

## Does FINRA Accurately Seed Enforcement Issues?

Law360, New York (May 17, 2011) -- Earlier this spring, with much anticipation, American sports fans waited for the announcement of the NCAA men's basketball tournament seeds on Selection Sunday. Many wondered whether Duke would again be ranked No. 1 in its region (as it usually should be). And once the teams were ranked and March Madness play began, many hoped to see a Cinderella team slay a seemingly unbeatable Goliath (to mix fairy tales and Bible stories).

Similarly, every spring, officials from the Financial Industry Regulatory Authority (and its predecessor, NASD) announce regulatory priorities in their annual Examination Priorities Letters. Much like basketball fans (and "participants" in office pools across the country), broker-dealers and registered representatives focus on what types of subjects and cases FINRA intends to emphasize and pursue. Many also wonder whether these exam priorities will lead to enforcement cases.

With the February 2011 release of FINRA's 2011 Regulatory and Examination Priorities Letter, we thought it would be interesting to see whether FINRA's stated examination priorities actually lead to enforcement actions in those areas. Since it usually takes two to three years for FINRA to investigate an issue before deciding whether it has sufficient grounds to bring a disciplinary action, this article compares the 2007 and 2008 Examination Priorities Letters with the disciplinary cases brought by FINRA in 2009 and 2010, as set forth in FINRA's Regulatory Notices.

Based on this analysis, it appears that FINRA's rankings are good — although not perfect — predictions for the future. (FINRA, of course, would probably like to emphasize that past performance does not guarantee future results.)

### What Were the Top Seeds (or Priorities) in 2007 and 2008?

Although the 2007 and 2008 Examination Priorities Letters listed nearly 30 total issues, a handful of topics were addressed in both of these letters, including (1) anti-money laundering; (2) trade reporting; (3) supervision; and (4) suitability. Furthermore, many of the specific topics discussed in the 2007 and 2008 letters fall under these four broad categories.

### *Anti-Money Laundering*

Both the 2007 and 2008 letters repeatedly noted that the enforcement of the applicable anti-money laundering (AML) rules would be an especially important focus for FINRA. Specifically, these letters emphasized that all members firms, even those that do not hold any customer funds, must develop and implement a reasonable and effective AML program.

### *Trade Reporting*

Similar to AML, both the 2007 and 2008 Examination Priorities Letters repeatedly indicated that various trade reporting issues would be an important focus for FINRA. In addition to noting the need to submit accurate trade reports to regulators, these Priorities Letters specifically emphasized the importance of TRACE reporting and the Order Audit Trail System (OATS).

### *Supervision*

A third major category emphasized by both the 2007 and 2008 Examination Priorities Letters was supervision. In fact, the 2008 letter noted that supervision is a “core element” and “vital” to overall compliance with FINRA rules. This letter also warned member firms that they “must establish adequate systems, policies and procedures for all areas of their business, and appropriately review and update their supervisory system.”

### *Suitability*

In both the 2007 and 2008 Examination Priorities Letters, firms and representatives were reminded that firms “must consider the suitability of any securities they recommend to their customers” and that such a suitability determination is “essential.” While the 2007 letter discussed this requirement specifically in the context of complex investments, such as hedge funds, the 2008 letter explicitly encouraged FINRA members to take a proactive approach when conducting due diligence of new products and determining the suitability of these potential investments.

## **Did Those Issues Result in FINRA Victories (or Enforcement Actions)?**

### *Anti-Money Laundering*

Even though AML was touted as an examination priority for FINRA in 2007 and 2008, it did not turn into a top enforcement issue. In 2009, enforcement actions for alleged AML violations were instituted in only 26 cases, leading to fines of about \$4.9 million. In 2010, FINRA brought only 31 such cases, with \$2.7 million in fines. (To put these numbers in perspective, FINRA brought 1,158 disciplinary actions in 2009 and 1,310 in 2010, fining firms and individuals approximately \$50 million in 2009 and \$45 million in 2010.)

