New Year Resolutions for a Happy, Healthy, and (Hopefully) Enforcement-Free 2016

By Brian L. Rubin and Andrew M. McCormick

The dawn of February brings with it the Super Bowl, an onslaught of heart-shaped candies, and, most importantly, the quick end to all those 2016 New Year’s resolutions. Although we probably cannot help your favorite NFL team hoist the Lombardi Trophy, this article reviews some key 2015 SEC and FINRA enforcement actions and ten takeaways that legal and compliance leaders at broker-dealers and investment advisers may want to include on their list of New Year’s resolutions. (Hopefully, you will be able to keep these resolutions a bit longer than we normally stick with our resolutions.)

Lose Some Weight, But Not Some Documents.

Many of us probably decided that 2016 would finally be the year we exercise more and eat healthier. While many of us may want to lose some weight in this New Year, there is one thing that broker-dealers do not want to lose: documents.

Books and records cases have been a focus for FINRA in recent years and 2015 was no exception. For example, a broker-dealer was fined $2.6 million in a November 2015 FINRA case for allegedly failing to preserve electronic records in a non-rewritable, non-erasable “WORM” format (“Write-Once, Read-Many”), as well as for failing to retain some outgoing emails.1 FINRA alleged that the firm failed to retain some documents in a WORM format during a three-year period and noted that the firm did not have a central document retention process, but rather, each department was responsible for retaining its own documents. FINRA also alleged that the firm failed to retain 168 million outgoing emails in WORM format during a three-year period, which ultimately resulted in those records being deleted. These were automated emails, such as address change and password notification emails sent by the firm and its vendors. When announcing this case, FINRA stated that these types of document retention issues are critical for broker-dealers because books and records are a firm’s “primary means of monitoring compliance with applicable securities laws.”2

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A Practical Compliance Takeaway for a Happy New Year: Firms may want to inventory their documents to determine whether documents that should be preserved in a format pursuant to SEC Rule 17a-4 are in fact properly retained. In addition, firms may want to confirm that unique categories of emails, such as the automatic reply emails at issue in this case, as well as blind carbon copy (BCC) and listserve emails, are being retained and supervised.

Treat Everyone Equally, Unless You’re Not Supposed To.

Although your grandmother may have taught you to treat everyone equally, that philosophy got some broker-dealers in trouble in 2015. A key enforcement focus for FINRA in 2015 involved firms that treated everyone equally when they were supposed to offer certain clients sales discounts. In these cases, the firms did not properly give sales discounts to customers, such as charities and retirement plans, that purchased mutual funds and/or Unit Investment Trusts (UITs). FINRA announced 20 such cases in three separate News Releases in 2015, which resulted in $52 million in restitution and $2.6 million in fines.3 FINRA noted that these firms unreasonably relied on financial advisors to provide these sales discounts to their customers, but the firms did not provide the necessary information and training to these representatives. These waves of cases enabled FINRA to surpass its previous record for restitution, which was $52 million in 2014.4

A Practical Compliance Takeaway for a Happy New Year: Issues such as fee discounts may not typically receive as much compliance scrutiny as sales-related positions, but these recent cases demonstrate that these types of activities can have significant and damaging effects on a firm and its customers. If broker-dealers are going to delegate these types of activities to financial advisors, they should consider whether the advisors have sufficient information and training.

Give More Money Away to Family, Except if it Gets You in Trouble.

After a lot of hard work, budgeting, and saving in 2015, this may finally be the year you can give some money to Uncle Ponzi to support his new investment scheme, errr, opportunity. Although giving money away to family is typically a good thing and a very nice gesture, this got one broker-dealer in trouble in August 2015, resulting in a $2 million fine.5 FINRA alleged that on three different nights, during a six-week period, the firm had net capital deficiencies of up to $775 million. These deficiencies arose after the firm received cash inflows that were too much to invest in existing facilities, causing the firm to transfer $1 billion to its parent company for overnight investments on each of these occasions. The relevant departments of the firm did not communicate about how these transfers could impact the firm’s net capital.

Keep Your Friends Close and Your Suspicious Friends Closer.

