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Mid-Year Report: FINRA Enforcement Builds Momentum After Historic Penalties

After collecting near-record amounts in fines, restitution, and disgorgement in 2021 – which included a \$70 million monetary penalty against a financial institution in a single action – FINRA continues to raise the bar on disciplinary sanctions for member firms that fail to meet the requirements of the self-regulatory authority. This alert provides a mid-year review of some of FINRA's most notable recent actions and identifies key-takeaways for member firms to observe as the year progresses.

A snapshot of a few of FINRA's largest sanctions against member firms this year include:

1. A large member firm was ordered to pay over \$15 million in restitution and interest for a sales practice and supervision action after failing to correctly identify and implement applicable limits on customers' Class C share purchases.
2. Another large member firm paid a \$9 million fine for operational failures pertaining to compliance with the Customer Protection Rule related to fully paid and excess margin securities and for failing to keep electronic brokerage records in non-erasable and non-rewriteable, or "WORM," format.
3. Two registered funding portals were sanctioned a combined \$1.75 million for failing to comply with crowdfunding regulations.

SALES PRACTICE AND SUPERVISION

As in the past, FINRA remains laser focused on sales practices and related supervision requirements. Indeed, several of the matters carrying the most severe monetary penalties this year have involved situations where sales practices or lack of supervision have caused harm or have had the potential to cause harm to retail investors. Commonly, these actions are enforced when firms failed to ensure that proper monitoring systems are in place, or when firms failed to implement sufficient internal controls to prevent or



detect customer harm. Speaking to the importance of supervision amidst the announcement of a regulatory action late last year, Jessica Hopper, Executive Vice President and Head of FINRA's Department of Enforcement, reminded firms that "[r]ecognizing and responding to red flags is the hallmark of proper supervision" and went on to note "FINRA's commitment to holding accountable the firm, supervisors and individuals responsible, and providing restitution to harmed customers."¹ To date, supervisory actions represent the largest source for fines and restitution ordered against member firms that failed to implement and maintain reasonable systems and controls.

Supervisory violations, specifically for product overcharges, were also a continuing trend from years past. This year, a prominent member firm was ordered to pay over \$15.2 million in restitution and interest for recommending that customers purchase Class C mutual fund shares when Class A shares were available at a lower cost.² FINRA found the firm had violated FINRA Rule 3110³ and Rule 2010⁴ for failing to establish and maintain a supervisory system, including written procedures, reasonably designed to supervise sales of mutual fund Class C shares. Specifically, in FINRA's view, the firm failed to correctly identify and implement applicable limits on customers' Class C shares purchases.⁵ This resulted in customers' paying approximately \$13.4 million in excess fees and expenses.⁶ Notably, FINRA exercised discretion and waived any fine in part because the firm provided "extraordinary cooperation" with the investigation.⁷

Excessive and unsuitable trading, another historically common area of scrutiny regarding firm supervision, arose late last year and appears to be a continuing focus. In a November 2021 matter, FINRA sanctioned a member firm approximately \$2.8 million – spread across a \$1.7 million restitution order to 68 customers whose accounts were "potentially excessively and unsuitably trad[ed] by the firm's representatives"⁸ and a \$1.1 million fine for related supervisory violations.⁹ According to FINRA, trading in the impacted accounts generated, on average, cost-to-equity ratios and other trading expenses of 71.6 percent, causing customers to incur more than \$2.9 million in trading costs.¹⁰ FINRA stated that the supervisors of the firm failed to take reasonable steps to investigate "red flags" indicative of potentially excessive and unsuitable trading, which included over 50 complaints from customers alleging excessive, unsuitable, or unauthorized trading in their accounts.¹¹ Further, FINRA alleged that when the firm's compliance department identified deficiencies within the firm's system and procedures for monitoring potentially excessive trading, the firm did not promptly address the deficiencies or improve its supervision.¹²

