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FINRA's Most Significant 2016 Enforcement Actions

By Jon Eisenberg and Michael T. Dyson

The Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization for broker-dealers, brings about 1,500 enforcement actions a year. Often lost in the volume of actions, however, are the ones that merit particular attention because of the size of the fines imposed. We briefly describe the actions that resulted in fines (or in a few cases restitution) of $1 million or more in 2016 and five lessons that emerge from these cases.

I. Sales Practices

a. Variable Annuities

In the largest fine of the year, FINRA fined a broker-dealer $20 million and ordered it to pay up to $5 million in restitution in connection with its sale of replacement variable annuities.[1] The misrepresentations and omissions occurred over a six-year period and affected almost three-quarters of the tens of thousands of variable annuity replacements sold by the firm during that period. FINRA found, among other things, that the firm understated the value of existing variable annuity contracts and failed to disclose that existing guarantees would be forfeited by replacing the existing contracts with new ones.

FINRA also fined eight firms a total of $6.2 million and ordered five of the firms to pay more than $6 million in restitution because they failed to adequately supervise the sale of L-share variable annuities, which typically have shorter surrender periods but higher fees than other variable annuities. [2]

FINRA fined another firm $1.75 million because the firm's compensation policy incentivized registered representatives to favor variable annuities sponsored by the firm.[3] It also found that the firm did not provide sufficient information to principals responsible for approving variable annuity transactions.

b. Nontraditional ETFs

FINRA fined a firm $2.25 million in connection with its sale of leveraged and inverse Exchange-Traded Funds ("ETFs") that were designed to be held for a single trading day.[4] Even though FINRA previously stated that these securities typically were not suitable for retail investors, the firm executed $1.7 billion of transactions in these ETFs in 30,740 retail brokerage accounts. FINRA found that the firm failed to enforce its policy prohibiting registered representatives from soliciting nontraditional ETFs and that it executed unsolicited trades for customers who had not satisfied the firm's prequalification requirements. It also found that the firm failed to establish procedures to monitor customers' holding periods in these securities.

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[1] FINRA Acceptance, Waiver and Consent ("AWC") No. 2014040870001 (May 3, 2016).

[2] FINRA News Release, "FINRA Fines Eight Firms a Total of $6.2 Million for Supervisory Failures Related to Variable Annuity L-Shares," (Nov. 2, 2016).

[3] AWC No. 2014042360001 (Nov. 28, 2016).

[4] AWC No. 2013038180801 (June 20, 2016).

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c. Other Complex Products

FINRA fined a firm $5 million in connection with its sale of strategic return notes sold to retail investors because the offering materials did not adequately disclose one of the costs associated with the notes.[5] FINRA stated that the disclosures made it appear that the product had lower fixed costs than it did.

d. Unsuitable Share Classes

FINRA brought more than a half-dozen cases against firms in 2016 for selling unsuitable mutual fund share classes to retirement plans and charitable organizations, with required restitution ranging from $200,000 to $2.1 million.[6] It found that these accounts should have been placed in fee-waived Class A shares, but were instead placed in Class A shares without a fee waiver or in more expensive Class B or Class C shares. FINRA brought nearly a dozen similar actions in 2015, three of which each required restitution of $10 million or more. Although FINRA required restitution, it did not impose fines in these cases and it cited the firms' cooperation in self-reporting these matters to FINRA.

FINRA has also continued to bring a large number of disciplinary actions against firms that failed to apply available sales charge discounts to customers' purchases of unit investment trusts.[7] In those cases, it has generally ordered both restitution and fines.

e. Leverage and Concentration

FINRA fined a firm $6.25 million and ordered it to pay close to $800,000 in restitution because it failed to prevent the use of nonpurpose lines of credit, provided by its affiliated bank, to purchase margin stock.[8] FINRA also found that the firm lacked adequate supervisory procedures to prevent excessive concentration in Puerto Rico securities.

f. Excessive Trading

A FINRA hearing officer, accepting an offer of settlement, fined a firm $1 million and ordered it to pay $1 million in restitution for excessive trading.[9] It found that the firm permitted many of its registered representatives to recommend an unsuitable active trading investment strategy that the representatives did not understand, and that other registered representatives engaged in discretion without written authorization or trading that exceeded the benchmarks for excessive trading and churning.