Parents often share some important advice with their teenage children: (1) do not spend more money than you have (or more than I have); (2) follow the rules (particularly the federal securities laws); and (3) choose your friends (and your representatives or agents) wisely. That advice holds true for financial firms. The last rule was at issue in a large March 2015 FINRA case.6 FINRA alleged that the firm failed to supervise a financial advisor who excessively traded in his customers’ accounts and even stole customer funds. The firm was required to pay a $2.5 million fine, $1.25 in restitution to affected customers, and $6 million to customers in arbitrations. Prior to joining the firm, the advisor had 12 reportable events, including seven customer complaints and also criminal charges, but he was still hired by the firm. Shortly thereafter, the firm allegedly learned that the financial advisor had been sued by his business partners for allegedly defrauding them out of millions of dollars. However, the firm did not place the advisor on heightened supervision. FINRA also alleged that the firm ignored red flags in correspondence and wire requests, which allowed the advisor to steal nearly $3 million from his customers’ accounts. Finally, FINRA also alleged that the firm failed to properly supervise the advisor’s excessive trading in his customers’ accounts.
A Practical Compliance Takeaway for a Happy New Year: This case imparts many important lessons, including that it is important that firms: (1) respond to red flags promptly and effectively, especially when there is possible customer harm; (2) exercise sufficient due diligence during the hiring process; and (3) apply heightened supervision when necessary.

Clean Up, Well, Everything.

If your house is messy, car is messy, and office is messy, you may want to clean things up in 2016 before your mom/spouse/boss gets mad. Or FINRA. In May 2015, one firm was fined $10 million for broad supervisory failures in many key areas. FINRA alleged that over a period of multiple years, the firm did not adequately: (1) supervise the sales of complex products; (2) train sales representatives; (3) monitor customer accounts; (4) disclose fees; (5) detect and monitor high-risk trading and potential anti-money laundering (AML) activity; (6) deliver 14 million confirmations; and (7) report trade information to regulators. FINRA further alleged that the firm failed to devote sufficient resources to its compliance department. In addition to the $10 million fine for these alleged violations, FINRA also ordered the firm to pay $1.7 million in restitution to certain customers who purchased Exchange-Traded Funds (ETFs).

A Practical Compliance Takeaway for a Happy New Year: The key message from this case, which all compliance officials will likely appreciate, is that firms may want to consider devoting additional resources to compliance departments because wide-reaching deficiencies can lead to substantial fines and increased regulatory scrutiny.

Work on Improving Your Short Temper (and Short Sale Compliance Program).

Short selling issues are a frequent enforcement priority for regulators and often result in significant fines, including a $1.4 million fine announced by FINRA in November 2015. FINRA alleged that the firm reported its short interest positions incorrectly over an eight-year period because it reported the net, rather than gross, short positions in its financial aggregation account. Additionally, FINRA alleged that the firm improperly included the securities positions of a non-U.S. broker-dealer affiliate in the firm’s trading operations data during a ten-year period. Thomas Gira, FINRA’s Head of Market Regulation said that the “foundation for Regulation SHO compliance…is that firms properly track their short positions…and it is incumbent on firms to accurately calculate this information.” FINRA also fined another firm $2 million in a May 2015 case after FINRA alleged that the firm failed to accurately report short interest positions.

Invest Wisely (in Your Compliance Program).

Two 2015 SEC cases against investment advisers serve as reminders that firms’ compliance manuals should be adapted to their businesses and that firms should have enough resources committed to compliance. In the first
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case, from January, the SEC alleged that the firm relied on an “off-the-shelf” compliance manual template that did not reflect the specifics of the firm’s business. The SEC also alleged that the firm did not implement certain review procedures, such as the review of best execution issues and marketing materials. The firm was required to pay a $50,000 penalty. In the second case, from June, an investment adviser, the firm’s president, and two portfolio managers were ordered to pay a combined amount of $285,000 in penalties for allegations that the firm did not devote adequate staffing to the compliance department and did not conduct annual compliance program reviews. Allegedly due to these deficiencies, the firm did not detect compliance violations, including missing documentation of best execution reviews, unreported personal trading by firm representatives, a failure to conduct reviews of the firm’s Code of Ethics, and the failure to hold annual compliance meetings. During the SEC’s investigation of these issues, the firm also self-reported that it had failed to provide best execution to certain customers. In addition to the $285,000 in penalties, the firm’s president was suspended from any compliance or supervisory capacity at any investment firm for 12 months.

