

FINRA 2008: AN OSCAR WINNING YEAR?

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2008 marked the first full calendar year of existence for the Financial Industry Regulatory Authority or FINRA, the largest self-regulatory organization for United States broker-dealers and their associated persons.² FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration operations of the New York Stock Exchange (NYSE).³ When it began, FINRA promised more streamlined and efficient supervision of the broker-dealer industry.⁴

What kind of year did FINRA have in 2008? Did it have a *Slumdog Millionaire* kind of year, which involved destiny or did its year involve luck, where preparation meets opportunity? Was it a blockbuster or a bust? This review attempts to answer these questions by examining FINRA's enforcement activities in calendar year 2008, based on the disciplinary actions reported in FINRA's monthly reports of "Disciplinary and Other Actions."

The Numbers at the Box Office: Lower fines and fewer disciplinary actions

Salim: You want money, I'll give you money. . . .

Jamal: You know what I want. . . . She is my destiny, Salim.⁵

During 2008, broker-dealers and registered representatives enjoyed some respite from the record fines and enforcement actions of the past few years. FINRA fined firms and individuals approximately \$35 million in 2008,⁶ compared to \$77.6 million imposed during 2007,⁷ a decline of 55%.⁸ The 2008 fines represent an even sharper

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- 2 See FINRA Press Release, *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA* (July 30, 2007), available at <http://www.finra.org/Newsroom/NewsReleases/2007/P036329>.
- 3 Post-consolidation, the NYSE Enforcement Department continues to investigate and prosecute violations of NYSE Rules and applicable federal laws or regulations that occur on or through the systems and facilities of the Exchange.
- 4 See *id.*
- 5 <http://www.imsdb.com/scripts/Slumdog-Millionaire.html>.
- 6 This estimate was calculated based on the disciplinary actions and fines reported in FINRA's monthly reports of "Disciplinary and Other FINRA Actions" for calendar year 2008. FINRA has not yet released its Year in Review and Annual Financial Report for 2008.
- 7 This number represents the aggregate fines imposed during 2007 by NASD and the NYSE (pre-consolidation), and FINRA and the NYSE (post-consolidation). See FINRA Year In Review and Annual Financial Report for 2007 at 6 (reporting fines of \$47.6 million in 2007, which "reflect[ed] 12 months of NASD operations plus NYSE member regulation operations from July 30 through December 31, 2007"), available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p038602.pdf>; NYSE Group, Inc. Annual Report (10-K) for Year Ended December 31, 2007 at 66 (reporting \$30 million in "regulatory fine income" for 2007), available at <http://www.nyse.com/pdfs/23542acl.pdf>.
- 8 The 2007 fines include all NYSE cases (pre- and post-consolidation) in addition to all NASD and FINRA cases. The FINRA 2008 figures, which reflect only FINRA matters, do not include the cases brought by NYSE Enforcement—now independent of FINRA and only prosecuting members for violations on or through the Stock Exchange, reporting those statistics on www.nyse.com. However, the difference of the makeup of cases does not account for the substantial 55% drop. Indeed, NYSE Enforcement's

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decline from the peak in 2005, when NASD and the NYSE fined firms and individuals approximately \$184 million,⁹ and 2006 when the fines totaled approximately \$111 million.¹⁰ Moreover, there was a significant drop in “supersized” fines (i.e., fines over \$1 million), from 19 in 2007 to three in 2008.

The number of disciplinary actions also declined significantly from prior years. In 2008, FINRA resolved 1,007 formal disciplinary actions, which is a decline of approximately 9% from 2007, when FINRA resolved 1,107 disciplinary actions.¹¹ The magnitude of this drop is more significant than the numbers indicate because the 2007 statistics are for (1) NASD alone for one-half of the year and (2) the combined NASD and the NYSE for the second half of the year, while the 2008 statistics are for the combined entity. The 2007 and 2008 statistics represent a significant decline from prior years: NASD and the NYSE resolved 1,454 disciplinary actions in 2005 and 1,428 in 2006.¹²

Several factors appear to have contributed to these results. “Blockbuster” issues (where industry practice allegedly resulted in significant customer harm), such as market timing, late trading, directed brokerage, revenue sharing, and mutual fund share class issues, characterized enforcement actions in 2005. These matters each resulted in several enforcement actions involving large fines. As a result, in 2005 there were a record number (35) of “supersized” (or \$1 million-plus) fines, including seven fines in excess of \$5 million.¹³ The number of “supersized” fines decreased to 19 in both 2006 and 2007.¹⁴ In 2006 only three fines were greater than \$5 million, while in 2007 one was greater than \$5 million.¹⁵ As discussed above, in 2008, FINRA assessed only three “supersized” fines and no fine exceeded \$5 million.

