

FINRA's sanctions in 2009: a sign of things to come?

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Reprinted with permission *Journal of Investment Compliance*, Volume 11, Issue 4

Purpose – The purpose of the paper is to summarize a review of all of FINRA's 2009 notices and releases to understand the areas in which FINRA has focused and to try to predict where FINRA may be going in the coming year.

Design/methodology/approach – The paper summarizes fines, disciplinary actions, and top enforcement issues; analyzes trends; and draws conclusions.

Findings – FINRA reported modest increases in fines and disciplinary actions compared to 2008; however, FINRA was less active than in 2005, 2006 and 2007. The types of cases that generated the most fines, in descending order, were mutual funds, suitability, variable products, licensing, and advertising. One may see more advertising, money laundering, an electronic communications cases in the near future. Given the recent financial crisis and market scandals, and resulting pressure on the regulators, it is perhaps more likely that FINRA's enforcement activity and fines will increase over the next few years, not decrease.

Originality/value – The paper provides expert guidance from experienced financial services lawyers.

1. Introduction

Every year our clients ask us the following questions about FINRA's priorities: "What are they focusing on?" and "What areas should we worry about?". For the past several years, to respond to these questions, we have reviewed all of FINRA's notices and releases to understand the areas in which FINRA has focused and to try to predict where FINRA may be going in the coming year.

¹ Deborah G. Heilizer and Brian L. Rubin were formerly on the staff of the Securities and Exchange Commission. In addition, Brian L. Rubin was previously on the staff of NASD, while Deborah G. Heilizer previously served as in-house counsel. The authors would like to thank Dawn O'Neill for her assistance in assembling the data for this analysis.

What were our conclusions for 2009? FINRA reported modest increases in fines and disciplinary actions compared to 2008; however, FINRA was less active than in 2005, 2006 and 2007. In addition, our review identified the top enforcement issues for FINRA in 2009, as well as possible future trends.

2. The analysis

2.1 Fines and disciplinary actions

FINRA fined firms and individuals approximately \$50 million in 2009, almost twice as much as in 2008. While that increase is noteworthy, FINRA's fines in 2009 were still significantly less than the fines obtained by FINRA and its predecessors (NASD and the New York Stock Exchange) in 2005, 2006, and 2007. Similarly, FINRA resolved more disciplinary actions in 2009 (1,090) than in 2008, but those numbers are less than in prior years. Table I shows details regarding these results.

Table I				
	<i>Fines (approximate figures, in millions of dollars)</i>	<i>Year-to-year percentage change</i>	<i>Number of disciplinary actions</i>	<i>Year-to-year percentage change</i>
2005	184	N/A	1,344	N/A
2006	111	<40 >	1,147	<15 >
2007	77	<31 >	1,107	<5 >
2008	28	<64 >	1,007	<9 >
2009	50	79	1,090	8

2.2 Top enforcement issues

Every year, we analyze which types of cases generated the most fines. For 2009, those results were as shown in Table II.

Table II	
<i>Issue</i>	<i>Fines (approximate figures, in millions of dollars)</i>
Mutual funds	12
Suitability	11.9
Variable products	6.45
Licensing	5.6
Advertising	5.5

2.2.1 Mutual funds

Mutual funds cases, which generated the largest total fines in 2008, once again produced the highest aggregate fines in 2009 (approximately \$12 million), narrowly edging out suitability cases. Mutual fund cases accounted for nearly one-fourth of FINRA's total fines in 2009. More than one-half of the mutual fund cases (representing approximately \$6.6 million in fines) also included suitability allegations (e.g., share class cases, discussed below). FINRA also levied significant fines in cases involving specific

mutual fund issues, such as failing to comply with NASD's breakpoint self-assessment (25 firms were fined a total of \$2.1 million).

It should be noted that the \$12 million in mutual fund fines, while significant, represents a small fraction of the fines in mutual fund cases in 2005 and 2006 (\$104 million and \$95 million, respectively).