II. Inadequate Due Diligence of Customers

FINRA fined two affiliated broker-dealers a total of $17 million for violating antimoney laundering ("AML") requirements.[10] It found, among other violations, that (i) the firm's AML resources were inadequate, (ii) the firm's AML procedures were inadequate, (iii) the firm gave insufficient attention to whether to file suspicious activity reports ("SARs"), especially for clearing firm clients, (iv) the firm closed thousands of alerts each month without reasonably identifying the purpose of the conduct that triggered the alert, (v) the firm did not conduct adequate due diligence on its foreign financial institution clients, some of which were located

[5] AWC No. 2012032967901 (June 23, 2016).
[6] *E.g.,* AWC No. 2015047269801 (July 29, 2016); AWC No. 2015045594601 (Apr. 15, 2016).
[7] *E.g.,* AWC No. 2013035035901 (Oct. 3, 2016).
[8] AWC No. 2014042578001 (Nov. 30, 2016).
[9] Order Accepting Offers of Settlement, 2014039091903 (Aug. 25, 2016).
[10] AWC No. 2014043592001 (May 18, 2016).

in countries of primary money laundering concern, and (vi) the firm's due diligence review of low-priced securities was also inadequate.

FINRA also fined another brokerage firm $16.5 million for inadequacies in its AML program, including the failure to conduct enhanced due diligence of correspondent accounts of its own affiliated foreign banks.[11]

III. Alternative Trading Systems and Algorithmic Trading

a. ATS Access Disclosures

FINRA fined a firm $3.25 million because of inaccurate disclosures regarding its alternative trading system ("ATS").[12] The firm represented that it would provide all ATS users with "identical access to all services and features," but failed to adequately disclose that some users were given the ability to include or exclude certain counterparties or groups of counterparties.

b. Inadequate Supervision

FINRA, acting on behalf of The Nasdaq Stock Market, fined a firm $1 million because it failed to reasonably supervise an algorithmic trading strategy that led to the firm trading a high percentage of the volume of certain Nasdaq securities close to the open and that "unduly impacted or had the potential to unduly impact" the preopening and opening price of the securities.[13] FINRA stated that no registered person at the firm was responsible for designing, testing, or approving the strategy, that the registered person responsible for supervising it did not have a detailed understanding of the strategy, that the firm did not monitor the potential impact of the strategy on prices, and that the firm did not provide adequate supervision to ensure that the trading strategies did not unduly or artificially impact market prices.

IV. Recordkeeping and Reports to Regulators

a. Electronic Records

FINRA fined 12 broker-dealers $14.4 million because they failed to maintain electronic records in a "write once, read many" format, which prevents the alteration of records stored electronically.[14] In some cases, the deficiencies affected hundreds of millions of records. The fines per firm ranged from $500,000 to $4 million.

b. "Blue Sheet" Responses

FINRA fined a firm $6 million because it submitted inaccurate and untimely "blue sheets" to the Securities and Exchange Commission ("SEC") and FINRA over a seven-year period.[15] Blue sheets are trade data submitted in an automated format in response to regulatory investigations focused on equity trading, including suspicious transactions and insider trading. Over the period at issue, the firm misreported at least 1,077,706 transactions to FINRA and at least 12,575 transactions to the SEC. The errors were due in part to programming errors.

[11] AWC No. 2013038726101 (Dec. 5, 2016).

[12] AWC No. 20140429134-01 (Dec. 16, 2016).

[13] Nasdaq AWC No. 20100235180 (Oct. 19, 2016).

[14] FINRA News Release, "FINRA Fines 12 Firms a Total of $14.4 Million for Failing to Protect Records from Alteration," (Dec. 21, 2016).

[15] AWC No. 2015044296601 (June 29, 2016).

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c. Trade and Position Reports

FINRA and other regulators fined a firm $4,070,000 based on, among other violations, the failure to submit complete and accurate Large Options Positions Reports.[16] FINRA found that during a sampled period between January 2010 and March 2015, the firm (i) failed to report as many as two million instances of conventional options positions, (ii) over-reported positions in as many as 1.5 million instances, and (iii) inaccurately reported options positions in tens of millions of instances.

FINRA and other regulators fined another firm $2.2 million based on the failure to submit complete and accurate Large Options Positions Reports.[17] It found more than 13 million instances in which the firm reported positions without identifying the relevant accounts as acting in-concert and that the firm reported positions in the wrong account type in 38 million instances.

