SUTHERLAND

FINRA's 2011 enforcement record, priorities, and trends

Deborah G. Heilizer, Brian L. Rubin and Andrew M. McCormick

As published in Journal of Investment Compliance, September 2012. Reprinted with permission.

Abstract

Purpose - *The paper's aim is to describe a recent increase in FINRA enforcement activity and to discuss how broker-dealers and representatives may want to prepare themselves for FINRA's increasing willingness to sanction members in the wake of the recent financial crisis.*
Design/methodology/approach - *The paper analyzes FINRA's recent enforcement record, including trends over the past several years in disciplinary actions and fines. It also discusses FINRA's top enforcement issues in 2011; advertising, short selling, auction rate securities, and suitability; and recommends increased compliance efforts in light of FINRA's growing aggressiveness.*
Findings - *It is important that firms and representatives understand how the priorities of this self-regulatory organization have changed since the financial crisis, fueling this recent growth in FINRA enforcement activity.*
Originality/value - *The paper offers practical guidance from experienced financial services lawyers.*
Keywords *Financial institutions, United States of America, Enforcement, Broker-dealer, Registered representative, Law enforcement*
Paper type *Technical paper*

After a substantial decline in FINRA enforcement activity in the years immediately preceding the recent financial crisis, broker-dealers (BDs) and registered representatives are faced with a potentially daunting new reality: an active regulator that is bringing a lot more cases and imposing a lot more fines. Since 2008, the number of disciplinary cases filed by FINRA annually has jumped nearly 39 percent and the fines levied have increased by 143 percent[1].

It is important that firms and representatives understand how the priorities of this self-regulatory organization have changed since the financial crisis, fueling this recent growth in FINRA enforcement activity This article analyzes these new priorities in light of FINRA's recent enforcement record, including how 2011 cases compare with those in prior years, and discusses how BDs and representatives may want to prepare themselves for FINRA's increasing willingness to sanction members in the wake of the recent financial crisis.

1. FINRA's recent enforcement record

FINRA reported filing 1,488 disciplinary actions in 2011, a considerable increase from the 1,310 cases the regulator initiated in 2010[2]. As noted above, 2011 was the third straight year in which the number of FINRA disciplinary actions increased. While the growth in 2009 was relatively modest (8 percent), FINRA posted double-digit increases for both 2010 and 2011, approximately 13 percent each year. In total, the annual number of cases reported by FINRA has increased from 1,073 in 2008 to 1,488 in 2011, a change of nearly 39 percent. The number of individuals barred by FINRA also increased significantly in 2011 - from 288 in 2010 to 329 this past year, a jump of more than 14 percent. The combined number of representatives who were barred or suspended has increased by nearly 18 percent since 2008 (from 684 in 2008 to 804 this past year). These figures evidence FINRA's zeal in taking a more aggressive stance against firms and their representatives. FINRA also filed 97 formal complaints to be tried before the Office of Hearing Officers in 2011. That number rose for the fourth straight year after significant slowdowns in 2006 and 2007[3]. Table I shows the number of disciplinary actions FINRA has filed in recent years, as well as the corresponding amount of fines reported.

Despite the significant growth in the number of disciplinary actions reported in 2011, the jump in the amount of fines assessed was even greater, from $45 million in 2010 to $68 million in 2011, an increase of 51 percent. This is a considerable reversal from 2010, when there was a $5 million drop in the total amount of fines notwithstanding a 13 percent increase in the number of actions filed. While the $68 million reported in 2011 is still a far cry from the $184 million and $111 million that FINRA fined firms and representatives in 2005 and 2006, respectively, it may signal continued heightened enforcement efforts for the near future.

These statistics demonstrate that, following the financial crisis FINRA has become a much more aggressive regulator. In light of these trends, firms and individuals may want to prepare themselves for the possibility of increased FINRA enforcement activity in the immediate future, particularly in those areas that captured the regulator's attention in 2011.

2. The top 2011 FINRA enforcement issues

The four topics discussed below are FINRA's top 2011 enforcement issues based on the total fines assessed[4]. Due to the emphasis the regulator placed on these issues during the past year, it is likely that they will continue to be enforcement priorities for FINRA in the immediate future.

2.1 Advertising

For the second straight year, advertising was the top enforcement issue for FINRA. The fines reported for cases involving alleged advertising violations jumped from $4.75 million in 2010 to $21.1 million in 2011, an increase of 344 percent. Table II shows the total number of advertising enforcement actions and fines that FINRA has reported during each of the past six years.