2.2.2 Suitability

Suitability cases finished a close second in total fines (approximately \$11.9 million). Firms were fined for unsuitable sales of various products (such as collateralized mortgage obligations, hedge funds, unit investment trusts, installment plan contracts, and variable products), as well as for excessive trading.

Not surprisingly, the biggest fines were in mutual fund suitability cases. Fines of more than \$1 million ("supersized" fines) were ordered in the following cases:

- \$4.41 million fine of a firm for, among other things, unsuitable sales of Class B and Class C mutual funds; and
- \$3.05 million fine of a firm for, among other things, failing to supervise two registered representatives who persuaded customers to take early retirement and executed unsuitable mutual fund transactions in those customers' accounts.

Also notable is the \$1.65 million in total fines assessed against five bank broker-dealers for failing to have adequate systems and procedures to supervise the suitability of mutual fund, variable annuity, and unit investment trust transactions.

2.2.3 Variable products

Variable products cases generated approximately \$6.45 million in fines in 2009. "Supersized" fines were imposed in the following cases:

- \$1.75 million fine of a firm for executing 250 unsuitable variable annuity sales and exchanges, which included transactions that were part of an alleged "mass switch" campaign by a particular registered representative; and
- \$1.5 million fine of another firm for alleged "complete meltdown" of its supervisory systems and procedures for the review of variable annuity sales.

2.2.4 Licensing

Licensing violations (including failures related to registration, testing and continuing education) were found in 50 disciplinary actions in 2009. In those actions, FINRA imposed approximately \$5.6 million in fines. The largest fines were levied against firms that violated licensing-related regulations, while also committing other unrelated violations. For example, one firm was fined \$1.75 million for permitting at least 22 Series 6 registered representatives to execute equity and bond transactions and for allowing an individual to park his securities license, while the firm was also charged for unsuitable variable annuity sales and exchanges. In another case, a firm was fined \$1 million for allowing an unregistered person (who had been barred by the Securities and Exchange Commission) to perform stock loan functions requiring registration; that firm was also charged for failing to supervise stock loan activities.

2.2.5 Advertising

Advertising cases came in fifth place with \$5.5 million in total fines. Of those fines, approximately \$3.5 million, or 64 percent, were imposed in auction rate securities (ARS) cases. In the ARS cases, FINRA found, among other things, that the firms used advertisements, sales literature and/or internal use only communications that:

- were not fair and balanced;
- did not provide a sound basis for evaluating the facts regarding ARS purchases; and
- failed to adequately disclose the risks of investing in ARS.

The cases involving internal use only pieces may suggest that FINRA is pursuing a new standard, establishing the same risk disclosure requirements for both internal use only pieces designed for trained professionals registered with FINRA and for materials used by the investing public (even though investors are presumed to be less informed than securities professionals).

2.3 Trends

While it is impossible to predict the future (or, as the regulators encourage firms to say, “past performance does not guarantee future results”), we analyzed the results from 2009 to determine whether we could see any trends for future cases.

2.3.1 “Supersized” fines

In 2009, FINRA imposed ten “supersized” fines (greater than \$1 million), representing a significant increase compared to 2008 (which had only three “supersized” fines). However, the number of “supersized” fines in 2009 was far less than those imposed in 2006 and 2007 (19 in each year). It is possible, given the credit crisis, and the microscope that both the SEC and FINRA have been under, that FINRA may try to bring more “supersized” cases in 2010. Table III illustrates the past results.

<i>Year</i>	<i>Number of supersized fines (> \$1 million)</i>
2006	19
2007	19
2008	3
2009	10

2.2.3 Advertising and anti-money laundering

While the top enforcement issues in 2009 included several of the “usual suspects” (e.g. mutual funds and suitability), advertising and anti-money laundering (AML) cases came in fifth and sixth place, respectively, after not making the prior years' lists.

Advertising cases resulted in \$5.5 million in fines. As explained above, in the coming years, FINRA may bring additional advertising cases involving internal use only pieces.