The reduction in “blockbuster” cases with outsized fines may be due, in part, to the industry’s adoption of policies and procedures in response to these matters. It is also possible that FINRA is no longer imposing rulemaking-by-enforcement. Finally, FINRA may have been affected by the SEC’s well-publicized retrenchment on the enforcement

regulatory fine income for 2008 was only \$3 million; therefore, it does not appear that the current jurisdictional differences had a material impact on the analysis. See NYSE Euronext Annual Report (10-K) for Year Ended December 31, 2008 at 50, available at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzMyNTk4fENoaWxkSUQ9MzE0OTc0fFR5cGU9MQ==&t=1>.

- 9 NASD fines in 2005 were approximately \$148.5 million, while NYSE’s “regulatory fine income” was approximately \$35.4 million. See NASD Annual Financial Report for 2005 at 3, available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p016650.pdf>; NYSE Group, Inc. Annual Report (10-K) for Year Ended December 31, 2006 at 51, available at http://www.nyse.com/pdfs/NYSE_Group_10-K2006.pdf.
- 10 NASD fines in 2006 were approximately \$75 million, while NYSE’s “regulatory fine income” was approximately \$36.4 million. See NASD Year in Review and Annual Financial Report for 2006 at 10, available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p019044.pdf>; NYSE Group, Inc. Annual Report (10-K) for Year Ended December 31, 2006 at 51, available at http://www.nyse.com/pdfs/NYSE_Group_10-K2006.pdf. According to press reports, SEC penalties also dropped precipitously during this time period. See “In Cox Years at the SEC, Policies Undercut Action,” *The Washington Post*, June 1, 2009 (“During [Chairman Christopher] Cox’s tenure, penalties imposed on companies fell 84 percent, from \$1.59 billion in 2005 to \$256 million in 2008”).
- 11 FINRA Statistics, available at <http://www.finra.org/Newsroom/Statistics/index.htm>. Based on correspondence with staff, these “formal actions resolved” include settlements (both Letters of Acceptance, Waiver and Consent, as well as accepted Offers of Settlements, Hearing Panel decisions in litigated cases and minor rule violations).
- 12 In 2005, NASD resolved 1,344 formal disciplinary actions, and the NYSE resolved 109 formal disciplinary actions. See NASD 2005 Year in Review at 7, available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p016705.pdf>; NYSE List of 2005 Disciplinary Actions, available at http://www.nyse.com/RegulationFrameset.html?nyseref=http%3A//www.nyse.com/DiscAxn/discAxn_2006.html&displayPage=/regulation/1020656068674.html. In 2006, NASD resolved 1,147 formal disciplinary actions and the NYSE resolved 281 formal disciplinary actions. See NASD Year in Review and Annual Financial Report at 8, available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p019044.pdf>; NYSE List of 2006 Disciplinary Actions, available at http://www.nyse.com/DiscAxn/discAxn_2006.htm.
- 13 These statistics are based on NASD’s Notices to Members and cases reported on the Lexis New York Stock Exchange Disciplinary Actions database for calendar year 2005.
- 14 These statistics are based on NASD’s Notices to Members in 2006, cases reported on the Lexis New York Stock Exchange Disciplinary Actions database for calendar year 2006, disciplinary actions reported in NASD Notices to Members (January 2007 through July 2007), FINRA’s “Disciplinary and Other FINRA Actions” (August 2007 through December 2007), and the NYSE website (calendar year 2007).
- 15 *Id.*

front.¹⁶ Whether market losses and current interest in regulatory reform stemming from, among other things, the credit crisis will result in an increase in investigations, formal actions and fines remains to be seen.

The Stars of 2008

Inspector: Professors, lawyers, doctors, General Knowledge Wallahs never get beyond sixteen thousand rupees. And he's on ten million? What the hell can a slumdog possibly know?

