exam priorities letter.

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

[1] [www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf](http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf)

[2] [www.finra.org/Newsroom/Statistics](http://www.finra.org/Newsroom/Statistics). Statistical Review 2005-2009.

[3] [www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2009/index.htm](http://www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2009/index.htm).

[4] A word cloud is a graphical representation of word frequency. Word clouds present a picture of the most common words, displaying in larger font the words used most often.

[5] Due to the large amounts of money involved and the important policy issues involved, the description of ARS cases tended to be much longer than the usual case description and used the term ARS repeatedly.