AML cases generated approximately \$4.9 million in fines in 2009. Given that AML issues have been touted as an enforcement and examination priority for the past several years, we may see an increase in fines generated from these cases in the future.

2.2.4 Electronic communications

For several years prior to 2009, cases involving electronic communications generated significant aggregate fines, but in 2009 these cases generated only \$4 million in aggregate fines. One probable explanation for this trend is that most firms have adopted e-mail retention systems, and as a result, FINRA has been primarily focusing on narrower issues, like retention of instant messages and the use of external e-mail accounts, which tend to generate lower fines. The results may differ in 2010 because FINRA has been examining firms' failures to follow up on "glitches" or "hiccups" in e-mail retention. For example, in May 2010, one broker-dealer was fined \$700,000 for failing to retain approximately 4.3 million e-mails, and for failing to inform FINRA of its e-mail retention and retrieval "glitches", which impacted the firm's ability to comply with production requests from FINRA. These types of issues may cause electronic communications to climb back to the top five in 2010.

2.2.5 Past priorities

Purported FINRA enforcement priorities like sales to seniors and retirees, alternative investments, private placements, and Ponzi schemes did not make the list of top fine-generating enforcement issues in 2009. However, this trend may reverse in 2010. In February 2010, FINRA fined a firm \$200,000 for failing to supervise sales of reverse convertible notes and for making unsuitable sales of reverse convertible notes to a retired couple. In addition, in March 2010, FINRA expelled a firm for facilitating fraudulent private placement sales that were marketed as income-producing investments, but according to FINRA, these products were fraudulent securities sold in a classic Ponzi scheme.

2.2.6 FINRA's take on Sutherland's analysis

Following the initial publication of Sutherland's 2009 analysis, Reuters spoke with FINRA's acting enforcement Director James Shorris.² According to the article, Mr Shorris made the following points:

- Fines do not reflect enforcement activity – According to Reuters, "FINRA acting enforcement chief James Shorris told Reuters the volume of fines imposed is not a true reflection of FINRA enforcement activity".
- *Investors should focus on issues, other than the fines* – According to the article, "FINRA acting enforcement chief James Shorris told Reuters the volume of fines imposed is not a true reflection of FINRA enforcement activity. Rather, investors should look at the numbers of cases brought each year, the types of misconduct under scrutiny and the size of the brokerages involved".

² Giannone, J.A. (2010), "Analysis: Fines by Wall St cop on pace to fall this year," Reuters, New York, NY, July 29, available at: www.reuters.com/article/idUSTRE66S54R20100729

- *Not all cases generate big fines* – Mr Shorris told Reuters: “We go after [wrongful conduct] wherever it is, but not all those cases are going to generate huge fines”.
- *Large fines in the past were justified because of facts and circumstances in those cases* – According to Reuters, “Federal and state regulators generated bigger fines earlier in this decade when they attacked analyst research conflicts and mutual fund trading violations among Wall Street’s biggest names. ‘Those were the big firms, and they were dealing with conduct that was enormous in terms of the number of affected customers and the potential dollars involved. As a result there were very large fines levied,’ Shorris told Reuters”.

3. Conclusion

While the number of disciplinary actions and fines during 2009 represent an increase from prior years, what will happen in the coming years? According to one report, through the end of July, FINRA is assessing fines at a pace that would reach \$30 million for 2010,³ which would represent a significant decrease compared with 2009. The extrapolation may not be reasonable. While we know what cases have been instituted, FINRA has not disclosed what cases are in its pipeline. Given the recent financial crisis and market scandals, and resulting pressure on the regulators, it is perhaps more likely that FINRA’s enforcement activity and fines will increase over the next few years, not decrease.

³ Giannone, J.A. (2010), "Analysis: Fines by Wall St cop on pace to fall this year," Reuters, New York, NY, July 29, available at: www.reuters.com/article/idUSTRE66S54R20100729