FINRA fined another firm $2.8 million because certain configuration and other errors caused the firm to report hundreds of millions of transactions to FINRA inaccurately and to maintain inaccurate books and records.[18]

FINRA, acting on behalf of The Nasdaq Stock Market, fined a firm $2.25 million because it entered nearly 65 million orders into the Nasdaq Market Center that failed to correctly indicate that the orders were short sales and, in addition, incorrectly recorded the short sales as long sale orders on the firm's books and records.[19] The mismarking occurred over a four-year period. FINRA found that the mismarking resulted from a coding error in one of the firm's order handling systems.

FINRA fined another firm $1.3 million because 15 systems issues at the firm led to 3.6 billion reporting violations between 2008 and 2016.[20] The firm omitted special handling codes from 2.3 billion reports, submitted over one billion inaccurate time stamps, and submitted 7.1 million inaccurate execution quantities. It also failed to submit 290 million cancel reports.

d. Reports of Disciplinary Actions

FINRA fined a firm $1.575 million based largely on its failure to (i) timely make 273 filings relating to regulatory findings of securities law violations, disciplinary actions taken by the firm against its employees, and settlements of securities-related arbitrations and litigation claims; (ii) file copies of 92 civil complaints and arbitration claims; and (iii) disclose that one of its branch administrative managers had received a Wells notice from the SEC.[21]

V. Multiple Violations of Numerous Regulatory Requirements

FINRA fined two affiliated firms a total of $1.025 million because one or both failed to: (i) send letters to 3,266 customer accounts confirming changes in their investment objectives within 30 days of the change; (ii) review as many as 12,456 outside brokerage account statements; (iii) send letters providing a copy of the account record to 1,310 new account holders within 30 days of account opening; (iv) provide transaction confirmations involving

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[16] AWC No. 20110296003-01 (Mar. 28, 2016).
[17] AWC No. 20150441008-01 (Oct. 17, 2016).
[18] AWC No. 20130358229-01 (Oct. 18, 2016).
[19] Nasdaq AWC No. 20120316429 (Apr. 22, 2016).
[20] AWC No. 20140417499-01 (Aug. 3, 2016).
[21] AWC No. 2015046355401 (Nov.7, 2016).

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92,563 transactions; (v) retain certain letters from customers updating their investor profiles; and (vi) send required Privacy Notices to hundreds of thousands of account holders.

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What are the common elements across a number of the million-dollar-plus FINRA fines?

Surprisingly, culpability turns out not to be a meaningful predictor. The vast majority of the cases discussed above involved unintentional violations. Of course, the fines might have been much larger if FINRA had found intentional or reckless misconduct, but it is still worth noting that the largest fines of the year did not involve findings of either. The five factors that appear to create the greatest risk of a large fine are the following.

First, the best predictor of a large fine is a combination of a large firm with a significant problem that affects a very large number of transactions over a considerable period of time. Most multi-million dollar fines involve a small number of very large firms because at a large firm even a single problem can be multiplied into thousands, millions, and sometimes even billions of violations.

Second, in the sales practice area, the areas that pose the greatest risk are (i) complex products sold to retail investors without adequate understanding and supervision, (ii) share classes that are more expensive than identical lower-cost share classes involving the same investment, or (iii) an investment with an unusual degree of risk that eventually leads to large losses across a large number of customers.

Third, inadequate due diligence of high-risk customers and high-risk activities, as well as inadequate attention to SARs filings, pose the greatest risk in the AML area. Every year AML is a high priority for FINRA, and two of the three largest FINRA fines in 2016 involved AML violations.

Fourth, programming errors that systemically affect large numbers of reporting events—often hundreds of millions of reportable events over a multi-year period—pose the greatest risks in the trade reporting area. More often than not trade reporting problems are technology-driven problems and the technology fix is often complicated and expensive to implement.

Finally, the failure to fix violations of clear regulatory requirements previously identified by FINRA, internal audit, compliance, or risk substantially increases the chance of a large fine. At some point after a firm fails to correct previously-identified problems, FINRA will conclude that a fine must be large enough to make the cost of violating a regulatory requirement greater than the cost of complying with it.

Authors:

Jon Eisenberg
jon.eisenberg@klgates.com
+1.202.778.9348

Michael T. Dyson
michael.dyson@klgates.com
+1.202.778.9417

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