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SUPERVISION AND COMPLIANCE OF BROKERAGE FIRMS

Christine Lazaro

Supervision is a cornerstone of broker-dealer regulation. It serves a number of important goals: primarily ensuring that the firms follow the governing rules and regulations so that investors can have confidence in the firms with which they do business. Unfortunately, FINRA supervision rules often do not set out specifically how a firm is to supervise its brokers. This article will set forth the general supervision rules governing brokerage firms, as well as the rules that govern specific behavior and conflicts.

Background

Brokerage firms have certain obligations to ensure that their employees comply with applicable securities regulations. The Securities Exchange Act of 1934 (the “34 Act”) imposes liability on a brokerage firm for an employee’s violation of applicable rules and regulations under section 15(b)(4)(E), unless the firm can demonstrate that:

- (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
- (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.¹

A firm may also be culpable as a control person under section 20(a) of the ‘34 Act for an employee’s violation of applicable securities regulations if the firm has failed to establish an adequate system of supervision.²

In addition, FINRA rules, promulgated pursuant to federal law, require that “[e]ach member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve

1. 15 U.S.C.A. § 78o(b)(4)(E) (West 2017).

2. 15 U.S.C. § 78t (West 2017); *see* *CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807, 830 (S.D.N.Y. 2006).

compliance with applicable securities laws and regulations, and with applicable FINRA rules.”³

FINRA accomplishes its oversight of firm supervision through its examination process. At the beginning of each year, FINRA issues its regulatory and examination priorities to firms. Supervision always represents a key component to FINRA’s priorities. Each year, FINRA’s focus shifts slightly. For example, in 2016, FINRA focused its examination of member firms on their overall management of conflicts of interest. FINRA formalized its assessment of firm culture and found that the culture was integral to a firm’s management of conflicts of interest:

A firm’s culture is both an input to and product of its supervisory system, including its approaches to identifying and managing conflicts of interest and ensuring the ethical treatment of customers. This means that firms should take visible actions that help mitigate conflicts of interest, and promote the fair and ethical treatment of customers. For example, material breaches of firm policies and procedures should not be tolerated, and compliance functions should be equipped with necessary resources to help firms navigate a complex and changing regulatory and market environment. In this regard, FINRA’s focus on firm culture is closely related to another area of focus for 2016: supervision.⁴

FINRA focused its examination of a firm’s management of conflicts of interest on four main areas: (1) incentive structures; (2) investment banking and research business lines; (3) information leakage; and (4) position valuation.

For 2017, FINRA focused on firms’ supervision of high-risk and recidivist brokers.⁵ Specifically, FINRA examined:

[W]hether firms develop and implement a supervisory plan reasonably tailored to detect and prevent future misconduct by a particular broker based on prior misconduct and regulatory disclosures. We will also

3. FINRA, RULE 3110(a) (2017).

4. See FINRA, 2016 REGULATORY AND EXAMINATION PRIORITIES LETTER, *available at* <http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf>.

5. See FINRA, 2017 REGULATORY AND EXAMINATION PRIORITIES LETTER, *available at* <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>.

focus on firms with a concentration of brokers with significant past disciplinary records or a number of sales practice complaints or arbitrations.⁶

In 2018, FINRA's examination priorities include fraud, high-risk brokers and firms, suitability, and initial coin offerings and cryptocurrencies, among other items.⁷ FINRA remains focused on brokers conducting business away from their firms, including private securities transactions and outside business activities.⁸

Although FINRA shifts its examination priorities each year to a different aspect of supervision, firms are required to follow all of the supervision rules. This article will examine the FINRA rules specifically dedicated to supervision, including those portions of other rules which pertain to supervision. This article will also discuss FINRA's examination priorities, including the guidance and best practices which FINRA has issued with respect to supervision.

A. Supervisory Rules

FINRA supervisory rules mandate the establishment and maintenance of written procedures, the designation of principals to establish and enforce supervisory policies, and the designation of a Chief Compliance Officer. FINRA has also promulgated rules which discuss firms' supervisory obligations with respect to OTC equities, day-trading accounts, senior investors, direct participation programs, deferred variable annuity contracts, options, and outside business activities and private securities transactions.

6. *Id.*

7. See FINRA, 2018 REGULATORY AND EXAMINATION PRIORITIES LETTER, available at <http://www.finra.org/sites/default/files/2018-regulatory-and-examination-priorities-letter.pdf>.

8. *Id.*

1. FINRA Rule 3110: Supervision

FINRA Rule 3110, which became effective in December 2014, requires that the firm's supervisory system provide for the establishment and maintenance of written procedures.⁹ The rule further requires that appropriately registered individuals be designated to carry out the supervisory responsibilities of the firm.¹⁰ Each location of the firm must be registered and designated as either a branch office or an office of supervisory jurisdiction (OSJ), if it meets the definitions of the rule.¹¹ Each branch and OSJ must have a supervisor assigned to it, and each broker must be assigned a supervisor.¹² It is presumed that a principal will not be assigned to supervise more than one OSJ, because "[t]he designated on-site principal for each OSJ must have a physical presence, on a regular and routine basis, at each OSJ for which the principal has supervisory responsibilities."¹³ To the extent the firm determines it is necessary for a principal to supervise more than one OSJ, the firm must consider several factors, as well as document the factors it used to determine why it considers the supervisory structure reasonable.¹⁴

The firm's written procedures must be specific to the type of business in which the firm engages and the activities of its brokers.¹⁵ There must be written procedures for the review of all transactions relating to the investment banking or securities business of the member.¹⁶ FINRA does not require that every transaction be reviewed if the firm uses a "reasonably-designed risk-based review system that provides a member with sufficient

9. The prior supervision rule, NASD Rule 3010, contained many of the same provisions. For purposes of this article, I will focus on the new FINRA rule. FINRA, RULE 3110(a)(1) (2017).

10. FINRA, RULE 3110(A)(2) (2017).

11. FINRA, RULE 3110(A)(3) (2017).

12. FINRA, RULE 3110(A)(4) AND (5) (2017).

13. FINRA, RULE 3110.03 (Supp. 2017).

14. *Id.*

15. FINRA, RULE 3110(b)(1) (2017).

16. FINRA, RULE 3110(b)(2) (2017).

information that permits the member to focus on the areas that pose the greatest numbers and risks of violation.”¹⁷ FINRA describes “risk-based” as “the type of methodology a firm may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and self-regulatory organization (SRO) rule violations.”¹⁸

Firms may utilize technology-based review systems with parameters designed to assess which transactions merit further review; however, a principal is required to review the parameters and to document that review in writing.¹⁹ Even when relying on an automated supervisory system, the principal remains “responsible for any deficiency in the system’s criteria that would result in the system not being reasonably designed.”²⁰

Firms must include procedures for reviewing all incoming and outgoing correspondence (including electronic) as well as the internal communications relating to the firm’s investment banking or securities business.²¹ Firms may employ risk-based principles to review correspondence and internal communications.²² Firms must also retain evidence of the review, either electronically or on paper, which identifies the reviewer, the correspondence or communication that was reviewed, the date of the review, and the actions taken if any regulatory issues were raised by the review.²³ To the extent a firm utilizes a lexicon-based²⁴ screening tool in its review of correspondence

17. FINRA, RULE 3110.05 (Supp. 2017).

18. FINRA, REGULATORY NOTICE 14-10: CONSOLIDATED SUPERVISION RULES; SEC APPROVES NEW SUPERVISION RULES, at 4, (Mar. 2014), *available at* <http://www.finra.org/sites/default/files/NoticeDocument/p465940.pdf>.

