

FINRA Facts and Trends: May 2023

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Welcome to the latest issue of Bracewell's FINRA Facts and Trends, a monthly newsletter devoted to condensing and digesting recent FINRA developments in the areas of enforcement, regulation and dispute resolution. This month, we report on FINRA's appearance at SIFMA, new Reg BI guidance, and the SEC's approval of further changes to the expungement process. Read about these issues, along with notable enforcement actions and regulatory notices, below.

FINRA's Areas of Interest Include Crypto and "FinFluencers"

At the recent Securities Industry and Financial Markets Association (SIFMA) [Compliance and Litigation Seminar](#), FINRA staff members highlighted several areas they expect FINRA to focus on in 2023.

- **Digital Assets.** While the SEC Division of Enforcement has recently announced [doubling the size](#) of its Crypto Assets and Cyber Unit, FINRA has thus far released few details about its plans to regulate in this space. At the SIFMA conference, FINRA panelists indicated that FINRA is exploring regulation of matters "adjacent to" traditional broker-dealer activities. As perhaps a clue into its plans, FINRA separately [announced](#) it was expanding its Memorandum of Understanding with the National Futures Association to address information sharing and collaboration in the areas of crypto assets, blockchain technology development and crypto asset regulatory risks.
- **Social Media.** According to panelists, FINRA expects to monitor closely firms' use of social media in providing financial and investment advice. In line with this expectation, in March, FINRA provided an [update](#) of its ongoing targeted sweep to review firms' social media practices, including use of financial influencers (or "FinFluencers") and referral programs.
- **Regulation Best Execution.** Although FINRA already has long-standing best execution rules in place, it expects that there may be new rulemaking in light of the SEC's proposed "[Regulation Best Execution](#)" for securities.
- **Regulation Best Interest (Reg BI).** As the compliance date for Reg BI approaches its third anniversary, FINRA has indicated that it has come to see this as a "mature" rule, and may continue to increase enforcement.

- **Remote Inspections.** FINRA said it expects to revise its proposals relating to inspections of branch offices and home offices, which are currently awaiting SEC approval.
- **Complex Products.** FINRA panelists indicated that they intend to focus on sales of complex products and options to retail investors.

SEC Issues New Reg BI Guidance

The U.S. Securities and Exchange Commission (SEC) has published [guidance](#) on how broker-dealers and investment advisors can meet their care obligations when providing investment advice and recommendations to retail investors. The guidance, the agency's third bulletin on Reg BI, clarifies brokers' and advisers' "care obligations" under Reg BI and the Investment Advisers Act of 1940 for investment advisors.

Reg BI's care obligation consists of three general categories: understanding the potential risks, rewards and costs associated with investments and strategies; understanding the retail investor who will be receiving the recommendations or advice; and based on that knowledge and a consideration of reasonably available alternatives, what investments or strategies are in the best interest of the investor.

The bulletin, released in Q&A form, is divided into five parts that address the following topics:

- To what extent financial professionals need to understand the investment or investment strategy they are advising on or recommending;
- To what extent professionals need to understand the retail investor's investment profile;
- Whether and how firms and professionals should develop and evaluate reasonably available alternatives;
- What considerations should be given to complex or risky products; and
- What considerations should be given concerning recommendations and advice by dual registrants.

While the bulletin is intended to assist broker-dealers and their investment professionals in meeting their care obligations, ultimately the evaluation of whether the recommendation or advice satisfies the care obligation is an objective standard based on the unique facts and circumstances of the particular recommendation and the investment profile of the customer at the time the recommendation is made.

The current set of guidelines follows a report earlier this year in which FINRA confirmed its plan to complete at least 1,000 Reg BI exams of broker dealers by year-end. This means that by the end of 2023, approximately one-third of all FINRA's member firms will be examined for compliance with Reg BI.

SEC Approves FINRA's Changes to Expungement Process

A FINRA proposal designed to make it harder for brokers to rid their records of customer disputes has now been approved by the SEC. FINRA first filed its proposed changes to the expungement process in September 2020. FINRA then withdrew that proposal in July 2021 after

investor attorneys and state securities regulators raised concerns that the reform would not sufficiently address what they believed to be a too-lenient expungement process. As we reported [previously](#), in an effort to address those concerns, FINRA filed a revised version of the proposal last July with the SEC. The SEC has now approved this proposal.