Thus, despite being emphasized in the 2007 and 2008 Examination Priorities Letters (as well as the 2006, 2009 and 2010 versions) as an area of great importance, AML cases still make up only a small fraction of FINRA's enforcement cases. These numbers (and the likelihood that most firms probably have AML procedures in place at this point) may explain why this topic was not highlighted in 2011's Examination Priorities Letter.

### *Trade Reporting*

Unlike AML, the number of trade reporting cases has exploded since the 2007 and 2008 letters were published. In 2009, FINRA brought 120 trade reporting cases, and in 2010, the number jumped to 165 cases. Interestingly, despite this significant increase in the number of cases, the total monetary amount of fines has dropped slightly and the average fine has dropped substantially. Specifically, while FINRA imposed fines of \$6.2 million in 2009, that number fell to \$6 million in 2010.

### *Supervision*

Supervision has always been an important enforcement issue. In fact, in many cases, it appears that a supervision charge is "tacked on" to an underlying substantive violation — apparently because FINRA often believes that if a substantive violation occurred, then there must have been deficient supervisory procedures as well. In 2009, FINRA brought 196 cases for alleged supervisory deficiencies, which resulted in more than \$38 million in total fines. In 2010, the number of cases involving supervisory issues jumped to 220 cases, with fines totaling \$30.8 million.

### *Suitability*

Suitability cases, which are often brought after a market downturn, have had ups and downs (much like the market) (and basketballs). In 2009, FINRA imposed sanctions in 47 FINRA disciplinary actions, which resulted in more than \$7.3 million in fines. Although the number of suitability cases increased to 53 in 2010, the total amount of fines dropped to roughly \$3.8 million.

## **What Were the Cinderella Issues?**

Like Virginia Commonwealth University's surprising "Cinderella" run to the 2011 Final Four, which included victories over four higher-ranked teams, unexpected issues sometimes rise to the top of FINRA's enforcement actions. Each year, Sutherland conducts a study of all FINRA's disciplinary actions and determines the top five issues that garnered the largest amount of fines for the regulator.

The cases that resulted in the most fines for FINRA in 2009 were (1) mutual funds (\$12 million); (2) suitability (\$11.9 million); (3) variable products (\$6.45 million); (4) licensing (\$5.6 million); and (5) advertising (\$5.5 million). In 2010, the issues that generated the most fines were (1) advertising (\$4.75 million); (2) credit default swap (CDS) cases (\$4.5 million); (3) electronic communications (\$4 million); (4) suitability (\$3.75 million); and (5) short selling (\$3.5 million).

While 2010 was a remarkable year for Cinderellas in the NCAA basketball tournament, as the Butler Bulldogs were only inches away from beating a superior and higher ranked Duke team and capturing a national title, the above results indicate that 2010 was also a very strong year for regulatory Cinderellas. In 2010, while advertising and credit default swap cases were among the top two fine-generating categories, neither of these issues was discussed in either the 2007 or the 2008 Examination Priorities Letters.

### *Advertising*

While the 2007 and 2008 letters discussed a number of issues, advertising was not highlighted as an examination priority for FINRA. However, according to Sutherland's annual analysis, advertising cases generated the fifth highest total amount of fines for FINRA in 2009 (\$5.5 million) and the highest total in 2010 (\$4.75 million).

Most of the 2009 total came from a series of auction rate securities (ARS) cases, which in part involved unbalanced sales literature and internal use only communications that failed to adequately disclose the relevant risks. Even though there were very few ARS cases in 2010, advertising cases still jumped to the top of the fine-generating list. After ranking near the top of Sutherland's list for two consecutive years, it seems likely that advertising cases have transitioned from being a Cinderella story to an expected regulatory priority for FINRA.

### *Credit Default Swaps*

Credit default swaps were not mentioned in FINRA's 2007 and 2008 Examination Priorities Letters. However, like the 2009 ARS advertising cases, a series of CDS cases pushed this category to the top of the rankings. While no fines were issued for CDS violations in 2008, FINRA imposed \$3.15 million in fines in CDS cases in 2009 and \$4.5 million in 2010.