19. *Id.*

20. *Id.*

21. FINRA, RULE 3110(b)(4) (2017).

22. FINRA, RULE 3110.06 (Supp. 2017).

23. FINRA, RULE 3110.07 (Supp. 2017).

24. FINRA defines “lexicon-based” reviews as “those based on sensitive words or phrases, the presence of which may signal problematic communications.” FINRA, REGULATORY NOTICE 07-59: SUPERVISION OF ELECTRONIC COMMUNICATIONS; FINRA PROVIDES GUIDANCE REGARDING THE REVIEW AND SUPERVISION OF ELECTRONIC COMMUNICATIONS, at 12, (Dec. 2007), *available at* <http://www.finra.org/sites/default/files/NoticeDocument/p037553.pdf>.

and communications, FINRA has reminded firms that those tools have limitations and that firms should consider whether further supervisory review is warranted.²⁵

FINRA requires that firms have policies designed to “capture, acknowledge, and respond to all written (including electronic) customer complaints.”²⁶ Although the rule does not apply to oral customer complaints, FINRA has stated that “failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).”²⁷ FINRA has encouraged firms to provide customers with a “form or other format that will allow customers to communicate their complaints in writing.”²⁸

Supervisory Personnel must also be supervised. Those who perform supervisory functions may not (i) supervise their own activities; or (ii) report to, or have their compensation or continued employment determined by, a person they are supervising.²⁹ This section replaced the section in the prior NASD rule which was primarily concerned with producing branch managers. The new rule is intended to address the supervision of all supervisory personnel rather than just a small subset. The rule recognizes that there may be circumstances where there may need to be exceptions. FINRA Rule 3110.10 reflects the expectation that the exception will be used sparingly, such as in a single person firm, or where the person holds a very senior executive position within the firm.

Firms must also have procedures in place which prevent the standards of supervision from being compromised due to conflicts of interest that may be present, including from the revenue generated by the broker being supervised.³⁰ This provision does not require the elimination of conflicts of

25. *See* FINRA, REGULATORY NOTICE 14-10, at 6. *See also* FINRA, REGULATORY NOTICE 07-59, at 12.

26. FINRA, RULE 3110(b)(5) (2017).

27. FINRA, REGULATORY NOTICE 14-10, at 7.

28. *Id.*

29. FINRA, RULE 3110(b)(6)(C) (2017).

30. FINRA, RULE 3110(b)(6)(D) (2017).

interest, but requires that the “supervisory procedures be reasonably designed despite the firm’s conflicts of interest.”³¹

Firms are required to conduct a review, at least annually, of the businesses in which they engage.³² Firms must review the activities of each of their offices, which includes an examination of customer accounts. Firms must review every OSJ and supervisory branch office at least annually and every non-supervisory branch office at least once every three years.³³ The review must include the testing and verification of the firm’s policies and procedures related to:

- a. safeguarding of customer funds and securities;
- b. maintaining books and records;
- c. supervision of supervisory personnel;
- d. transmittal of funds or securities from customers to third parties; and
- e. changes of customer account information.³⁴

Both the transmittal of funds and changes of customer account information must have a means or method of customer confirmation, notification or follow-up that can be documented.³⁵ Customer account information includes more than address and investment objective changes; it includes changes to a customer’s name, marital status, telephone, and email address as examples.³⁶

The firm must ensure the integrity of inspections, as well as the independence of the person conducting the inspection.³⁷ This portion of the rule is similar to that governing the supervision of supervisory personnel. FINRA eliminated the production thresholds present in the prior rule which triggered heightened office inspection requirements, and replaced them with the more general principle that the firm should ensure that the inspection is

31. FINRA, REGULATORY NOTICE 14-10, at 8.

32. FINRA, RULE 3110(c) (2017).

33. FINRA, RULE 3110(c)(1)(A) and (B) (2017).

34. FINRA, RULE 3110(c)(2)(A) (2017).

35. FINRA, RULE 3110(c)(2)(B) and (C) (2017).

36. FINRA, REGULATORY NOTICE 14-10, at 10.

37. FINRA, RULE 3110(c)(3).

not compromised due to conflicts of interest in all circumstances.³⁸ This does not require that the firm eliminate conflicts of interest, just that the firm address the potential conflicts when establishing procedures for inspections.³⁹

The firm must also establish policies and procedures designed to prevent the misuse of material, non-public information by brokers.⁴⁰ This section of the rule addresses the procedures necessary to ensure that the rules and regulations prohibiting insider trading are followed.

Finally, firms have an obligation to investigate “the good character, business reputation, qualifications and experience” of brokers it intends to hire.⁴¹ This review includes examining the broker’s most recently filed form U5 or form CFTC Form 8-T.⁴² In addition, the firm must verify the accuracy and completeness of information contained in the broker’s form U4 by, at a minimum, searching reasonably available public records.⁴³

2. FINRA Rule 3120: Supervisory Control System

In addition to the policies and procedures set forth above, firms must designate one or more principals who will establish, maintain and enforce a system of supervisory control policies that will test and verify that the firm’s supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA rules.⁴⁴ Those individuals are also responsible for creating additional supervisory procedures or for making changes to the policies already in place based on the outcomes of the testing and verification procedures.⁴⁵ The principals

38. See FINRA, REGULATORY NOTICE 14-10, at 11.

39. *Id.* at 12.