OPERATIONAL FAILURES

After issuing updates to certain interpretations of its financial and operational rules last year,¹³ FINRA reached a \$9 million settlement earlier this year with a large member firm for, among other things, failing to comply with the Customer Protection Rule.¹⁴ FINRA determined that the firm violated Exchange Act Rule 15c3-3 by failing to maintain possession or control of billions of dollars of fully paid and excess margin securities it carried for customers and by failing to accurately calculate its required customer reserve.¹⁵ The settlement also included disclosure-related violations for the firm's research reports which contained inaccuracies regarding potential conflicts of interest and recordkeeping violations for failing to preserve billions of electronic brokerage records in a non-erasable and non-writable format.¹⁶

FUNDING PORTALS

Recently, FINRA has also shown heightened interest in some less traditional areas, for example on policing crowdfunding misconduct. Earlier this year, FINRA fined two registered funding portals a total \$1.75 million for failing to comply with securities laws and rules designed to protect crowdfunding investors.¹⁷ The two funding portals raised approximately \$20 million over crowdfunding limits, exceeding the scope of permitted activities set forth in Regulation C-F.¹⁸



SNAPSHOT RECAP AND TAKEAWAYS

- After several years of declining totals for fines, restitution, and disgorgement, FINRA is now building momentum and approaching the heights it achieved in the mid-2010s. Sanctions levied for single matters are now approaching the nine-figure mark. Member firms should anticipate that these numbers will continue to follow an upward trajectory as FINRA seeks a seat at the table with other federal securities and prudential regulators.
- Sales practices and supervision remain high on FINRA’s list of Enforcement priorities. Share class initiatives and other product overcharges remain an area of focus with potential for commanding a combination of fines, restitution, and disgorgement.
- Excessive trading practices continue to result in imposition of multi-million-dollar fines. Member firms should ensure that supervisory policies and procedures are reasonably designed to monitor and detect potentially problematic trading activity and pay attention to any customer complaints that involve excessive trading or churning.
- The Customer Protection Rule and FINRA’s recent interpretive guidance should be observed broadly by member firms in the business of taking custody of customer assets. Member firms should also expect further scrutiny of their operational processes more generally.
- Nontraditional areas of interest are also drawing additional scrutiny. Whether related to FinTech developments or through new member participants like funding portals, FINRA will be scrutinizing new products and services that have the potential to harm retail customers.

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¹ News Release, FINRA, FINRA Orders Aegis Capital Corp. to Pay \$1.7 Million in Restitution to Customers Whose Accounts Were Excessively and Unsuitably Traded; Two Supervisors Fined, Suspended for Failing to Respond to Red Flags; Representatives Sanctioned, <https://www.finra.org/media-center/newsreleases/2021/finra-orders-aegis-capital-corp-pay-1-point-7-million-restitution> (Nov. 9, 2021).

² See FINRA Letter of Acceptance, Waiver, and Consent No. 2020068535401 (June 1, 2022).

³ FINRA Rule 3110, Supervision, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110>.

⁴ FINRA Rule 2010, Standards of Commercial Honor and Principles of Trade, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010>.

⁵ *Id.* at 2.

⁶ *Id.* at 3.

⁷ *Id.* at 3-4.

⁸ See FINRA Letter of Acceptance, Waiver, and Consent No. 2016051704305 (Nov. 8, 2021) at 1, 7.

⁹ *Id.* at 7.

¹⁰ *Id.* at 1-2.

¹¹ *Id.* at 4.

¹² *Id.* at 4-5.

¹³ Regulatory Notice 21-45, FINRA Announces Update of the Interpretations of Financial and Operational Rules, available at <https://www.finra.org/rules-guidance/notices/21-45>.

¹⁴ News Release, FINRA, FINRA Fines Credit Suisse Securities \$9 Million for Multiple Operational Failures (Jan. 20, 2022), available at <https://www.finra.org/media-center/newsreleases/2022/finra-fines-credit-suisse-securities-9-million-multiple-operational>.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ News Release, FINRA, FINRA Fines Wefunder \$1.4 Million for Crowdfunding Rule Violations; StartEngine Capital Separately Fined \$350,000 (May 4, 2022), <https://www.finra.org/media-center/newsreleases/2022/finra-fines-for-crowdfunding-rule-violations>.

¹⁸ *Id.*