*Jamal: The answers.*¹⁷

The top five fine-generating issues for FINRA in 2008 were: mutual funds, suitability, licensing, excessive brokerage compensation (commissions/markups/markdowns), and electronic communications.¹⁸ While this list includes some of the “usual suspects” (mutual funds, suitability, and electronic communications), there are some surprises (such as excessive brokerage compensation and licensing).

An analysis of the disciplinary actions in the top five categories reveals the following trends:

- The “blockbuster” mutual fund cases of the past few years (e.g., market timing, late trading, unsuitable sales of Class B mutual fund shares, and directed brokerage) are on the wane;
- The issues that FINRA has been trying to turn into “blockbusters,” such as variable product and hedge fund sales, sales to seniors, and anti-money laundering generally have not yet generated “supersized” fines;¹⁹ and
- FINRA seems to have been more attentive to more traditional, individual sales practice and gate-keeping violations (e.g., suitability and licensing violations), than to more novel rulemaking-by-enforcement industry violations, such as market timing.²⁰

1. Mutual Funds

Mutual funds led the way as the highest fine-generating issue for FINRA in 2008, although the fines attributable to fund issues declined from the records of 2005 and 2006. Nearly one-third of FINRA's total fines in 2008

16 See, e.g., “In Cox Years at the SEC, Policies Undercut Action,” *The Washington Post*, June 1, 2009 (“After [Christopher] Cox became SEC chairman in mid-2005, he adopted practices that undermined the enforcement division’s efforts to investigate cases of corporate wrongdoing and punish those involved, according to interviews with 19 current and former SEC officials”); GAO March 31, 2009 report, “Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement,” (“[R]esource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. . . . Enforcement management, investigative attorneys, and others agreed that two recent corporate penalty policies—on factors for imposing penalties, and Commission pre-approval of a settlement range—have delayed cases and produced fewer, smaller penalties. GAO also identified other concerns, including the perception that the SEC had ‘retreated’ on penalties, and made it more difficult for investigative staff to obtain ‘formal orders of investigation,’ which allow issuance of subpoenas for testimony and records. . . . Some investigative attorneys came to see the commission as less of an ally in bringing enforcement actions and more of a barrier. . . . [Cox’s policies] contributed to an adversarial relationship between enforcement and the commission.”) available at <http://www.gao.gov/products/GAO-09-358>.

17 <http://www.imsdb.com/scripts/Slumdog-Millionaire.html>.

18 To perform this analysis, the authors categorized disciplinary actions reported in FINRA's monthly reports of “Disciplinary and Other FINRA Actions” for calendar year 2008 based on the issues involved; however, certain very broad categories, such as supervision and books and records, were excluded from this analysis. For example, a disciplinary action that involved unsuitable mutual fund sales, the failure to retain emails and inadequate supervision was categorized as “Mutual Funds,” “Suitability,” and “Electronic Communications,” but there was no separate supervision category. In addition, disciplinary actions that imposed no fines were not considered for purposes of this analysis. Finally, the analysis also excluded violations primarily enforced by FINRA Market Regulation (e.g., TRACE and OATS reporting issues, inaccurate advertised trade volume).

19 See FINRA Improving Examination Results at 1-2 (May 2008) (listing examination priorities), available at <http://www.finra.org/Industry/Regulation/Guidance/ImprovingExaminationResults/p038526>; NASD Improving Examination Results at 1-2 (May 2007) (listing examination priorities), available at <http://www.finra.org/Industry/Regulation/Guidance/ImprovingExaminationResults/p019177>.

20 Rulemaking-by-enforcement occurs when a regulator attempts to alter industry practice in the absence of a specific rule by bringing an enforcement action, without prior warning that the practice is sanctionable, creating new standards of conduct. See Jonathan R. Macey, *The Tenth Abraham L. Pomerantz Program: Wall Street in Turmoil: Who is Protecting the Investor?: State-Federal Regulations Post-Eliot Spitzer*, 70 BROOKLYN L. REV. 117, 128 n.36 (Fall 2004); Financial Services Institute, *FSI on the Issues: Rulemaking by Enforcement*, available at <http://www.financialservices.org/assets/0/56/288/8b6c4588-6d0b-4d8b-a822-9b799f373185.pdf>.