40. FINRA, RULE 3110(d) (2017).

41. FINRA, RULE 3110(e) (2017).

42. *Id.*

43. *Id.*

44. FINRA, RULE 3120(a)(1) (2014).

45. FINRA, RULE 3120(a)(2) (2014).

must submit a report to the firm's senior management each year detailing the supervisory controls and the test results.⁴⁶ If the firm had \$200 million or more in gross revenue in the prior year, the report must include:

- (i) a tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year; and
- (ii) discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas:
 - a. trading and market activities;
 - b. investment banking activities;
 - c. antifraud and sales practices;
 - d. finance and operations;
 - e. supervision; and
 - f. anti-money laundering.⁴⁷

These requirements are taken from NYSE Rule 342.⁴⁸ They are meant to provide valuable information to both FINRA's regulatory program and to the firm's senior management.⁴⁹

3. FINRA Rule 3130: Annual Certification of Compliance and Supervisory Processes

FINRA must also designate a chief compliance officer on Schedule A of Form BD.⁵⁰ Each year, the firm's chief executive officer must certify "that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer(s) has conducted one or more meetings with the chief

46. *Id.*

47. FINRA, RULE 3120(b) (2014).

48. *See* FINRA, REGULATORY NOTICE 14-10, at 15.

49. *Id.*

50. FINRA, RULE 3130(a) (2008).

compliance officer(s) in the preceding 12 months to discuss such processes.”⁵¹

4. *FINRA Rule 2114: OTC Equity Securities*

FINRA Rule 2114 relates to recommendations to customers in OTC Equity Securities. It places additional supervisory requirements on firms if a broker makes such a recommendation. The firm is required to review the current financial statements and material business information of the issuer and make a determination that “such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.”⁵² There are several securities which are excluded from the heightened diligence of the rule. The rule does not apply to transactions (i) that meet the requirements of Rule 504 of Regulation D; (ii) in an issuer’s securities if the issuer has at least \$50 million in total assets and \$10 million in shareholder equity; (iii) in securities of a bank or insurance company; or (iv) in securities that have a bid price of at least \$50 per share.⁵³

This rule was adopted to address abuses in microcap stocks.⁵⁴ The rule does not supersede existing obligations. Rather, it places additional obligations on the firm when making recommendations in microcap stocks. A broker must still abide by the requirements of the suitability rule.

51. FINRA, RULE 3130(b) (2008).

52. FINRA, RULE 2114(a) (2011).

53. FINRA, RULE 2114(e) (2011).

54. See NASD, NOTICE TO MEMBERS 02-66: OTC EQUITY SECURITIES; SEC APPROVES NASD RULE 2315; RECOMMENDATIONS TO CUSTOMERS IN OTC EQUITY SECURITIES, (Oct. 2002), available at <https://www.finra.org/sites/default/files/NoticeDocument/p003455.pdf>.

5. *FINRA Rule 2130: Day-Trading Accounts*

When a firm promotes day-trading strategies, it must have special account opening procedures in place.⁵⁵ The firm must provide the customer with a day-trading risk disclosure statement, and must either approve the account for day-trading or receive a written agreement from the customer that the customer does not intend to use the account for purpose of engaging in day-trading.⁵⁶

To approve an account for day-trading, the firm must obtain essential facts relative to the customer, including:

- f. investment objectives;
- g. investment and trading experience and knowledge;
- h. financial situation, including: estimated annual income from all sources, estimated net worth (exclusive of family residence), and estimated liquid net worth;
- i. tax status;
- j. employment status;
- k. marital status and number of dependents; and
- l. age.⁵⁷

FINRA adopted heightened requirements for day-trading accounts because this strategy often requires aggressive trading. It may require significant capital and a sophisticated understanding of the securities markets and trading techniques. This rule was adopted to address those investor protection concerns.⁵⁸

55. FINRA, RULE 2130(a)(1) (2013).

56. FINRA, RULE 2130(a)(1) and (2) (2013).

57. FINRA, RULE 2130(b) (2013).

58. See NASD, NOTICE TO MEMBERS 00-62: DAY-TRADING RULES; SEC APPROVES DAY-TRADING RULES, (Sept. 2000), available at http://www.complinet.com/file_store/pdf/rulebooks/nasd_0062.pdf.

6. *FINRA Rules 2165 and 4512: Senior Investors*

FINRA has adopted rules to protect senior investors and other specified persons from financial exploitation. FINRA is concerned about the increase in financial exploitation of seniors.⁵⁹ FINRA adopted Rule 2165 and amended Rule 4512 to provide firms with tools to address suspected financial exploitation of seniors faster and more effectively.⁶⁰ The rules permit, although do not mandate, that firms may contact a trusted contact person and place a temporary hold on disbursements from a customer's account if financial exploitation is suspected.⁶¹

FINRA Rule 2165 allows a firm to place a temporary hold on disbursements from accounts if the firm believes that financial exploitation is occurring, has been attempted, or will be attempted.⁶² To rely on the protections in the Rule, the firm must develop training policies or programs that ensure associated persons comply with the requirements of the Rule.⁶³

FINRA Rule 4512 obligated FINRA to obtain the "name of and contact information for a trusted contact person age 18 or older who may be contacted about the customer's account" for each account.⁶⁴ A firm is permitted to open the account without this information if the firm has made reasonable attempts to obtain the information.⁶⁵

59. See FINRA, REGULATORY NOTICE 17-11: FINANCIAL EXPLOITATION OF SENIORS; SEC APPROVES RULES RELATING TO FINANCIAL EXPLOITATION OF SENIORS, (March 2017), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/r/e/Regulatory-Notice-17-11.pdf.

60. *See id.*

61. *See id.*

62. FINRA, RULE 2165(b)(1) (2018).

63. FINRA, RULE 2165.02 (2018).

64. FINRA, RULE 4512(a)(1)(F) (2018).

65. FINRA, RULE 4512.06 (2018).

7. *FINRA Rule 2310: Direct Participation Programs*

FINRA requires that firms conduct additional diligence before participating in a public offering of a direct participation program (DPP) or REIT.⁶⁶ The firm must obtain sufficient information from the sponsor to determine that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program.⁶⁷ At a minimum, the firm must obtain information relating to:

- (i) items of compensation;
- (ii) physical properties;
- (iii) tax aspects;
- (iv) financial stability and experience of the sponsor;
- (v) the program's conflict and risk factors; and
- (vi) appraisals and other pertinent reports.⁶⁸

The firm must also ensure that the general partner or sponsor of the DPP or REIT will disclose a per share estimated value of the security in each annual report distributed to investors.⁶⁹ This was recently added to the rule and is meant to address the general industry practice to use the offering price for the DPP or REIT for years after the offering. This practice failed to recognize that fees and costs may have reduced the investors' principal or that the underlying assets within the DPP or REIT may have decreased in value.⁷⁰ Investors should have more accurate pricing of their DPP or REIT with this new section of the rule.

66. FINRA, RULE 2310(b)(3) (2016).

67. FINRA, RULE 2310(b)(3)(A) (2016).

68. FINRA, RULE 2310(b)(3)(B) (2016).

69. FINRA, RULE 2310(b)(5) (2016).

70. See FINRA, REGULATORY NOTICE 15-02: DPP AND UNLISTED REIT SECURITIES; SEC APPROVES AMENDMENTS TO FINRA RULE 2310 AND NASD RULE 2340 TO ADDRESS VALUES OF DIRECT PARTICIPATION PROGRAM AND UNLISTED REAL ESTATE INVESTMENT TRUST SECURITIES, (Jan. 2015), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf.