Table I FINRA's sanctions statistics, 2005-2011

	Fines reported	*Percentage change*	*Disciplinary actions*	*Percentage change*
2005	$184 million	_	1,412	_
2006	$111 million	(40)	1,204	(15)
2007	$ 77 million	(31)	1,177	(2)
2008	$ 28 million	(64)	1,073	(9)
2009	$ 50 million	79	1,158	8
2010	$ 45 million	(10)	1,310	13
2011	$ 68 million	51	1,488	13.6

Table II FINRA's advertising sanctions statistics, 2006-2011

		Percentage	*Percentage of total*	*Cases*	*Percentage*

	Fines reported	change	FINRA fines	reported	change
2006	$362,000	_	0.3	8	_
2007	$6.1 million	1,585	8	18	125
2008	$1.2 million	(80)	4%	22	22
2009	$5.5 million	358	11	28	27
2010	$4.75 million	(14)	11	24	(14)
2011	$21.1 million	344	31	45	88

As seen in Table II, the number of cases involving advertising charges has increased nearly every year since 2006, growing from eight actions reported in 2006 to 45 this past year (a 463 percent increase). These statistics also demonstrate that cases involving alleged advertising violations have made up an increasing percentage of FINRA's annual fines over time.

In 2011, advertising cases involving auction rate securities (ARS) played a prominent role. In fact, 45 percent of the 2011 advertising fines ($9.5 million) involved ARS. One of the largest sanctions imposed in an ARS advertising case was a $3 million fine against a firm for allegedly creating misleading marketing materials that were used when the securities were sold to retail customers (FINRA, 2011e). FINRA charged that these advertisements did not adequately disclose the liquidity risks of ARS (including the possibility of auction failure) and that they improperly described these securities as ''safe and liquid investments.'' Brad Bennett, FINRA's Chief of Enforcement, said that the firm ''was aware of facts that raised significant red flags about the ability of investors to obtain liquidity,'' but still ''failed to revise their marketing brochures to disclose these risks'' (FINRA, 2011e). Mr Bennett further stated that the firm's alleged advertising violations ''deprived investors of important information'' (FINRA, 2011e).

Two firms were fined in excess of $1 million for providing potential investors with incorrect historical delinquency rates for residential subprime mortgage securitizations (FINRA, 2011f). One of those firms was fined $3 million for allegedly publishing on its website incorrect rates that were available to investors considering purchasing those securities. Potential investors used these materials to evaluate how similar mortgage loans had performed when deciding whether to make an investment. FINRA believed that these errors were ''significant enough to affect an investor's assessment of subsequent securitizations'' and the fair market value and potential yields of these investments (FINRA, 2011f). Mr Bennett said that this ''depriv[ed] investors of information essential to assessing the profitability of mortgage-backed investments'' (FINRA, 2011f). Another firm was fined $4.5 million for allegedly publishing inaccurate RMBS data on its website (FINRA, 2011f). Although there were only one-third as many reporting errors in this second case (21 vs61), FINRA alleged that the second firm knew of these inaccuracies but did not sufficiently investigate the problem.

In another case relating to the recent financial crisis, a firm was fined $2.5 million for allegedly using misleading advertising materials when selling principal-protection notes (PPNs) offered by Lehman Brothers (FINRA, 2011b). These materials allegedly suggested that investors were guaranteed a return of principal if they held the note to maturity but failed to indicate that these investments were unsecured obligations of Lehman Brothers and could result in principal loss (which they did). According to FINRA, this case highlighted that financial advisors must understand the complex securities they sell and that firms ''need[] to be clear and comprehensive in disclosing risks of the structured products [they sell] to retail investors'' (FINRA, 2011b). The firm was also required to pay $8.25 million in restitution to investors who were allegedly misled.

The increasing number of advertising cases, the amount of resulting fines, and FINRA's emphasis on disclosure of risks to the ultimate purchaser demonstrate that FINRA is taking seriously perceived violations of its advertising rules and deficiencies in disclosures to investors. Firms may want to review the disclosures made in their advertising materials, especially those involving complex products for accuracy and completeness, both in materials provided to investors and in internal marketing or training materials[5].

2.2 Short selling

Short selling cases were the second biggest enforcement issue for FINRA in 2011, as these cases garnered $16.8 million in fines for the regulator. This represented a significant increase from the prior year when fines for short selling violations totaled $3.5 million and ranked fifth on 2010's list of top enforcement issues. Table III indicates the total number of short selling enforcement actions and fines that FINRA has reported during each of the past six years.