(approximately \$10.3 million) were imposed in cases involving alleged mutual fund-related violations. It should be noted, however, that one-half of this amount is attributable to a National Adjudicatory Council (NAC) decision upholding a single \$5 million fine against American Funds Distributors, Inc. in a directed brokerage case originally brought by NASD in 2005.²¹

(a) Relevant Disciplinary Actions in 2008

Of the 32 cases generating \$10.3 million of FINRA fines in this category, the overwhelming majority (\$9.65 million) related to the “blockbuster” issues of prior years. More specifically, \$5 million of the fines related to a directed brokerage case; \$3.5 million in fines were imposed in matters involving share class issues;²² and \$1.15 million in fines were assessed for alleged market timing and/or late trading.

Although the largest 2008 fine resulted from the NAC upholding a \$5 million fine against American Funds Distributors, that amount represents a steep discount from the \$28 million and \$98 million in alternative fines that the Department of Enforcement had originally advocated.²³ It is also millions of dollars below the \$8.4 million or \$29 million fine in presumed settlement, assuming that NASD proposed settling the matter for 30% of the directed-brokerage payments, which appears to have been the formula used in other directed-brokerage cases. This matter shows that it may pay to litigate, even if a respondent loses on liability.²⁴

(b) Comparison to Prior Years

The \$10.3 million in FINRA fines in mutual fund cases in 2008 represents a sharp drop from 2005 and 2006 when firms and individuals were fined approximately \$104 million and \$95 million, respectively.²⁵ However, 2008’s fines represent only a modest decrease from 2007’s fines of approximately \$13.7 million.²⁶ Of course, if the \$5 million NAC award discussed above is excluded, 2008 fines relating to mutual funds are less than one-half of those imposed in 2007.

While in 2008, there were some matters involving the “blockbuster” issues, such as market timing, late trading, share class issues, revenue sharing and directed brokerage, the number of those cases has declined substantially. Until and unless FINRA finds new “blockbuster” mutual fund issues, the decline in overall fines in this category may continue.

2. Suitability

The suitability of securities sales has long been a central focus of FINRA’s (and its predecessors’) enforcement efforts, and it is therefore not surprising that suitability was a top fine-generating issue in 2008. Suitability is one of the few categories in which fines increased slightly from 2007, although the fines in both years were substantially lower than those obtained by NASD and the NYSE in 2005 and 2006. In all, FINRA brought 24 suitability actions in 2008, imposing \$4.46 million in fines. Products including Class B share mutual funds, variable products, and hedge funds tended to generate the largest fines.

21 *Department of Enforcement v. American Funds Distributors, Inc.*, Complaint No. CE3050003 at 2 (NAC 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p038418.pdf>.

22 The share class issues included: allegedly unsuitable sales of Class B and/or Class C mutual fund shares; failing to provide all eligible investors the ability to purchase Class A mutual fund shares at net asset value (NAV) through NAV transfer programs; and brokers falsely representing that purchasers of Class B or Class C mutual fund shares were eligible for contingent deferred sales charge (CDSC) waivers.

23 *Department of Enforcement v. American Funds Distributors, Inc.*, Disciplinary Proceeding No. CE3050003 at 22 (OHO 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p018498.pdf>.

24 See Brian L. Rubin and Christian J. Cannon, *Sutherland Annual Study Finds That It Sometimes Pays to Litigate Against FINRA (formerly NASD)* (May 12, 2008), available at <http://www.sutherland.com/files/News/cd174a10-112e-4f88-957b-989177b4de24/Presentation/NewsAttachment/6b04ce56-1dba-411c-b8d6-3e7c814130d3/NASDStudy2008.pdf>.

25 These statistics are based on NASD’s Notice to Members in 2005 and 2006 and cases reported on the Lexis New York Stock Exchange Disciplinary Actions database for calendar years 2005 and 2006.

26 This estimate is based on an analysis of disciplinary actions reported in NASD’s Notices to members (January 2007 through July 2007), FINRA’s monthly reports of “Disciplinary and Other FINRA Actions” (August 2007 through December 2007), and the NYSE website (calendar year 2007).