8. *FINRA Rule 2330: Deferred Variable Annuity Contracts*

Firms have specific suitability and supervisory obligations when selling deferred variable annuity contracts.⁷¹ A broker must obtain the following information prior to making a recommendation to purchase or exchange a deferred variable annuity contract:

- (i) the customer's age;
- (ii) annual income;
- (iii) financial situation and needs;
- (iv) investment experience;
- (v) investment objectives;
- (vi) intended use of the deferred variable annuity;
- (vii) investment time horizon;
- (viii) existing assets (including investment and life insurance holdings);
- (ix) liquidity needs;
- (x) liquid net worth;
- (xi) risk tolerance;
- (xii) tax status; and
- (xiii) such other information used or considered to be reasonable by the firm in making the recommendation.⁷²

A principal must review the application and approve it prior to transmitting it to the issuing insurance company if the supervisor determines the transaction is suitable for the customer.⁷³ The firm must have specific written supervisory policies and procedures for sales and exchanges of deferred variable annuity contracts.⁷⁴ The policies must specifically examine whether individual brokers have excessive annuity exchange rates which suggest the policies and procedures governing heightened scrutiny of annuity exchanges are not effective.⁷⁵

71. FINRA, RULE 2330 (2014).

72. FINRA, RULE 2330(b)(2) (2014).

73. FINRA, RULE 2330(c) (2014).

74. FINRA, RULE 2330(d) (2014).

75. *Id.*

In addition to the requirements set forth in the rule, FINRA has provided additional guidance to firms with respect to their supervisory obligations over variable annuity replacement transactions. In particular, firms are to pay close attention to replacements by brokers who have recently switched firms to ensure that recommendations are not a function of the desire of the broker to obtain compensation that would be lost if the customer were to retain the previously sold investment.⁷⁶ Specifically, firms are to do the following:

For a reasonable period following the association of a new representative, the new firm should review replacements recommended by the associated person with a view to identifying any recommendations to liquidate or surrender mutual funds or variable products that may be inconsistent with the customer's investment needs and objectives or that have not been preceded by appropriate disclosure to the customer. Special supervisory consideration should be given to those transactions involving the replacement of a customer's existing variable annuity product with a "bonus variable annuity" offered by the new firm. The firm should review these transactions with a view to ensuring that full disclosure is made to the customer regarding all fees, expenses and surrender charges that may apply to the replacement product; a "bonus" on premium payments may not be considered an "offset" against any other fees or expenses, including surrender charges applied to the replaced product.⁷⁷

This guidance is applicable to both variable annuities as well as mutual funds.

76. NASD, NOTICE TO MEMBERS 07-06: SUPERVISION OF RECOMMENDATIONS AFTER A REGISTERED REPRESENTATIVE CHANGES FIRMS; SPECIAL CONSIDERATIONS WHEN SUPERVISING RECOMMENDATIONS OF NEWLY ASSOCIATED REGISTERED REPRESENTATIVES TO REPLACE MUTUAL FUNDS AND VARIABLE PRODUCTS, (Feb. 2007), available at <https://www.finra.org/sites/default/files/NoticeDocument/p018630.pdf>.

77. *Id.* at 4.

9. *FINRA Rule 2360: Options*

Before a firm is allowed to accept any options transactions for a customer, the customer must first be provided with certain disclosures, and the account must specifically be approved for options trading.⁷⁸ The firm must obtain the following information about the customer:

- (i) investment objectives;
- (ii) employment status;
- (iii) estimated annual income from all sources;
- (iv) estimated net worth (exclusive of family residence);
- (v) estimated liquid net worth;
- (vi) marital status and number of dependents;
- (vii) age; and
- (viii) investment experience and knowledge for options, stocks and bonds, commodities, and other financial instruments.⁷⁹

Firms must ensure that the supervisory policies adequately address the firm's options business.⁸⁰

78. FINRA, RULE 2360(b)(16)(A) and (B) (2014).

79. FINRA, RULE 2360(b)(16)(B)(i) (2014).

80. FINRA, RULE 2360(b)(20) (2014).

10. FINRA Rules 3270 and 3280: Outside Business Activities and Private Securities Transactions

A broker may not receive compensation from any outside business activity without providing prior written notice to the firm.⁸¹ Upon receipt of the notice from a broker, the firm must consider whether the activity will: “(1) interfere with or otherwise compromise the registered person’s responsibilities to the member and/or the member’s customers or (2) be viewed by customers or the public as part of the member’s business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered.”⁸² The firm may place conditions on the activity or prohibit the activity.⁸³

Prior to participating in any private securities transaction, a broker must also provide written notice to the firm.⁸⁴ If the broker is to receive compensation for the transaction, the firm must advise the broker whether it approves or disapproves of the broker’s participation in the proposed transaction.⁸⁵ Both of these rules relate to a broker engaging in business “away from the firm,” and stem from FINRA’s concerns about a broker not being properly supervised when doing so.

FINRA has expressed concern about issues involving sales of promissory notes, which may or may not be securities, and many of which have been fraudulent.⁸⁶ FINRA has suggested that firms ensure that they are adequately educating their brokers regarding the importance of reporting all sales of notes, whether securities products or not.⁸⁷ FINRA has also suggested that

81. FINRA, RULE 3270 (2015).

82. FINRA, RULE 3270.01 (Supp. 2015).

83. *Id.*

84. FINRA, RULE 3280(b) (2017).

85. FINRA, RULE 3280(c)(1)(A) and (B) (2017).

86. *See* NASD, NOTICE TO MEMBERS 01-79: SELLING AWAY AND OUTSIDE BUSINESS ACTIVITIES; NASD REMINDS MEMBERS OF THEIR RESPONSIBILITIES REGARDING PRIVATE SECURITIES TRANSACTIONS INVOLVING NOTES AND OTHER SECURITIES AND OUTSIDE BUSINESS ACTIVITIES, (Dec. 2001), *available at* <https://www.finra.org/sites/default/files/NoticeDocument/p003677.pdf>.