This 2010 fine amount was second only to the \$4.75 million in fines issued in advertising cases. However, almost all of these 2009 and 2010 fines stemmed from a related set of cases involving allegedly improper communications between firms regarding brokerage rate reductions in the wholesale CDS market. Thus, it appears that these recent CDS cases were simply the equivalent of a one-hit wonder for FINRA.

### **Post-Game Analysis**

In the NCAA men's basketball tournament, it's rare that all of the top seeded teams go all the way to the Final Four. In fact, since the NCAA started ranking teams in 1979, all four of the No. 1 seeds have made it to the semi-finals only once, in 2008.

Of the four examination categories discussed above (anti-money laundering, trade reporting, suitability and supervision), all but anti-money laundering generated significant numbers of disciplinary actions and corresponding fines since the 2007 and 2008 Examination Priorities Letters were published. While this shows that the Examination Priorities Letters can accurately predict future enforcement activity, the recent rise of advertising and credit default swap cases to the top of FINRA's disciplinary list shows that new and unexpected issues can also capture FINRA's attention and investigative resources.

Thus, it appears that FINRA's predictions are sometimes fairly accurate guarantees of future enforcement results. Accordingly, firms and individuals in the securities industry would probably benefit from analyzing the February 2011 Examination Priorities Letter several times a year. After all, FINRA's senior management thinks these issues are important enough to highlight in their annual letter, and FINRA's staff is conducting examinations into these issues.

A review of the 2011 letter indicates that issues such as short sales, private placements, outside business activities, municipal securities and social media are FINRA's examination priorities this year. By studying these issues, firms may be able to enhance their procedures, fix problems and hopefully prevent an enforcement action. Remember, as one sports legend said (more or less), good compliance is 90 percent mental, the other half is physical.

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[1] One of the authors graduated from Duke University, where he (not surprisingly) did not play basketball.

[2] The other author, a University of Virginia graduate, notes that the Duke Blue Devil "Goliaths" have fallen victim to lower-seeded teams in the NCAA men's basketball tournament in eight of the past ten seasons.

[3] <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p122863.pdf>.

[4] See also Deborah G. Heilizer, Brian L. Rubin, and Andrew M. McCormick, Annual Sutherland FINRA Sanction Study Shows Enforcement Actions on the Rise, Mar. 1, 2011, <http://www.sutherland.com/files/News/2dc0cf3f-7d23-4e75-8c0b-4a63dc2ea7bd/Presentation/NewsAttachment/14cc3d75-6f1d-4556-a8a7-4ac677880ee3/LIT%20Alert%203.1.11.pdf>.

[5] <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p018635.pdf>.

[6] <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p038169.pdf>.

[7] 2008 Examination Priorities Letter at 4.

[8] *Id.*

[9] *Id.*; 2007 Examination Priorities Letter at 3.

[10] <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p122863.pdf>.

[11] Deborah G. Heilizer, Brian L. Rubin and Shynyn L. Gillespie, FINRA's sanctions in 2009: a sign of things to come?, *Journal of Investment Compliance*, November 2010, Volume 11, Issue 4, at 2, available at <http://www.sutherland.com/files/Publication/dbbe8420-fcfe-4e83-8b65-67cf5a154ffd/Presentation/PublicationAttachment/99951ef1-f482-42f0-8d4c-76211ab4fa30/RubinHeilizerGillespieFINRASanctions2009JournalofInvestmentCompliance.pdf>.

[12] See note 4, *supra*.

[13] See notes 1 & 2, *supra*.

[14] See *supra* notes 11-12 and accompanying text.

[15] [http://www.washingtonpost.com/blogs/reliable-source/post/obamas-march-madness-his-2011-bracket-has-all-1-seeds-in-the-final-four/2011/03/16/AB9CF9f\\_blog.html](http://www.washingtonpost.com/blogs/reliable-source/post/obamas-march-madness-his-2011-bracket-has-all-1-seeds-in-the-final-four/2011/03/16/AB9CF9f_blog.html).

[16] Cf. <http://www.quotationspage.com/quote/27220.html> (“Baseball is 90 percent mental, the other half is physical.”) (Yogi Berra).