(a) Relevant Disciplinary Actions in 2008

Of the \$4.5 million fines in this category in 2008, the overwhelming majority, \$3.275 million (or 73%), involved allegedly unsuitable sales of Class B mutual fund shares, another former “blockbuster” issue. Unsuitable sales of B shares resulted in fines ranging from \$25,000 to \$1.1 million, and only two “supersized” fines. Variable product sales generated four cases resulting in a total of \$365,000 in fines, of which annuity exchanges accounted for \$295,000 or (or 81%) of the fines.²⁷ Hedge funds suitability issues generated \$155,000 in fines.

While the variable product and hedge fund fines represent relatively small amounts, the 2008 cases may represent early warnings of upcoming “blockbuster” issues. For example, while FINRA failed to impose any “supersized” fines in cases involving annuities or hedge funds in 2008, in April 2009, it fined a firm \$1.75 million for 250 allegedly unsuitable variable annuities transactions in April 2009.²⁸ If investors continue to suffer the effects of the current economic downturn, FINRA may target products that have not fared well, particularly if FINRA believes the products are difficult to understand.

(b) Comparison to Prior Years

The \$4.46 million in total fines for suitability cases in 2008 is virtually unchanged from the \$4.39 million in fines for similar matters in 2007. Likewise, the number of cases involving suitability remained almost constant between 2007 and 2008 (25 and 24, respectively). Not surprisingly, both years saw only a fraction of the number of matters brought during 2005 and 2006 (58 and 40, respectively). NASD and the NYSE also obtained far greater fines in suitability cases in 2005 (approximately \$9.9 million) and in 2006 (approximately \$31 million) than in 2007 and 2008.

3. Licensing

Disciplinary actions involving licensing issues (registration, testing and continuing education) were the third most lucrative category for FINRA in 2008, resulting in fines totaling approximately \$4.35 million in 66 actions. These matters included the employment of barred or statutorily disqualified individuals, individuals functioning without the proper licenses, continuing education testing irregularities, “parking” of registrations, FINRA licensing examination violations, and the failure to perform background checks and submit fingerprints.²⁹ This category is ranked third because of the sheer volume of these cases, more than twice as many as any other category in the top five list, rather than the average size of the fines, which was approximately \$66,000. Moreover, fines exceeded \$100,000 in only seven of the 66 cases. In addition, this is the only category in which there was an increase in fines between 2005 and 2008.

(a) Relevant Disciplinary Actions in 2008

The largest fines imposed in this category involved:³⁰

- Permitting a barred individual to perform duties that required registration (one firm fined \$1 million);³¹
- Allowing individuals who did not hold the requisite licenses to author research reports and/or to act as supervisory analysts (two firms fined \$650,000 and \$175,000);³²

27 See FINRA Case No. 2005002262901, Disciplinary and Other FINRA Actions at 5 (Feb. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038010.pdf>; FINRA Case No. EAF0401040001, Disciplinary and Other FINRA Actions at 6-7 (Sept. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p116989.pdf>.

28 See FINRA Press Release (April 14, 2009), available at <http://www.finra.org/Newsroom/NewsReleases/2009/P118471>.

29 Alleged Form U4 or U5 violations were not included in this category.

30 Each case also involved unrelated violations.

31 See AWC No. 2007009525901 (Sept. 22, 2008).

32 FINRA Case No. 2005002206101, Disciplinary and Other FINRA Actions at 4-5 (Sept. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p116989.pdf>; FINRA Case No. 2006003679802, Disciplinary and Other FINRA Actions at 2-3 (Sept. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p116989.pdf>.

- Failing to investigate the records of, and submit fingerprints for, certain permanent and temporary employees (one firm fined \$425,000);³³
- Permitting an individual to serve as its securities lending manager when he was not registered with NYSE (one firm fined \$300,000);³⁴
- Allowing individuals to act as principals without the requisite securities licenses (one firm fined \$150,000);³⁵ and
- Failing to have a written continuing education plan (one firm fined \$125,000).³⁶

The most common issue was continuing education testing irregularities, which accounted for almost one-third of the disciplinary actions in this category. In those cases, individuals were fined for either directing others to complete their continuing education requirements or for completing such requirements on behalf of others.³⁷ Those individuals were fined between \$5,000 and \$10,000 and suspended between 30 days and six months.