87. *Id.*

firms “might consider conducting ‘preventive compliance conferences’ that specifically address selling notes away from the firm.”⁸⁸

In its 2018 examination priorities, FINRA has stated that it will “assess firms’ ability to monitor the proper use of proceeds from [private securities transactions]” and will assess whether the brokers have made the appropriate disclosures about “interest in, control of, or association with the issuer.”⁸⁹ With respect to outside business activities, FINRA will examine firm’s controls to identify when a broker has borrowed money from a customer or made payments to a customer from the broker’s outside business bank accounts.⁹⁰

B. Examination Priorities and Supervisory Guidance

FINRA has focused its supervision-related examination priorities on a number of different areas over the past few years, and has issued guidance specifying best practices for supervision when dealing with these issues. This guidance flows from the general and specific supervisory rules. For example, FINRA has discussed the supervision related to various conflicts of interest, the heightened supervision that may be necessary when supervising a problem broker to ensure that the broker complies with applicable securities laws and regulations and with applicable FINRA rules, and concerns that may arise when dealing with senior customers.

1. Conflicts of Interest

FINRA has become concerned with conflicts of interest, and how those conflicts are managed. In 2016, FINRA focused its examinations on conflicts related to incentive structures, as well as investment banking and research, among other areas of focus.

88. *Id.* at 699.

89. FINRA, 2018 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 2.

90. *Id.*

a. Incentive Structure Conflicts

FINRA has several concerns associated with a firm's incentive compensation structures and conflicts of interest. FINRA is concerned with the conflicts of interest connected to a firm's sales of proprietary or affiliated products, or products for which a firm receives third-party payments such as revenue sharing.⁹¹ Another concern relates to the financial incentives a broker may receive when hired, which may be driven by the assets a broker transfers to the new firm and may create conflicts of interest.⁹² FINRA is also concerned with advice concerning "wealth events" such as IRA rollovers, which present opportunities to invest large sums of money at a single time.⁹³

i. Differential Compensation Structures

Many firms offer compensation structures which vary based on the product being sold, or the amount of revenue the broker has generated. This may create tensions between the broker's own interests and the interests of the client.

FINRA Rule 2111, "Suitability," requires that a broker "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."⁹⁴

In the past, the SEC has sanctioned a firm for establishing a compensation structure that provided substantially higher payouts to its brokers for stocks covered by the firm's research department.⁹⁵ The

91. See FINRA, 2016 REGULATORY AND EXAMINATION PRIORITIES LETTER.

92. *Id.*

93. See FINRA, 2015 REGULATORY AND EXAMINATION PRIORITIES LETTER, available at <http://www.finra.org/sites/default/files/p602239.pdf>.

94. FINRA, RULE 2111(a) (2014).

95. In the Matter of Olde Disc. Corp., S.E.C. Release No. 7577, Release No. 40423, Release No. 33-7577, Release No. 34-40423, 1998 WL 575171 (Sept. 10, 1998).

production requirements and position quotas that the firm imposed on its brokers had the effect of requiring the brokers, if they were to be successful, to concentrate their selling efforts on the firm covered stocks. A number of customers with conservative investment needs and objectives ended up with most or all of their assets concentrated in these firm covered stocks. The SEC found that the brokers had violated their suitability obligation to these customers, and the firm had failed to establish a system of supervision which would prevent such violations. In fact, the compensation structure established by the firm contributed to such violations.

Following the SEC sanction, FINRA examined whether differential compensation structures should be prohibited with respect to proprietary products:

The Tully Report concluded that the payment of higher compensation to registered representatives for the sale of proprietary products can create incentives to inappropriately favor such products over nonproprietary products. Such compensation arrangements can create conflicts of interest by encouraging representatives to recommend proprietary products to maximize their commissions, rather than to best meet their customers' needs. Such arrangements may provide point-of-sale incentives that could compromise proper customer suitability determinations and may present a situation where the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers. In this regard, the Tully Report cited as a "best practice" the use of identical payout ratios for representatives that offer both proprietary and non-proprietary products, noting that most firms interviewed had already adopted this practice.⁹⁶

FINRA (NASD at the time) sought comment on whether such compensation should be prohibited specifically with respect to mutual funds. While this proposal was never adopted, FINRA had already implemented prohibitions on incentives which favor one mutual fund over another on the

96. NASD, NOTICE TO MEMBERS 99-81: SALESPERSON COMPENSATION PRACTICES; NASD REGULATION REQUESTS COMMENT ON PROPOSED SALESPERSON COMPENSATION RULES, at 607, (Sept. 1999), available at <http://www.finra.org/sites/default/files/NoticeDocument/p004080.pdf>.

basis of the commission paid by the mutual fund. For example, a firm may not:

[P]rovide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions.⁹⁷

Although these prohibitions had been in effect for several decades, the concerns remained that brokers had been improperly incentivized to favor specific mutual funds or proprietary products. When considering whether to prohibit differentiated compensation, FINRA questioned whether potential conflicts of interest may already be adequately addressed by existing rules, such as the suitability rule.⁹⁸

With respect to proprietary products, FINRA has issued guidance to firms when bringing new products to the market.⁹⁹ FINRA asked firms to consider the following questions when designing their policies and procedures:

- What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be

97. FINRA, RULE 2341(k)(7)(A) (2017).

98. *See* NASD, Notice to Members 99-81.

99. *See* NASD, NOTICE TO MEMBERS 05-26: NEW PRODUCTS; NASD RECOMMENDS BEST PRACTICES FOR REVIEWING NEW PRODUCTS, (April 2005), *available at* <http://www.finra.org/sites/default/files/NoticeDocument/p013755.pdf>.

addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.¹⁰⁰

Answering these questions can help a firm determine whether the conflicts of interest are so insurmountable that the product should not even be offered.

Given the focus on potential conflicts with proprietary products, FINRA examined firms and their policies and practices to avoid those conflicts:

An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.¹⁰¹

Accordingly, firms avoid incentivizing the sale of proprietary products by not differentiating the compensation.

ii. Recruitment Compensation

For some time, FINRA has been concerned with conflicts that may arise when a broker moves from one firm to another. Conflicts may arise in a number of different ways.

On occasion, clients will hold securities in their accounts that are proprietary to the broker's prior firm, and accordingly, may not be transferred to the broker's new firm. Alternatively, clients may hold products from issuers with whom the broker's new firm does not have a

100. *Id.*

101. FINRA, REPORT ON CONFLICTS OF INTEREST, at 30, (Oct. 2013), available at <http://www.finra.org/sites/default/files/Industry/p359971.pdf>.

dealer or servicing agreement. As a result, the clients may not transfer those specific products even if they transfer the rest of their accounts to the broker at the new firm. Concerned that brokers may have been making inappropriate recommendations to liquidate these products to permit the transfer of the assets to the broker's new firm, as discussed above, FINRA issued a notice reminding firms of their supervisory obligations in such a situation.¹⁰² Specifically, FINRA noted:

A recommendation to liquidate, replace or surrender an existing investment must be suitable and based upon the customer's investment needs and not the financial needs of the firm or its associated persons. *See, e.g., Notice to Members 99-35* (May 1999). A firm may consider the fact that the firm lacks a dealer or servicing agreement with the product sponsor and, therefore, the registered representative cannot provide the customer with the service that the customer desires with respect to the product. The suitability analysis must also include other considerations, however, including whether the customer's mutual fund or variable product is subject to a contingent deferred sales charge or a required holding (surrender) period, or has other features that materially affect its value or liquidity, and the fees and expenses associated with the new product being recommended.¹⁰³

Accordingly, while a broker may consider the fact that he can no longer service the investment, such a consideration may not trump the overall suitability analysis in making a recommendation to liquidate the investment.