These statistics show substantial increases in the amount of fines that FINRA has imposed during the past three years in cases involving alleged violations of FINRA's short selling rules. As the amount of fines assessed in short selling cases has grown during this time, these cases have represented an increasing percentage of FINRA's overall fines.

Table III FINRA's short selling sanctions statistics, 2006-2011

	Fines reported	*Percentage change*	*Percentage of total FINRA fines*	*Cases reported*	*Percentage change*
2006	$1.1 million	-	1	11	-
2007	$9.9 million	800	13	38	245
2008	$289,000	(97)	1	7	(82)
2009	$2.5 million	765	5	28	300
2010	$3.5 million	40	8	54	93
2011	$16.8 million	380	25	38	(30)

Although short selling placed second on Sutherland's 2011 ''Top Enforcement Issues'' list with $16.8 million in fines, this was due largely to a single case that resulted in a $12 million fine (FINRA's largest in 2011) for a firm's alleged violations of Regulation SHO and corresponding supervisory deficiencies (FINRA, 2011i). Regulation SHO requires a seller to reasonably believe a security can be acquired and delivered before it may be sold short. It also requires sellers to mark the shares as either long or short. Mr Bennett said that the firm's alleged behavior, which included making millions of short sales without a reasonable belief that the securities could be acquired and mismarking millions of short sales, ''created a potential harm for the integrity of the market'' (FINRA, 2011j). Mr Bennett also warned firms that their trading and supervisory systems must be designed to ''prevent potentially abusive naked short selling'' (FINRA, 2011j).

Two other firms were each fined $900,000 for alleged short selling violations in 2011. In the first case, which was settled, afirm was sanctioned $900,000 for Regulation SHO charges similar to those described above (FINRA, 2011a). The firm allegedly released hundreds of short sale orders without first obtaining a ‘‘locate’’ (identifying the source from which the security will be borrowed) and documenting that the security could be acquired. FINRA also alleged that the firm did not properly train and equip personnel to locate securities that were the subject of short sales. Further, FINRA claimed there was a systemic failure to implement an effective frameworkfor Regulation SHO compliance, including having incomplete and incorrect written policies regarding short sales. In the second case, which was litigated, FINRA expelled and barred Legacy Trading Co., LLC, and its CEO and imposed a $900,000 fine against these respondents for ‘‘egregious’’ and ‘‘willful’’ violations of short selling rules (Dept. of Enforcement vs Legacy Trading Co., LLC and Mark Uselton, 2009). The firm was found to have executed nearly 2,200 short sales without making any effort to determine whether the security being sold could be borrowed. The hearing officer found that some short sales were executed even though the respondents knew those sales violated SEC and FINRA rules.

The message from these three cases, and the growing amount of short selling fines, is clear: FINRA will be reviewing the thoroughness and effectiveness of firms’ supervisory systems and procedures relating to short sales and Regulation SHO. When short selling becomes more frequent in bad markets, it appears that FINRA will respond with increased enforcement activity in this area.

2.3 Auction rate securities (ARS)

Auction rate securities (ARS) generated the third-largest amount of fines for FINRA in 2011, generating $10 million in fines from seven ARS matters, an increase from 2010s $1.78 million in sanctions from only two cases. As evidenced by Table IV, which notes that no ARS cases were reported before 2009, FINRA’s focus on ARS cases is a product of the recent financial crisis, which contributed to the unexpected failure of a number of ARS auctions.

Alleged violations of FINRA’s advertising rules have been at the heart of many of these ARS cases, including the failure to disclose to firm representatives and/or customers in advertising materials (including ‘‘internal use only’’ documents) that auctions could fail. Although there has not been an overwhelming number of ARS cases, FINRA has taken these matters very seriously and these cases have yielded average fines of approximately $700,000.

Table IV FINRA's ARS sanctions statistics, 2006-2011

	Fines reported	*Percentage change*	*Percentage of total FINRA fines*	*Cases reported*	*Percentage change*
2006	0	-	-	0	-
2007	0	-	-	0	-
2008	0	-	-	0	-
2009	$3.47 million	-	7	13	-
2010	$1.78 million	(49)	4	2	(87)
2011	$9.9 million	456	15	7	250

The largest 2011 ARS fine was a $4.6 million sanction that a firm paid for making allegedly false representations and omissions regarding the safety and liquidity of ARS (FINRA, 2011h). The firm acted as an underwriter for ARS and its customers had $1.6 billion of these securities in their accounts with the firm. However, according to FINRA, the firm failed to disclose its concerns about auction failures to its sales representatives, many of whom continued to offer these securities as safe and liquid investments. The marketing materials used by the firm purportedly failed to provide a fair description of ARS because they did not sufficiently disclose that ARS auctions could fail and instruments could become illiquid. Mr. Bennett stated that this prevented sales representatives from ''making proper recommendations and their customers from making informed decisions about ARS'' (FINRA, 2011h).