(b) Comparison to Prior Years

This is the only category out of the top five in which there was an increase in fines between 2005 and 2008. In 2005, NASD and the NYSE obtained approximately \$1.8 million in fines in licensing cases, compared with almost triple that amount (approximately \$4.35 million) in 2008. Fines in this category actually crested in 2006 and 2007 at approximately \$7 million. During both years, however, a single large matter accounted for much of the total fines. In 2006, one firm paid a \$5 million fine to settle charges that it, among other things, permitted persons without the proper licenses to supervise certain call center representatives.³⁸ In 2007, another firm agreed to pay a \$3.75 million fine to settle charges that the firm, among other things, permitted 1,100 individuals to park their registrations.³⁹ Thus, much of the difference in yearly results stems from the presence (or absence) of “supersized” fines, rather than changes in enforcement activity or interest.

4. Brokerage Compensation

Excessive brokerage compensation cases (involving commissions, markups and markdowns) were significant for FINRA in 2008, involving 21 disciplinary actions and fines of \$3.5 million. FINRA appears to have dramatically stepped up its enforcement activity in this area; indeed, FINRA brought more actions involving these excessive payments in 2008 than FINRA, NASD and the NYSE brought in 2005, 2006 and 2007 combined.

(a) Relevant Disciplinary Actions in 2008

FINRA's fines for the 21 relevant disciplinary actions in 2008 ranged from \$10,000 to \$750,000. About one-half of those actions were stand-alone excessive brokerage compensation cases; the other half involved additional violations.

33 FINRA Case No. 2007009428304, Disciplinary and Other FINRA Actions at 6 (July 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038918.pdf>.

34 FINRA Case No. 2007011877401, Disciplinary and Other FINRA Actions at 3-4 (Aug. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p039079.pdf>.

35 FINRA Case No. E062005006701, Disciplinary and Other FINRA Actions at 5 (Oct. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117220.pdf>.

36 FINRA Case No. 2006003702101, Disciplinary and Other FINRA Actions at 3-4 (Jan. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p037831.pdf>.

37 See FINRA Case No. 2005003511203, Disciplinary and Other FINRA Actions at 13 (June 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038727.pdf>; FINRA Press Release (Mar. 6, 2008), available at <http://www.finra.org/Newsroom/NewsReleases/2008/P038092>; FINRA Case No. 2005003511201, Disciplinary and Other FINRA Actions at 10 (Jan. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p037831.pdf>; FINRA Case No. 2005003511202, Disciplinary and Other FINRA Actions at 16 (Jan. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p037831.pdf>.

38 AWC No. E9B030421 at 11 (2008).

39 NASD NTM Disciplinary Actions at 12-14 (Apr. 2007), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p018923.pdf>.

The three highest fines in this category (\$750,000, \$700,000, and \$500,000) were against firms that also allegedly committed significant, unrelated violations.⁴⁰ In contrast, the 11 stand-alone cases led to fines ranging from \$10,000 to \$250,000.

(b) Comparison to Prior Years

In 2005, NASD and the NYSE brought only six excessive brokerage compensation cases; in 2006, there were eight; and in 2007, there were six. Despite the greater number of cases in 2008, the total fines of \$3.5 million, which, while greater than 2007's \$1.8 million, are similar to the fines imposed in 2006 (\$3 million), but only one-half of the fines obtained in 2005 (\$6.8 million). While the reasons for the decrease in the average fine are not clear, it is possible that FINRA views such conduct to be less severe than it had previously. Alternatively, it is possible that the amount of the allegedly excessive brokerage compensation charged by firms has been less (and the corresponding fines are, therefore, also less).

5. Electronic Communications

Alleged violations involving electronic communications generated significant FINRA enforcement activity in 2008, with 26 disciplinary actions and approximately \$3 million in total fines. FINRA's interest in this area appears to have evolved from traditional email retention to more novel issues, such as retention of instant messages, supervision of email retention systems, and substantive email reviews. While \$3 million in fines is significant, it is but a mere fraction of the fines FINRA, NASD and the NYSE obtained for such violations in 2005, 2006 and 2007.