In addition to conflicts related to potentially improper investment advice for products that are not portable, FINRA has also been concerned with compensation paid to brokers when they move from one firm to another. Brokers may be paid upfront compensation which is dependent on the broker's production over the past twelve months. Brokers may also receive certain bonuses dependent on the assets they are able to transfer to their new firm.

FINRA has now mandated that firms provide customers with educational material which will alert clients to these potential conflicts as well as the fact

102. *See* NASD, NOTICE TO MEMBERS 07-06.

103. *Id.* at 3.

that all assets may not be portable to the broker's new firm.¹⁰⁴ As of November 2016, firms are required to provide clients with a communication highlighting the following potential implications of transferring assets to the new firm:

- whether financial incentives the representative receives may create a conflict of interest;
- that some assets may not be directly transferrable to the recruiting firm and as a result the customer may incur costs to liquidate and move those assets or incur account maintenance fees to leave them with his or her current firm;
- potential costs related to transferring assets to the recruiting firm, including differences in the pricing structure and fees the customer's current firm and the recruiting firm impose; and
- differences in products and services between the customer's current firm and the recruiting firm.¹⁰⁵

FINRA's intent is that clients will seek additional information from their broker if they find this information relevant to their decision to transfer their assets to the broker at the new firm.

iii. Wealth Events

FINRA expects firms to scrutinize "wealth" events or "lifecycle milestone" events. Such events include key liquidity events in an investor's life, such as when an investor retires or changes jobs. At such a time, the investor must decide what to do with his or her 401(k) – leave it with the employer's plan or roll it over to an IRA. These events have the potential to heighten conflicts of interest because of the potentially large sums of money involved. This was a focus of FINRA in its Conflict of Interest Report:

104. FINRA, RULE 2273 (2016).

105. FINRA, REGULATORY NOTICE 16-18: RECRUITMENT PRACTICES; SEC APPROVES RULE REQUIRING DELIVERY OF AN EDUCATIONAL COMMUNICATION TO CUSTOMERS OF A TRANSFERRING REPRESENTATIVE, (May 2016), *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-18.pdf.

Firms have a strong incentive to gather assets, and as a recent Government Accountability Office report noted, “(r)ollovers have become the largest source of contributions to IRAs.” It is not always clear, however, that rolling over a 401(k) to an IRA—as opposed to keeping money within the plan or rolling it over to a new employer’s plan—is the best option for an investor. The recommendations a representative makes at these points in time may have profound implications for the investor and deserve thorough scrutiny and review.¹⁰⁶

Firms should supervise such recommendations closely to ensure that recommendations are consistent with the suitability rule.

Beginning in 2017, firms are required to comply with the Department of Labor’s Conflict of Interest Rule with respect to recommendations related to rollovers from 401(k)s to IRAs.¹⁰⁷ If a broker is paid a variety of compensation for such a recommendation, the broker is required to adhere to impartial conduct standards pursuant to the Best Interest Contract Exemption.¹⁰⁸

b. Investment Banking and Research Conflicts

For years, firms have been faced with conflicts of interest in connection with their investment banking and research lines of business. In 2002, investigations into major firms uncovered quid pro quo arrangements between the firms and their investment banking clients where the firms’

106. FINRA, REPORT ON CONFLICTS OF INTERESTS, at 31.

107. *See* Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (April 8, 2016), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2016-04-08/pdf/2016-07924.pdf>.

108. *See* Best Interest Contact Exemption, 81 Fed. Reg. 21002 (Apr. 6, 2016), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2016-04-08/pdf/2016-07925.pdf>; Best Interest Contract Exemption; Correction, 81 Fed. Reg. 44773 (Jul. 11, 2016), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2016-07-11/pdf/2016-16355.pdf>.

research department issued favorable research reports in exchange for investment banking business.¹⁰⁹

FINRA has remained concerned with conflicts of interest in connection with research reports. FINRA Rule 2241 requires firms to manage certain conflicts and prohibits others when issuing equity research. Rule 2241(b)(1) contains an overarching requirement that firms establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports and public appearances by research analysts and the interaction between research analysts and persons outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers. The rule now prohibits prepublication review by individuals in investment banking.¹¹⁰ The rule also incorporates an information barrier requirement, which is meant to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services activities, as well as other persons, including sales and trading personnel, who might be biased in their judgment or supervision.¹¹¹

FINRA has also adopted a similar rule with respect to debt research reports.¹¹² The rule contains many of the same provisions as the equity

109. See Press Release, New York Attorney General Eric T. Schneiderman, *Merrill Lynch Stock Rating System Found Biased By Undisclosed Conflicts Of Interest* (April 8, 2002), available at <https://www.ag.ny.gov/press-release/merrill-lynch-stock-rating-system-found-biased-undisclosed-conflicts-interest>; see also Press Release, SEC, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking*, (April 28, 2003), available at <https://www.sec.gov/news/press/2003-54.htm>.

110. See FINRA, RULE 2241(b)(2)(A) (2015), see also FINRA, REGULATORY NOTICE 15-30: EQUITY RESEARCH; SEC APPROVES CONSOLIDATED RULE TO ADDRESS CONFLICTS OF INTEREST RELATING TO THE PUBLICATION AND DISTRIBUTION OF EQUITY RESEARCH REPORTS, (Aug. 2015), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-30.pdf.

111. See FINRA, RULE 2241(b)(2)(G) (2015); see also FINRA, REGULATORY NOTICE 15-30 (Aug. 2015).

112. See FINRA, Rule 2242 (2016); see also FINRA, REGULATORY NOTICE 15-31: DEBT RESEARCH; SEC APPROVES RULE TO ADDRESS CONFLICTS OF INTEREST RELATING TO THE PUBLICATION AND DISTRIBUTION OF DEBT RESEARCH REPORTS,

research rule, and is aimed at managing or prohibiting the same types of conflicts while acknowledging the differences inherent in the debt markets.¹¹³

FINRA's tightening of the rules relating to conflicts of interest with respect to research reports follow a settlement in 2014 where 10 firms were fined a total of \$43.5 million.¹¹⁴ The firms allowed their equity research analysts to solicit investment banking business. Additionally, the firms offered favorable research coverage in connection with the 2010 planned initial public offering of Toys "R" Us.

