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Assessing FINRA Priorities And Results

Law360, New York (February 23, 2011) -- The Financial Industry Regulatory Authority's latest examinations priority letter and its published disciplinary actions provide useful insights into the self-regulatory agency's priorities. On Feb. 8, 2011, FINRA published its examination priorities letter for the coming year.[1]

This year's letter is 13 pages long and covers not only examination priorities but also new developments and areas of heightened importance to FINRA's Departments of Member Regulation, Market Regulation, Enforcement and Office of Fraud Detection and Market Intelligence.

FINRA's examination program continues to be "risk-based," adjusting the scope, content, frequency and nature of a firm's examination to the characteristics inherent to the firm, such as the risk, scale and nature of the firm's operations and business lines.

In addition to identifying areas of concern, the letter includes extensive guidance with respect to subject areas, including numerous citations to prior publications. The letter also describes the implementation of a "thematic approach" to certain examinations. In 2010, the thematic reviews focused on new products and information technology and cyber security.

New Developments

Although not explicitly mentioned in the letter, two of the five signatories to the letter have new positions. Susan Axelrod became head of Member Regulation, Sales Practice in July 2010, and Bradley Bennett became head of the Enforcement Department in January 2011.

FINRA has obtained approval for 85 percent of the Consolidated FINRA Rulebook and the letter summarizes seven new or revised rules: suitability; know your customer; financial responsibility; networking arrangements; reporting customer complaints; OATS; and trade reporting.

Regulatory and Business Considerations

The 2011 letter lays out 20 examination priorities: fraud detection; fraudulent activity associated with customer accounts; high-frequency trading, algorithms, sponsored access, direct market access and trading pauses; short sales and Regulation SHO; information barriers; private placements and private self-offerings; trading in nonpublic securities; high-yield investments; municipal securities; nonconventional investments; exchange traded funds and notes (ETFs); vulnerable customers; electronic communications and social media; consolidated account statements; hiring and compensation practices; outside business activities and private securities transactions; master/sub-account relationships; funding liquidity risk management; intercompany transactions/affiliate relationships and activities; and governance and control over margin lending.

Fraud has quite literally moved to the top of FINRA's list. The first two priorities are both centered on fraudulent activity and fraud is explicitly mentioned as a concern in three other listed priorities. The placement of high-frequency trading and market access in the third spot reflects a host of concerns arising from the May 6, 2010, "flash crash."

Once again, certain types of products and investors will receive special attention. This year's product focus will be on municipal securities, private placements, nonpublic securities, ETFs, and high-yield and nonconventional investments.

FINRA's prior stated emphasis on senior investors has been expanded to "vulnerable investors" which includes retired, elderly or ill customers, or those who are part of an affinity group, which may be particularly vulnerable to certain risks. Other priorities, such as the use of social media, high-frequency trading and direct access are decidedly new and cutting-edge concerns.

Insight Into FINRA's Disciplinary Actions

In 2010, FINRA brought 1,173 disciplinary actions, levied $41.1 million in fines and ordered almost $8 million in restitution.[2] While FINRA reports the total number of cases resolved each year, it does not provide a breakdown 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" Web page.[3] The summary descriptions of disciplinary actions identify the sanctioned parties and the sanctions, and provide a textual description of the findings.

The descriptions generally do not cite 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 441 pages of published disciplinary actions for 2010.

Despite a relatively constant number of disciplinary actions,[4] in recent years FINRA has issued more press releases about disciplinary actions. The number of press releases about disciplinary actions rose from 15 releases in 2008, to 40 and 31 releases in 2009 and 2010, respectively. The current practice appears to be to issue a press release for almost all actions with fines of $300,000 or more.

In 2010, FINRA published descriptions of 334 disciplinary actions against 270 different FINRA member firms and descriptions of over 800 actions against individuals associated with member firms.[5] Among all cases against firms, 183 (60 percent) included some form of supervision violation.

FINRA's Sanction Guidelines recognize a distinction between "quality of markets" rules[6] and the rest of the rules, which I will refer to as general rules. There were 191 (57 percent) disclosed actions involving quality of market rules and 143 (43 percent) disclosed actions involving general rules.

Among quality of market cases, the leading types and approximate numbers of violations cited were: OATS (91), trade reporting (66), TRACE and RTRS reporting (48), short sales and short interest (33), confirmations (23), SEC Rules 605 and 606 (22), markups (17), books and records (17), and best execution (16).

Most of these cases involve multiple types of violations. The average fine in a quality of market case was just over $42,000 with a median fine of $20,000.

By examining the case numbers that are assigned when an investigation is commenced, and disclosed in most of the summaries, it appears that most quality of markets investigations were resolved in approximately two years or less and 80 percent were resolved in less than three years.

Summarizing the cases involving the general rules is more difficult due to the large number of different rules and the number of actions in which inadequate supervision of any number of rules is the only charge. There were also cases imposing significant fines for which there are only one or two cases during the year.

An analysis of the number of cases brought for specific rules tends to overstate FINRA's emphasis on discrete rules, such as anti-money laundering ("AML"), which are routinely charged as violations by the firm rather than as a failure to supervise.

With those caveats in mind, among cases involving the general rules, the leading types and approximate numbers of violations are: fraud and manipulation (13); AML (22); e-mail retention and review (16); various reporting requirements (10) (customer complaints, U-4/5, etc.); net capital, reserves, and related computations (13); and excessive markups and fees (8). The average fine in a general rule case was over $250,000 with a median fine of $52,500.

Conclusion

FINRA’s statement of examination priorities adds transparency to FINRA’s examination and disciplinary process and is a helpful tool to promote compliance through education. Firms will also gain insights into FINRA’s priorities by examining the cases brought last year as they tend to be an excellent predictor of cases that will be brought in the next year.

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[1] Available on the FINRA website under Communications to Firms.

[2] FINRA 2010 Year in Review available on the FINRA website under News Releases.

[3] Available on the FINRA website under Enforcement/Disciplinary Actions.

[4] New disciplinary actions filed by FINRA totaled 1,073 in 2008, 1,158 in 2009 and 1,310 in 2010. Available on the FINRA website under Newsroom/Statistics.

[5] This article generally refers to cases disclosed or published. The number of cases disclosed in FINRA’s monthly and quarterly publications is different than the total number of cases brought. Cases with sanctions of less than $10,000 are not disclosed, and some year-end cases are disclosed in the following calendar year.

[6] FINRA Sanction Guidelines pages 50-70.