A Practical Compliance Takeaway for a Happy New Year: These cases serve as helpful reminders that firms may want to consider reviewing their policies and procedures to see if they are sufficiently tailored to their businesses and are being enforced effectively. Regulators will not only penalize firms for failing to adopt and implement such policies and procedures, but also for the compliance failures that result from these deficiencies.

Learn How to Surf (the Internet Without Clicking on Malware).

An investment adviser paid $75,000 to settle a September 2015 SEC enforcement action involving allegations that the firm failed to establish any cybersecurity policies, procedures, or systems. The firm eventually suffered a breach and the personally identifiable information (PII) of thousands of the firm’s clients was compromised (although it appears there was no customer harm). Despite this lack of action in advance of the breach, the firm acted promptly in response by hiring a cybersecurity consulting firm, notifying affected individuals, and offering free identify theft monitoring.

A Practical Compliance Takeaway for a Happy New Year: Although it is still far from certain what exactly is required of investment advisers (or broker-dealers) when it comes to cybersecurity, this case indicates that firms should do something and have some policies and procedures addressing this important issue. Further, when announcing this case, the SEC stated that, in addition to having cybersecurity policies and procedures, firms should “anticipate potential cybersecurity events” and prepare accordingly.

Tell the Truth, the Whole Truth, and Nothing but the Truth About Fees.

Sometimes, it can be awkward to talk about money (especially about whether cousins Randolph and Mortimer still owe you money for your failed investment in frozen concentrated orange-juice futures). However, a significant October 2015 settlement between the SEC and three affiliated investment advisers emphasizes that such discussions are sometimes critical. These investment advisers agreed to pay nearly $39 million to settle allegations that they failed to fully disclose fee information to investors. This payment included $29 million of restitution to affected investors. The SEC alleged that the three firms obtained accelerated monitoring fees paid by fund-owned portfolio companies, which reduced the value of the underlying fund companies. The firms did not inform the funds’ investors about these accelerated fees. The advisers
also negotiated a significant fee discount from an outside law firm for legal services performed for the adviser, but did not negotiate a similar discount for the underlying funds. The SEC asserted that these actions violated the advisers’ fiduciary duty to its clients.

**A Practical Compliance Takeaway for a Happy New Year:** This case demonstrates that investment advisers may want to review whether they are taking adequate steps to disclose all fee information to their customers. The SEC warned when announcing this settlement that it will “continue taking action against advisers that do not adequately disclose their fees and expenses.”17

Avoid Conflicts (or at Least Disclose Them).

An investment adviser agreed to pay a $20 million penalty in an August 2015 SEC action for allegedly breaching its fiduciary duty to its clients by failing to disclose a $50 million loan one of its senior executives received from an advisory client.18 The client and the executive later structured two transactions in which other advisory clients of the firm invested. These clients were not informed about the loan and neither was the firm’s compliance staff, even though senior officials at the firm and its parent company knew about the loan. Similarly, in a March 2015 SEC action, an investment advisory firm and its owner were required to pay a combined $589,000 penalty, including $239,000 in restitution, for allegedly failing to disclose loans between funds managed by the firm.19 A January 2015 SEC case against an investment adviser resulted in a $150,000 penalty after the SEC alleged that the firm failed to report a $50,000 personal loan between the firm’s CEO and another investment adviser that the firm recommended to some of its clients.20

**A Practical Compliance Takeaway for a Happy New Year:** Similar to the first investment adviser fee disclosure case referenced above, these three conflict of interest cases emphasize that regulators are focusing on the disclosures made to clients. It may not be sufficient to disclose only some material facts or certain conflicts of interest, but as the SEC noted when announcing the $20 million settlement, “investment advisors must be vigilant about disclosing all material facts to their clients, including actual and potential conflicts of interest.”

Conclusion

Although broker-dealers and investment advisers often emphasize that past results are not indicative of future performance, this may not apply to recent SEC and FINRA enforcement actions. The 2015 enforcement actions discussed above were significant cases that led to large penalties and fines being paid by financial firms last year. Firms shouldn’t be surprised if similar issues continue to capture the attention of the SEC and FINRA in 2016.
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9 Id.


15 Id.


17 Id.


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