A few weeks earlier, FINRA fined Citigroup Global Markets, Inc. \$15 million for supervisory failures related to its research department.¹¹⁵ Citigroup research analysts attended client dinners where they discussed stock picks, which, in some instances, were inconsistent with the analysts' published research. Additionally, a research analyst assisted two issuers in preparing presentations for investment banking road shows.

(Aug. 2015), available at <http://www.finra.org/sites/default/files/RegulatoryNotice-15-31.pdf>.

113. See FINRA, REGULATORY NOTICE 15-31, *supra* note 101.

114. See Press Release, FINRA, *FINRA Fines 10 Firms a Total of \$43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection With Toys "R" Us IPO*, (Dec. 11, 2014), available at <http://www.finra.org/newsroom/2014/finra-fines-10-firms-total-435-million>.

115. See Press Release, FINRA, *FINRA Fines Citigroup Global Markets Inc. \$15 Million for Supervisory Failures Related to Equity Research and Involvement in IPO Roadshows*, (Nov. 24, 2014), available at <http://www.finra.org/newsroom/2014/finra-fines-citigroup-15-million-failures-related-equity-research>.

2. Problem Brokers

The NASD, FINRA's predecessor, issued several notices providing guidance to firms regarding the appropriate level of supervision when overseeing a broker with a history of customer complaints. The guidance states that heightened supervision is often appropriate when the firm is supervising a broker with such a history.

In 1997, the NASD and the NYSE issued guidance following widespread examinations of the sales practices of firms. The agencies noted several red flags that may trigger heightened supervision:

- (i) brokers with a history of customer complaints, disciplinary actions, or arbitrations;
- (ii) persons hired in a non-registered capacity who previously were employed as brokers and who have such a history;
- (iii) brokers who develop such a history while associated with the firm;
- (iv) brokers terminated from prior employment for what appears to be a significant sales practice or regulatory violation; or
- (v) brokers who have had a frequent change of employers within the industry.¹¹⁶

FINRA provided guidance on developing a program of heightened supervision, and suggested that firms consider the nature of the conduct that resulted in the broker having a checkered history. FINRA suggested that firms examine "the product, customer, or activity type" and "identify the level and type of risk it presents. The firm should then determine what type of supervision might best control and limit this type of risk."¹¹⁷

In 1999, the NASD issued additional guidance on supervision, once again reminding firms that they should "design a supervisory system that is current and appropriately tailored to its specific attributes and structure" including "whether the firm employs persons who should be subject to heightened supervisory procedures due to a history of customer complaints, disciplinary actions, or arbitration proceedings."¹¹⁸ In 2008, in highlighting

116. See NASD, NOTICE TO MEMBERS 97-19: NASD REGULATION AND NEW YORK STOCK EXCHANGE MEMORANDUM DISCUSSES SWEEP REPORT AND PROVIDES GUIDANCE ON HEIGHTENED SUPERVISION RECOMMENDATIONS, at 160, (April 1997), available at <http://www.finra.org/sites/default/files/NoticeDocument/p004826.pdf>.

117. *Id.* at 161-162.

118. See NASD, NOTICE TO MEMBERS 99-45: NASD PROVIDES GUIDANCE ON SUPERVISORY RESPONSIBILITIES, at 294, (June 1999), available at <http://www.finra.org/sites/default/files/NoticeDocument/p004311.pdf>.

“new and existing areas that are of particular significance to FINRA’s examination program,” FINRA reminded firms that they “should also have procedures in place for reviewing and identifying individuals or business types that require enhanced scrutiny due to sales practice concerns, such as a pattern of customer complaints.”¹¹⁹

In 2011, FINRA issued a joint National Exam Risk Alert with the SEC.¹²⁰ FINRA had found that “firms with significant deficiencies in the integrity of their overall branch inspection process” typically “lack heightened supervision of individuals with disciplinary histories or individuals previously associated with a firm with a disciplinary history.”¹²¹

FINRA has emphasized its concern about this issue by making it a regulatory and examination priority.¹²² In 2014, FINRA stated:

In addition, FINRA is concerned about the potential risks posed by brokers who formerly worked at one or more firms that have been severely disciplined by FINRA, and who may bring unethical or illegal practices to a firm. Using sophisticated analytics—known as the Broker Migration Model—FINRA identifies and monitors both brokers who move from a firm that has been expelled or otherwise has a serious disciplinary history to another FINRA-regulated firm, and the firms that hire such individuals.¹²³

In 2015, FINRA stated that it was specifically focused on the supervision of high-risk brokers to determine whether it has been “tailored to specifically address the risks associated with the particular individual based on prior misconduct and regulatory disclosures.”¹²⁴ In 2017, FINRA once again made this issue an examination priority. In its 2017 Regulatory and Examinations Priority Letter, FINRA stated, “FINRA will devote particular attention to

119. See FINRA, 2008 EXAMINATION PRIORITIES, at 1, 4, available at <http://www.finra.org/sites/default/files/Industry/p038169.pdf>.

120. See FINRA, REGULATORY NOTICE 11-54: BRANCH OFFICE INSPECTIONS; FINRA AND THE SEC ISSUE JOINT GUIDANCE ON EFFECTIVE POLICIES AND PROCEDURES FOR BROKER-DEALER BRANCH INSPECTIONS, (Nov. 2011), available at <http://www.finra.org/sites/default/files/NoticeDocument/p125204.pdf>.

121. *Id.* at 2.

122. See FINRA, 2014 REGULATORY AND EXAMINATION PRIORITIES LETTER, available at <http://www.finra.org/sites/default/files/Industry/p419710.pdf>.

123. *Id.* at 3 (FINRA has placed this under the section entitled “*Focus on Recidivist Brokers*”).

124. FINRA, 2015 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 9.

firms' hiring and monitoring of high-risk and recidivist brokers, including whether firms establish appropriate supervisory and compliance controls for such persons."¹²⁵

In May 2017, the FINRA Board discussed several steps designed to heighten the oversight of high-risk brokers and the firms that employ them, including, among other things, "publication of a Regulatory Notice rearticulating heightened supervision obligations under FINRA Rule 3110 (Supervision)" and "publication of a Regulatory Notice proposing amendments to FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to disclose a member's status as a 'taping firm' under FINRA Rule 3170."¹²⁶

In 2018, FINRA stated it would continue to focus on the sales practices of high-risk brokers, including the recommendation of speculative or complex products.¹²⁷ FINRA once again reminded firms of their obligation to "adopt and implement tailored heightened supervisory procedures under FINRA Rule 3110 (Supervision) for high-risk individuals."¹²⁸

3. Senior Investors

As discussed above, FINRA recently adopted rules designed to mitigate financial exploitation of seniors.¹²⁹ In addition, FINRA has noted that there may be special concerns related to senior investors and firms may be better served by having policies and procedures in place to address these concerns. FINRA has expressed particular concern with the suitability of recommendations to, and communication aimed at, senior investors.¹³⁰

With respect to recommendations, FINRA reminded firms that a customer's investment time horizons, goals, risk tolerance, and tax status

125. FINRA, 2017 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 2.

126. See Robert Cook, *Update: FINRA Board of Governors Meeting*, FINRA (May 11, 2017), <http://www.finra.org/industry/update-finra-board-governors-meeting-051017>.