Among other things, the new rules will establish a special roster of arbitrators to hear “straight-in” expungement requests, will place time limits on when brokers can make expungement requests, preclude expungement requests in cases where a court had already found a broker liable, and require earlier notification of customers and state regulators when brokers seek expungement. FINRA has not yet announced when the new FINRA rules will go into effect.

Newly Released FINRA Data Confirms Sharp Decline in 2022 Net Income

FINRA recently released its 2023 Industry Snapshot, its annual report on the brokerage firms, registered representatives and market activity under its jurisdiction. “The 2023 Snapshot maintains FINRA’s commitment to providing a data-driven view into the securities industry and its activities through the lens of regulatory reporting,” said FINRA Chief Economist and Executive Vice President Jonathan Sokobin. “We continue to add new data categories to the Industry Snapshot, increasing the transparency of and visibility into an evolving securities industry.” The report found that brokerage firms of all sizes suffered during the financial downturn last year. Specifically, FINRA-registered firms obtained a pretax net income of \$42.3 billion in 2022, down sharply from \$91.6 billion in 2021 and \$77.3 billion in 2020. The report also found that the number of brokerage firms FINRA regulates fell last year to a total of 3,378, while the number of investment professionals increased to 620,882, up from 612,435 in 2021. This is the fourth straight year that the number of brokerage firms has fallen. The full report can be found [here](#).

BrokerCheck to Begin Identifying “Restricted Firms”

[Last year](#), we reported on FINRA’s adoption of Rule 4111, which establishes a “Restricted Firm” label for broker-dealers that historically have had higher levels of risk-related disclosures, and also requires those firms to put aside reserve funds that can be used only to pay future or unpaid investor claims. This month, FINRA adopted amendments to Rule 8312 to release information on BrokerCheck as to whether a particular member firm has a “restricted” designation. These amendments are to take effect soon, on June 1, 2023.

Notable Enforcement Matters and Disciplinary Actions

- **Over-the-Counter Options.** A multinational bank was sanctioned \$2.5 million for its alleged failure to accurately report approximately 4.3 million over-the-counter (“OTC”) options positions to FINRA’s Large Options Positions Reporting (LOPR) system. FINRA uses LOPR information to identify holders of large options positions and to police the market for potentially illegal behavior.

The bank’s reporting failures spanned more than a decade and resulted from four separate coding errors. FINRA also determined that the bank failed to establish and maintain a supervisory system with respect to LOPR reporting. The Letter of Acceptance, Waiver, and Consent (AWC) detailing FINRA’s findings on this matter is available [here](#).

- **Short Sale Orders.** A multinational investment bank was sanctioned \$3 million for allegedly mismarking as “long” about 60 million short sale orders, totaling more than 14

billion shares. This error, which took place over the course of approximately 2½ years, was apparently caused by the omission of a single line of code that was designed to copy the long or short mark from a parent sell order to its child.

Of the 60 million affected orders, approximately eight million were actually executed. The mismarked orders resulted in inaccurate trade reports being filed with FINRA, and more than 12,000 orders being executed at or below the national best bid while a short sale circuit breaker was in effect. The AWC for this matter is available [here](#).

- **Trading Approval.** A broker-dealer was fined \$3 million for its alleged failure to exercise due diligence in approving customers for options trading. The firm employed an automated system to approve customer accounts, which contained flaws and was insufficiently supervised, according to FINRA.

Due to the broker-dealer's alleged violations, customers were approved for options trading authority who did not satisfy eligibility criteria or whose accounts contained red flags. For example, more than 2,500 customers under the age of 21 were approved to trade options spreads, even though such customers were required to have at least three years of trading experience. The AWC for this matter is available [here](#).

Notices and Rule Filings

- **[Regulatory Notice 23-06](#):** In an update of last October's [warning](#) about a rising trend of fraudulent transfers of customer accounts using the Automated Customer Account Transfer Service (ACATS), FINRA disseminated advice explaining how to detect and address this fraudulent activity. ACATS is an automated system established by the National Securities Clearing Corporation to facilitate the transfer of customer assets from one firm to another.

FINRA advises that potential indicators of ACATS fraud include: repeated rejections of a customer's transfer requests; requests for asset transfers soon after a new account is opened; and sudden changes in a customer's usual communication pattern (e.g., communicating only by email).

To mitigate risk of ACATS fraud, FINRA recommends that member firms adopt policies to: verify customer identities for accounts established online; verify transfer requests (particularly if red flags are raised); ensure reviews of transfer requests by the customer; escalate suspicious issues via the firm's anti-money laundering program; and thoroughly investigate and report all potentially fraudulent account transfer requests.