A firm and two of its representatives were fined more than $1.5 million for allegedly failing to disclose material facts to institutional investors concerning the risks of ARS transactions (FINRA, 2011d). FINRA also alleged that the two representatives failed to disclose to investors that 32 ARS transactions resulted in additional compensation for the representatives or that higher-yield products were available that charged lower commissions. This case involved approximately 40 corporate investors that invested $650 million in ARS. In addition, the individual representatives improperly acted as agents for both the buyer and the seller in some ARS transactions without notifying their customers of this conflict. The firm also failed to deliver official transaction statements for a number of ARS transactions and had deficient or missing ticket orders for more than half of the ARS trades executed during the relevant time period. Similar to many other ARS cases, the advertising materials used by the firm described ARS as a ''cash equivalent investment'' akin to money markets and implied they were short-term investments. The firm was also required to pay back $425,000 in fees to the affected customers.
The ARS cases show that when market events affect a particular product, FINRA will examine many facets of the interactions between member firms and/or their representatives and investors, including advertising and the appropriateness of disclosures. As a result, firms may wish to consider reviewing disclosures, particularly with respect to market-sensitive products.

2.4 Suitability

FINRA reported $7.7 million in fines from 106 cases involving alleged suitability violations in 2011. Although suitability has consistently been a top enforcement issue for FINRA, 2011 saw a record number of suitability cases. The 106 suitability cases reported in 2011 were double the 53 that FINRA announced in both 2009 and 2010. Table V shows the total number of suitability enforcement actions and fines FINRA has reported during each of the past six years.

These statistics reveal that suitability cases routinely make up a significant percentage of FINRA's enforcement fines each year. In fact, nearly 15 percent of all FINRA sanctions since 2006 have stemmed from cases involving suitability allegations. The large increase in the number of suitability cases in 2011 may evidence that suitability is also a ''hindsight'' issue that garners additional attention from regulators in the wake of a substantial market decline.

Table V FINRA's suitability sanctions statistics, 2006-2011

	Fines reported	Percentage change	Percentage of total FINRA fines	Cases reported	Percentage change
2006	$30.1 million	-	27	42	-
2007	$4.2 million	(86)	5	38	(10)
2008	$4.5 million	7	13	40	5
2009	$11.9 million	164	24	53	33
2010	$3.75 million	(68)	8	53	0
2011	$7.7 million	105	11	106	100

One firm was fined $2 million in 2011 for allegedly selling unsuitable reverse convertible securities to retail customers (FINRA, 2011c). Mr Bennett, FINRA's Chief of Enforcement, stated that deficiencies in the firm's structured products business enabled ''unsuitable recommendations of concentrated positions in risky reverse convertibles - sometimes using funds that the firm helped customers borrow - to proceed without detection or review.'' FINRA cited a number of transactions that were inconsistent with investors' objectives and that exposed them to more risk than they desired. Apart from the FINRA settlement, the firm settled with 17 clients, paying them more than $6.9 million.

The case discussed in the advertising section above concerning the sale of PPNs by Lehman Brothers also involved alleged suitability violations (FINRA, 2011b). FINRA claimed that the firm did not have risk profile requirements for some PPNs, which resulted in these notes being improperly sold to certain investors, including those with conservative or moderate risk tolerances. Mr Bennett indicated that in some instances the firm's ''financial advisors did not even understand the complex products they were selling'' (FINRA, 2011b).

For allegedly failing to properly supervise the sale of collateralized mortgage obligations (CMOs)to retail customers, FINRA fined a firm $600,000 in 2011 (FINRA, 2011g). Thefirm's exception reporting system did not cover CMOs and the firm did not review transactions for potentially unsuitable levels of concentration in CMOs. FINRA claimed that failing to monitor the suitability of these investments led to 26 elderly customers having more than half of their assets at the firm invested in CMOs.