127. See FINRA, 2018 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 2.

128. *Id.*

129. See FINRA, RULES 2165 and 4512.

130. See FINRA, REGULATORY NOTICE 07-43: SENIOR INVESTORS; FINRA REMINDS FIRMS OF THEIR OBLIGATIONS RELATING TO SENIOR INVESTORS AND HIGHLIGHTS INDUSTRY PRACTICES TO SERVE THESE CUSTOMERS, (Sept. 2007), available at <http://www.finra.org/sites/default/files/NoticeDocument/p036816.pdf>.

may change as the customer ages.¹³¹ FINRA has cautioned firms that customers who are at or near retirement may be tempted to “reach for yield to maximize retirement income without the appreciation for the concomitant risk.”¹³² In particular, FINRA examiners are focused on broker recommendations that involve the following:

- (i) Products that have withdrawal penalties or otherwise lack liquidity, such as deferred variable annuities, equity indexed annuities, some real estate investments and limited partnerships;
- (ii) Variable life settlements;
- (iii) Complex structured products, such as collateralized debt obligations (CDOs);
- (iv) Mortgaging home equity for investment purposes; and
- (v) Using retirement savings, including early withdrawals from IRAs, to invest in high-risk investments.¹³³

In addition to suitability, FINRA has focused on communications. FINRA has expressed concern with the use of professional designations, in particular those suggesting an expertise in retirement planning or financial services for seniors.¹³⁴ Some firms ban the use of senior designations, while others require approval before they are used.¹³⁵ FINRA does not opine on the best practice.

FINRA has also been concerned with “free lunch” seminars that use high-pressure sales tactics under the guise of educational seminars to sell unsuitable products, predominately to senior investors. Generally, the seminars have been conducted in violation of FINRA rules. Accordingly, FINRA has reminded firms to review their policies and procedures related to sales seminars to ensure that they are adequate to ensure compliance with the rules and regulations.¹³⁶

Last, FINRA expressed concern regarding dealing with investors exhibiting signs of diminished mental capacity, as well as those who may be

131. *Id.* at 2.

132. *Id.* at 3.

133. *Id.* at 4.

134. *Id.* at 5.

135. *See id.* at 5. *See also* FINRA, REGULATORY NOTICE 11-52: SENIOR DESIGNATIONS; FINRA REMINDS FIRMS OF THEIR OBLIGATIONS REGARDING THE SUPERVISION OF REGISTERED PERSONS USING SENIOR DESIGNATIONS, (Nov. 2011), available at <http://www.finra.org/sites/default/files/NoticeDocument/p125092.pdf>.

136. *See* FINRA, REGULATORY NOTICE 07-43, at 6.

suffering from financial abuse by a family member or caregiver. FINRA outlined several policies and procedures a firm may adopt for dealing with these issues:

- (i) Designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about senior issues, as well as a repository of available resources.
- (ii) Providing written guidance to employees on senior-related issues, such as how to identify and/or what to do if they suspect their customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver or other third party.
- (iii) Asking, either at account opening or at a later point, whether the customer has executed a durable power of attorney.
- (iv) Asking, either at account opening or at a later time, whether the customer would like to designate a secondary or emergency contact for the account whom the firm could contact if it could not contact the customer or had concerns about the customer's whereabouts or health.
- (v) Asking the customer if he or she would like to invite a friend or family member to accompany the customer to appointments at the firm.
- (vi) Informing the customer (where appropriate) that, in the firm's view, a particular unsolicited trade is not suitable for the customer.
- (vii) Reminding brokers that it is important when dealing with customers, particularly seniors, to base recommendations on current information.
- (viii) Offering training to help brokers understand and meet the needs of older investors, including proper asset allocation, liquidity demand and longevity needs, as well as the possible changes in their suitability profiles.¹³⁷

Protecting senior investors remains a priority for FINRA. FINRA completed an examination initiative on senior initiatives, and has urged firms to review their procedures to "identify ways they may be able to improve their treatment of senior investors."¹³⁸ With respect to its examination priorities in 2017, FINRA stated:

137. *Id.* at 7-8.

138. FINRA, 2015 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 10.

FINRA will assess firms' controls to protect senior investors from fraud, abuse and improper advice. We are seeing numerous cases where registered representatives have recommended that senior investors purchase speculative or complex products in search of yield. While the quest for higher yield is not *per se* problematic, FINRA will assess whether such recommendations were suitable given an investor's profile and risk tolerance, and whether firms have appropriate supervisory mechanisms in place to detect and prevent problematic sales practices.¹³⁹

In 2015, FINRA established the FINRA Securities Helpline for Seniors, which is a "toll-free number that senior investors can call to get assistance from FINRA or raise concerns about issues with brokerage accounts and investments."¹⁴⁰ In two years, "the helpline has fielded more than 9,200 calls from all 50 states from individuals ranging in age from 17 to 102 years old (the average age of callers is 70 years old), and staff have referred nearly 650 matters to state, federal and foreign regulators, and made more than 130 referrals to Adult Protective Services under the mandatory reporting laws of 16 states."¹⁴¹ As of its second anniversary in April 2017, the helpline has led to \$4.3 million in voluntary reimbursements to callers.¹⁴²

Conclusion

Brokerage firm supervisory obligations are complex and less than clear. The rules are primarily principle based, offering the firms wide latitude in determining the appropriate level of supervision given the firm's structure. However, the FINRA guidance issued to firms will often set forth FINRA's expectations as to what an adequate supervisory system will look like. By examining the rules, the guidance, and disciplinary actions, one may get a clearer picture of a firm's supervisory obligations.

139. FINRA, 2017 REGULATORY AND EXAMINATION PRIORITIES LETTER, at 3.

140. *FINRA Securities Helpline for Seniors*, FINRA, <http://www.finra.org/investors/highlights/finra-securities-helpline-seniors> (last visited Feb. 26, 2018).

141. *FINRA Senior Helpline Marks Second Anniversary With \$4.3 Million in Voluntary Reimbursements to Callers*, FINRA (April 20, 2017), <http://www.finra.org/newsroom/2017/finra-senior-helpline-marks-second-anniversary-43-million-voluntary-reimbursements>.

142. *Id.*