(a) Relevant Disciplinary Actions in 2008

FINRA's enforcement priorities in the electronic communications arena are evolving. While FINRA continues to bring actions for failing to retain email, many of the recent disciplinary actions involved more varied issues, including the following:

- **External Email Accounts.** Three firms were disciplined for, among other things, failing to preserve business-related emails sent through external email accounts, usually personal email accounts of representatives. The fines for those firms ranged from \$11,000 to \$125,000.⁴¹
- **Substantive Email Review.** Five firms were sanctioned for, among other things, failing to review emails and/or failing to maintain documentation of such reviews. Those firms were fined between \$15,000 and \$125,000.⁴²

40 FINRA AWC No. E0720050092 at 3-7 (2008) (firm fined \$750,000 for inadequate supervision of markups and commissions, plus a bevy of other violations, including engaging in a fraudulent "cherry picking" scheme, failing to preserve emails and instant messages, failing to implement its anti-money laundering program, and certain other reporting and supervisory violations); FINRA AWC No. E072005012301 at 1-2 (Oct. 2008) (firm fined \$700,000 for charging excessive commissions in 2,968 transactions and for violations relating to its fee-based brokerage program); FINRA Case No. 2005000168303, Disciplinary and Other FINRA Actions at 2-3 (June 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038727.pdf> (firm fined \$500,000 for inadequately supervising its high-yield and distressed-bond desk regarding markups, recordkeeping, and confirmations to customers, and for certain TRACE reporting violations).

41 FINRA Case No. 2007008502601, Disciplinary and Other FINRA Actions at 1 (July 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038918.pdf>; FINRA Case No. 2007007288701, Disciplinary and Other FINRA Actions at 5 (Oct. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117220.pdf>; FINRA Case No. 2006003702101, Disciplinary and Other FINRA Actions at 3-4 (Jan. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p037831.pdf>.

42 FINRA Case No. 20070072252801, Disciplinary and Other FINRA Actions at 5 (Dec. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117534.pdf>; FINRA Case No. 2007007136801, Disciplinary and Other FINRA Actions at 1-2 (Sept. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p116989.pdf>; FINRA Case No. 20060039815-01, Disciplinary and Other FINRA Actions at 3 (Feb. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038010.pdf>; FINRA Case No. E9B2005014202, Disciplinary and Other FINRA Actions at 1-2 (Nov. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117408.pdf>; FINRA Case No. 2006003679802, Disciplinary and Other FINRA Actions at 2-3 (Sept. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p116989.pdf>.

- Instant Messages. Five firms were disciplined for, among other things, failing to retain instant messages. Fines for those firms ranged between \$17,500 and \$750,000.⁴³
- Technology Issues. One firm was fined \$750,000 for, among other things, failing to retain certain emails as a result of a change in email vendors.⁴⁴ Another firm was fined \$450,000 for, among other things, failing to retain certain emails because it did not properly configure its email retention system.⁴⁵
- Supervision of the Email Retention System. Three firms were sanctioned for, among other things, failing to perform audits, spot-checks or other reviews to ensure that its email retention system was compliant. Those firms were fined between \$15,000 and \$65,000.⁴⁶

Of the 26 disciplinary actions, only five matters involved only electronic communications issues, with fines ranging from \$11,000 to \$100,000. The majority of cases involved significant unrelated violations. For example, the highest fine (\$750,000) was imposed against a firm that, in addition to having certain lapses regarding the retention of emails and instant messages, also allegedly engaged in a fraudulent cherry-picking scheme, had certain reporting and supervisory deficiencies, and failed to implement its anti-money laundering compliance program.⁴⁷ Accordingly, it is possible that only a small portion of the fine was attributable to the electronic communications issues. The absence of “supersized” fines imposed for stand-alone email issues suggests that FINRA may no longer consider electronic communications violations to be a “blockbuster” issue.⁴⁸

(b) Comparison to Prior Years

FINRA’s 2008 fines for electronic communications cases were considerably lower than fines obtained in the past. The \$3 million in total fines obtained in 2008 represents approximately 30% of the fines obtained in 2006 and 2007 and 2% of the fines obtained in 2005. In 2007, there were 46 actions and \$15.7 million in fines, while in 2006, NASD and the NYSE brought fewer disciplinary actions involving electronic communications violations (40) and obtained lower fines (\$13.9 million). In contrast, in 2005, NASD and the NYSE brought 27 actions involving electronic communications violations and imposed total fines of approximately \$45 million.