In light of the substantial sanctions FINRA has imposed in suitability cases involving complex securities and regulatory notices, firms may wish to review their policies and procedures regarding complex products (FINRA, 2012). Representatives may also wish to pay especially close attention to these issues since nearly 30 individuals were barred from the industry by FINRA in 2011 for recommending allegedly unsuitable transactions.

3. Conclusion

As detailed above, FINRA's enforcement activity has increased dramatically since the financial crisis shocked investment markets in 2008. When asked about this increase in enforcement activity, Mr Bennett stated that he is proud of his staff's productivity, ability to work through a daunting caseload, and the fact that FINRA is acting aggressively to protect investors (Schoeff, 2012). Mr Bennett also explained that ‘‘[t]he cost of doing business incorrectly has to be greater than the cost of doing business correctly, or you give a competitive advantage to a noncompliant firm’’ (Schoeff, 2012). In light of this sentiment and FINRA’s growing aggressiveness, firms may want to increase their efforts to ensure they are ‘‘doing business correctly,’’ particularly regarding the issues detailed above.

Notes

1. The number of cases reported and the amount of corresponding fines referenced in this article come from the Disciplinary and Other FINRA Actions report that FINRA publishes each month. FINRA also publishes some enforcement statistics each year. FINRA Statistics, available at: www. finra.org/Newsroom/Statistics/index.htm
2. FINRA defines disciplinary actions as Letters of Acceptance, Waiver and Consent; Complaints; Rule 9522 suspensions; and Minor Rule Violations.
3. Prior to the filing of a formal complaint, an enforcement action can be settled through a Letter of Acceptance, Waiver and Consent. It can also be settled through an Offer of Settlement after a complaint is filed but before the case is tried.
4. While this article ranks issues based on fines, many FINRA disciplinary actions involve multiple allegations, making it difficult to attribute the exact amount of any particular fine to a particular allegation.
5. For additional analysis on FINRA’s actions concerning internal sales materials, see Heilizer et al. (2010).

References

Dept. of Enforcement vs Legacy Trading Co., LLC and Mark Uselton (2009), Disciplinary Proceeding no. 2005000879302, March 12.

FINRA (2011a), ‘‘FINRA Letter of Acceptance, Waiver and Consent’’, No. 2008013127801 (December 24).

FINRA (2011b), ‘‘FINRA News Release’’, April 11, available at:
www.finra.org/Newsroom/NewsReleases/2011/P123479
FINRA(2011c), ‘‘FINRANews Release’’, April 12, available at:
www.finra.org/Newsroom/NewsReleases/2011/P123491

FINRA (2011d), ‘‘FINRA Letter of Acceptance, Waiver and Consent’’, No. 2008013863701, April 14.

FINRA (2011e), ‘‘FINRA News Release’’, May 23, available at:
www.finra.org/Newsroom/NewsReleases/2011/P123723

FINRA (2011f), ‘‘FINRA News Release’’, May 26, available at:
www.finra.org/Newsroom/NewsReleases/2011/P123731

FINRA (2011g), ‘‘FINRA Letter of Acceptance, Waiver and Consent’’, No. 2009018771601, June 1.

FINRA (2011h), ‘‘FINRA Letter of Acceptance, Waiver and Consent’’, No. 2008013864101, June 29.

FINRA (2011i), ‘‘FINRA Letter of Acceptance, Waiver and Consent’’, No. 200814451 (October 24).

FINRA (2011j), ‘‘FINRA News Release’’, Oct. 25, 2011, available at: www.finra.org/Newsroom/News Releases/2011/P124806
FINRA (2012), ‘‘Complex Products’’, FINRA Regulatory Notice 12-03, January, available at: www.finra. org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf

Heilizer, D.G., Kirsch, C.E. and Rubin, B.L. (2010), ‘‘FINRA Restricts Internal Use Only Rules through Enforcement Actions’’, January 6, available at: www.sutherland.com/files/News/6eef03b3-2ddf-41ca-bf03-af80496d6456/Presentation/NewsAttachment/0a73686e-5c4e-48ca-95c4-96366e50c3f3/FINRA%20Restricts%20Internal%20Use%20Only%20Rules%20Through%20Enforcement%20Actions.pdf

Schoeff, M. (2012), ‘‘Finra files more cases, levies more fines in ‘11’’, March 18, available at: www.investmentnews.com/apps/pbcs.dll/article?AID = /20120318/REG/303189980

Corresponding author

Deborah G. Heilizer can be contacted at: deb.helizer@shutherland.com