

## Assessing FINRA's Priorities And Results

Law360, New York (March 09, 2012, 3:14 PM ET) -- There are two basic sources of information about the Financial Industry Regulatory Authority's examination and enforcement priorities. The first source is FINRA's annual examination priorities letter. The second source is the information FINRA makes public about its disciplinary actions.

The Priorities: The Examinations Priorities Letter

On Feb. 1, 2012, FINRA published its examination priorities letter for the coming year. This year's letter is 16 pages long and lays out 26 examination priorities.

The first priority listed is "Business Conduct and Sales Practice Concerns for Retail Customers." The letter cautions that in a challenging economic environment retail investors may be susceptible to recommendations to chase yields. FINRA will, therefore, be looking at pricing, suitability and disclosure of material risks.

In these cases, additional emphasis should be placed on liquidity and cash flow characteristics in assessing suitability. In prior years FINRA has highlighted its concern for senior or "vulnerable investors." The first priority has a stated concern for retail investors and throughout this year's letter FINRA has widened its focus from senior and vulnerable investors to retail investors.

"Microcap Fraud" is the second priority listed, replacing "Fraud Detection" which was the first priority on the 2011 letter. Various forms of the word "fraud" are used in eight of this year's listed priorities.

Some of the priorities, such as reverse mergers, foreign finders, rogue trading and supplemental FOCUS information, are new priorities. Concerns about the May 6, 2010, "Flash Crash" are reflected in the inclusion of market maker quoting obligations, high frequency trading, coding cases, and U.S. Securities and Exchange Commission Rule 15c3-5 as priorities.

The concept of supervision is part of the title of three priorities (integrity of supervision and internal controls, branch office inspections, and oversight of the creation and redemption of exchange-traded funds) and mentioned 26 times in the letter. Other priorities — such as books and records, information barriers and the Order Audit Trail System (OATS) — have been stated priorities for several years.

In recent years FINRA has devoted more of its resources to the fixed income market. The inclusion of fixed income and municipal securities as priorities and municipal securities and church bonds as products of concern suggest FINRA will continue this trend.

The remaining listed priorities are: private securities transactions and outside business activities; information technology and cybersecurity; outsourcing; fees; social media and electronic communications; leverage and liquidity; pricing of illiquid, hard-to-value securities; margin-lending practices and custody of assets collateralizing margin loans; net capital; expense sharing arrangements; protection of customer funds and securities; creation and redemption processes for ETFs; municipal securities; and conflicts of interest in the sale and marketing of complex investments.

FINRA notes that it continues to enhance its ability to focus its attention where there is the greatest risk. At the heart of this effort is a broader collection of data and a more comprehensive risk-assessment process. The first step will be a Risk Control Assessment (RCA) survey across the membership in the first quarter of 2012. The RCA is designed to give FINRA a better understanding of the members' business activities, product mix, customer base and underlying controls. Members should recognize that most new data collection efforts are followed by an enforcement effort to make sure the information collected is accurate, complete, and received when due.

The letter also lists the 11 products where FINRA's concerns about business conduct and suitability issues are heightened. Some of the products are new to the list: residential and commercial mortgage

backed securities; nontraded REITS; complex exchange-traded products; structured products; securities acquired in secondary markets; church bonds; promissory notes; and life settlements. Variable annuities, private placements, unregistered securities and municipal securities have appeared in most priority letters since 2008.

### The Results: FINRA's Disciplinary Actions Against Firms

In 2011, FINRA brought 1,411 disciplinary actions, levied \$63 million in fines and ordered \$19 million in restitution.[1] 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. For a small subset of more prominent cases, FINRA also publishes a press release. Since 2009, the number of press releases per year has fluctuated between 30 and 40. The current practice appears to be to issue a press release for almost all actions with fines or restitution of \$300,000 or more.

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.[2] 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 636 pages of published disciplinary actions for 2011. Now that FINRA makes all disciplinary actions searchable through its Disciplinary Actions Online Database it is possible — though not easy — to obtain greater insight into the results of FINRA's disciplinary actions.

In 2011, FINRA published descriptions of 373 disciplinary actions against 320 different FINRA member firms and descriptions of over 1,050 actions against individuals associated with member firms. Among all cases against firms, 204, or 56 percent, included some form of supervision violation.

The 32 press releases about disciplinary actions in 2011 were strongly focused on cases with customer harm. The most common violations, other than supervision, described in the press releases were: misrepresentations (6), suitability (6) and improper disclosure (4).

FINRA's Sanction Guidelines recognize a distinction between "quality of markets" rules and the rest of the rules, which I will refer to as general rules. There were approximately 173 (46 percent) disclosed actions involving quality of market rules and 200 (54 percent) disclosed actions involving general rules.

Among quality of market cases, the leading types and approximate numbers of violations cited were: TRACE and RTRS reporting (72); books and records (70); OATS (53); best execution (47); short sales and short interest (46); trade reporting (34); SEC Rules 605 and 606 (26); markups (24); and confirmations (12).

For quality of markets cases brought by Market Regulation in 2011 the average fine of approximately \$42,000 remained unchanged from 2010, and the median fine in 2011 decreased slightly to \$17,500 from \$20,000 in 2010.

Summarizing the cases involving the general rules is more difficult due to the larger number of rules enforced and the number of actions in which inadequate supervision of one or more rules is the only charge. There were also many cases imposing significant fines for which there are only a handful of cases during the year.

With those caveats in mind, among cases involving the general rules, the leading types and approximate numbers of violations are: fraud (30); sales practices and failure to supervise sales practices (50); AML (31); e-mail retention and review (24); net capital, reserves, and related computations (16); excessive

markups and fees (10); and various reporting requirements (8) (customer complaints, U-4/5, etc.). The average fine in a general rule case was over \$250,000 with a median fine of \$52,500.

By examining the case numbers that are assigned when an investigation is commenced, and disclosed in most of the summaries, it is possible to approximate the time it takes to resolve cases. For all disciplinary actions, including against individuals, the average time to resolution was slightly shorter, with 74 percent resolved in two years. Most disciplinary actions against firms for quality of markets issues were resolved in approximately two years or less and 80 percent were resolved in less than three years.

#### 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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