Several factors likely contributed to the drop in fines for electronic communications violations since 2005. First, regulators initially tagged large firms with significant fines for email retention violations, which prompted much of the industry to review and enhance relevant systems and procedures, resulting in fewer noncompliant systems for the regulators to sanction. Second, FINRA is now focusing on narrower electronic communications issues, as described above, which FINRA may view as warranting smaller fines.

43 FINRA Case No. 2007007154201, Disciplinary and Other FINRA Actions at 4 (Apr. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038330.pdf>; FINRA Case No. 2006003702701, Disciplinary and Other FINRA Actions at 2 (Dec. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117534.pdf>; FINRA Case No. E072003019507, Disciplinary and Other FINRA Actions at 2-3 (May 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038516.pdf>; FINRA AWC for BD No. 20580 at 7 (2008); FINRA Case No. E0720050092, Disciplinary and Other FINRA Actions at 24 (July 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p038918.pdf>.

44 FINRA AWC No. E0720050092 at 6 (2008).

45 FINRA AWC for BD No. 20580 at 7 (2008).

46 FINRA Case No. 2007007252801, Disciplinary and Other FINRA Actions at 5 (Dec. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117534.pdf>; FINRA Case No. 2007007288701, Disciplinary and Other FINRA Actions at 5 (Oct. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117220.pdf>; FINRA Case No. 2007007422001, Disciplinary and Other FINRA Actions at 1 (Oct. 2008), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117220.pdf>.

47 FINRA AWC No. E0720050092 at 3-7 (2008).

48 Cf. NASD Press Release, *SEC, NYSE, NASD Fine Five Firms Total of \$8.25 Million for Failure to Preserve Email Communications* (Dec. 3, 2002), available at <http://www.finra.org/Newsroom/NewsReleases/2002/P002873>.

The Future

*Maman: Your destiny is in your hands, bhai [brother].*⁴⁹

An age-old question (at least among certain lawyers and securities professionals) is: To what extent do regulators control their own destiny or do they primarily respond to market forces? While the number of disciplinary actions and fines during 2008 represents a significant decrease from prior years, 2008 may have been the calm before the storm. Given the current financial crisis, it is likely that FINRA's enforcement activity will increase in 2009. Furthermore, if FINRA is successful in its efforts to regulate investment advisers,⁵⁰ significant enforcement activities will likely result. Recently, new regulatory "blockbuster" issues have already emerged, including sales of auction rate securities, which are producing "supersized" agreements in principal.⁵¹ How active FINRA will be in 2009 remains to be seen, as the anticipated onslaught of regulatory activity has yet to fully materialize. In the meantime, securities professionals can take some comfort that last year offered a bit of a reprieve from the headline-inducing fines of recent years and, if one planned and watched the box office carefully, there may have been some time to catch a few flicks before the next regulatory upswing begins.

⁴⁹ <http://www.imsdb.com/scripts/Slumdog-Millionaire.html>.

⁵⁰ Remarks of Richard G. Ketchum, FINRA Chairman and CEO, from the SIFMA Compliance & Legal Division's Annual Seminar on March 23, 2009 at 6 (stating that "FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently"), available at <http://www.finra.org/Newsroom/Speeches/Ketchum/P118256>.

⁵¹ On September 18, 2008, FINRA announced "agreements in principal" with five firms to settle auction rate securities violations, assessing fines totaling \$3.25 million, with one firm to pay \$1.65 million. FINRA News Release dated Sept. 18, 2008 at 2, available at <http://www.finra.org/Newsroom/NewsReleases/2008/P117019>. Certain of those agreements in principal were announced as finalized in February and March 2009 (but not including the firm that agreed to pay \$1.65 million). See FINRA Case No. 2008014569401, Disciplinary and Other FINRA Actions at 5-6 (Feb. 2009), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117850.pdf>; FINRA Case No. 2008013057401, Disciplinary and Other FINRA Actions at 10 (Feb. 2009), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p117850.pdf>; FINRA Case No. 2008013055501, Disciplinary and Other FINRA Actions at 4-5 (March 2009), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p118153.pdf>.