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Annual Review of FINRA Sanctions Finds Disciplinary Slowdown Began to Reverse in 2009

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An annual review of disciplinary actions brought by the Financial Industry Regulatory Authority (FINRA) in 2009 conducted by the law firm Sutherland Asbill & Brennan LLP found that FINRA reported modest increases in fines and disciplinary actions in 2009, as compared to 2008, but was less active than in 2005, 2006 and 2007. Sutherland also identified the top enforcement issues for FINRA in 2009, as well as disciplinary trends.

The Results

Fines and Disciplinary Actions

FINRA fined firms and individuals approximately $50 million in 2009, almost twice as much as in 2008 (approximately $28 million). While that increase is noteworthy, FINRA's fines in 2009 were still significantly smaller than the fines obtained by FINRA and its predecessors (NASD and the New York Stock Exchange) in 2005, 2006, and 2007 ($184 million, $111 million, and $77 million, respectively). In addition, FINRA resolved more disciplinary actions in 2009 (1,090) than in 2008 (1,007), but fewer than were resolved in prior years (1,344 in 2005; 1,147 in 2006; and 1,107 in 2007).

Top Enforcement Issues

1. Mutual Funds, which generated the most total fines in 2008, once again produced the highest aggregate fines (approximately $12 million), narrowly edging out Suitability. 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, dis-

CONTINUED ON PAGE 3

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cussed below). FINRA also levied significant fines in cases involving mutual fund specific issues, *e.g.*, $2.1 million in fines levied against 25 firms for failing to comply with NASD's breakpoint self-assessment. It should also 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. Suitability cases finished a close second in total fines (approximately $11.9 million). Fines were imposed for excessive trading and unsuitable sales of various products, including collateralized mortgage obligations (CMOs), hedge funds, unit investment trusts, installment plan contracts, and variable products. Not surprisingly, the biggest fines were in mutual fund suitability cases, including "supersized" fines (defined as fines of more than $1 million) in the following cases: (a) $4.41 million fine of a firm for, among other things, unsuitable sales of Class B and Class C mutual funds; and (b) $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 variable annuity, mutual fund and unit investment trust transactions.

3. Variable Products cases generated approximately $6.45 million in fines in 2009. "Supersized" fines were imposed in the following cases: (a) $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 (b) a $1.5 million fine of another firm for alleged "complete meltdown" of supervisory systems and procedures for the review of variable annuity sales.

4. Licensing violations (including failures related to registration, testing and continuing education) were found in 50 disciplinary actions in 2009, in which more than $5.6 million in fines were imposed. 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 example, a firm was fined $1 million for allowing an unregistered person who had been barred by the Securities and Exchange Commission (SEC) to perform stock loan functions requiring registration; that firm was also charged for failing to supervise stock loan activities.

5. Advertising came in fifth place with $5.5 million in total fines. Of those fines, approximately $3.5 million or 64% were imposed in auction rate securities (ARS) cases. In those cases, FINRA found, among other things, that the firms used advertisements, sales literature and/or internal-use-only communications that: (1) were not fair and balanced; (2) did not provide a sound basis for evaluating the facts regarding ARS purchases; and (3) 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 internal-use-only pieces for trained professionals registered with FINRA and materials used by the investing public (even though investors are presumed to be less informed than securities professionals).

Trends

- *"Supersized" fines*—In 2009, FINRA imposed 10 "supersized" fines (an amount more 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).

- *Advertising and AML*—While the top enforcement issues in 2009 included several of the "usual suspects" (*e.g.*, mutual funds and suitability), Advertising and AntiMoney Laundering (AML), came in fifth place and sixth place, respectively, after not making the prior years' lists. Advertising resulted in $5.5 million in fines, while AML (which has been touted as an enforcement and examination priority for the past several years) generated approximately $4.9 million in fines. In addition, as explained above, FINRA may bring more advertising cases involving internal-use-only pieces.

- *Electronic Communications*—During the past several years, cases involving electronic communications have generated significant aggregate fines, but in 2009 they did not, generating only $4 million in aggregate fines. One explanation for this trend is that most firms have probably adopted email retention systems. Instead, FINRA has been primarily focusing on narrower issues, like retention of instant messages and the use of external email accounts, which tend to generate lower fines. The results may differ in 2010 as FINRA has been examining firms' failures to follow up on "glitches" or "hiccups" in email retention. For example, in May 2010, one broker-dealer was fined $700,000 for failing to retain approximately 4.3 million emails, and for failing to inform FINRA of its email 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.

- *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 in reality, the firm's affiliate engaged in a classic Ponzi scheme.