

FINRA Facts and Trends: September 2023

September 28, 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 a case that sheds light on potential liability for Chief Compliance Officers in connection with firms’ supervisory rule violations, new proposed rules on the use of artificial intelligence, the implementation of changes to both the arbitrator selection process and expungement proceedings, and much more.

FINRA Enforcement Action Highlights Focus on Reg BI and Potential Liability for Chief Compliance Officers

On August 31, FINRA released [a letter of Acceptance, Waiver and Consent](#) (AWC) pertaining to a settled enforcement action against Network 1 Financial Securities and its Chief Compliance Officer (CCO).

The case against Network 1 involved allegations of excessive trading, which FINRA found resulted in violations of both FINRA Rule 3110 (Supervision) and Regulation Best Interest (Reg BI). FINRA’s finding that Network 1 violated Rule 3110 was based on the firm’s alleged failure to implement written supervisory procedures (WSPs) designed to achieve compliance with the suitability rule, FINRA Rule 2111. In particular, FINRA noted that Network 1’s WSPs failed to provide guidance to supervisors as to: how to identify excessively traded accounts, what steps to take in the event of excessive trading, and when excessive commissions should be restricted in a customer’s account.

While cases involving excessive trading, or “churning,” are par for the course for FINRA Enforcement, there were two aspects of this case that made it especially notable.

First, the case highlights FINRA’s continuing focus on violations of Reg BI, which has been at the center of several cases brought by FINRA since Reg BI’s implementation in June 2020. In its findings, FINRA noted that the deficiencies in Network 1’s WSPs constituted a violation of Reg BI’s Compliance Obligation. FINRA also examined the efforts of Network 1 and its CCO to update the company’s WSPs to address the new Reg BI obligations. While Network 1 did issue new guidance to the firm’s employees and conducted new training programs concerning the new “best interest” standard, FINRA found that these new policies were implemented too late. Specifically, Network 1 and its CCO did not revise the firm’s WSPs consistent with Reg BI until March 2021, eight months after Reg BI’s effective date.

The second remarkable aspect of the case is the liability imposed on Network 1’s CCO. Disciplinary actions being brought against CCOs based on a firm’s alleged supervisory failures

are exceedingly rare. Indeed, when FINRA issued [**Regulatory Notice 22-10**](#) last year to clarify the standards for liability for CCOs, it noted that “charges against CCOs for supervisory failures represent a small fraction of the enforcement actions involving supervision that FINRA brings each year.” This comment is borne out by the data: between 2018 and 2021, FINRA brought nearly 440 enforcement actions involving violations of Rule 3110 for supervisory failures—and only 28 of those actions involved charges against a CCO. Even among those 28 cases, 18 involved a CCO who was also the Chief Executive Officer or president of the firm, while the remaining 10 cases involved CCOs upon whom the firm had conferred specific supervisory responsibility.

FINRA Regulatory Notice 22-10 set forth guidelines for the rare circumstances in which a CCO might be charged for failing to reasonably perform a designated supervisory responsibility. According to FINRA, factors that weigh in favor of charging a CCO in specific cases include where: (1) the CCO was aware of, but failed to address, multiple red flags; (2) the CCO failed to establish, maintain or enforce the firm’s WSPs; (3) the CCO’s supervisory failure resulted in actual rule violations; and (4) those violations caused a high likelihood of consumer harm. These factors presumably played a role in the imposition of liability on Network 1’s CCO, although the AWC itself does not provide much analysis as to how this case differed from the myriad other supervisory violations that do not result in individual charges brought against CCOs.

The settlement in this case holds lessons for financial institutions and their CCOs. Firms should be sure to update their WSPs in a timely manner when new regulations are issued, and to conduct reviews of supervisory procedures to ensure they are in full compliance with Reg BI. For their part, CCOs should closely review FINRA Regulatory Notice 22-10 and be aware of the potential for liability if they lack diligence in discharging their designated supervisory responsibilities.

Amicus Briefs Filed in Challenge to Constitutionality of FINRA’s Enforcement Powers

In July, we [**reported**](#) on the emergency injunction granted by the US Court of Appeals for the DC Circuit in an appeal brought by Alpine Securities Corporation (“Alpine”) challenging the constitutionality of decisions rendered by FINRA’s Enforcement division. Alpine’s legal argument seeks to build on a recent US Supreme Court decision that reined in the power of SEC administrative law judges based on a determination that their powers violated the Appointments Clause of the US Constitution. If the DC Circuit reaches a similar ruling on the merits against FINRA, it could have far-reaching implications for the future of FINRA’s regulatory and enforcement programs.

The DC Circuit appeal in *Alpine* remains pending, and briefing on the underlying merits of the appeal is ongoing (FINRA, as Respondent, has yet to file its appeal brief). Earlier this month, multiple third-party organizations filed amicus briefs setting forth their own positions and highlighting certain public policy implications for the potential decision.

The non-profit New Civil Liberties Alliance and the American Free Enterprise Chamber of Commerce, a membership organization backed by former Attorney General William Barr, both filed briefs arguing that FINRA’s powers should be declared unconstitutional. In its brief, the New Civil Liberties Alliance argues that FINRA’s enforcement program violates the Constitution because it is empowered “to investigate, prosecute, and punish securities brokers and firms for violating federal securities laws and rules without any meaningful direction or supervision of those functions even by SEC, much less the President.” The American Free Enterprise Chamber

of Commerce argues along similar lines that FINRA’s structure creates “an unaccountable arrangement,” in which FINRA is “private enough to avoid Article II’s structural appointment and removal safeguards, but public enough to garner immunity from private suit.”

On the other side of the coin, the Municipal Securities Rulemaking Board (MSRB) filed an amicus brief in support of the reverse argument: that the district court’s conclusion that FINRA is a private entity, not a state actor, should be upheld. The MSRB argues that FINRA—and the MSRB, which is itself a self-regulatory organization in the municipal securities market—is a private organization, not funded by any government entity, and which performs functions that are not shared by any government agency. In the MSRB’s view, these facts preclude a finding that FINRA is a governmental entity, and thus that its powers are subject to the Appointments Clause or are otherwise unconstitutional.

Bracewell continues to monitor this case and will report on its progress and potential implications for FINRA.

The SEC Takes on Artificial Intelligence

The SEC recently [*unveiled a new set of rules*](#) aimed at addressing conflicts of interest related to the use of predictive data analytics and similar technologies by broker-dealers and investment advisors. The proposed regulations would require firms to take specific actions to ensure that they prioritize investors’ interests above their own.

The SEC’s move comes in response to the accelerated adoption of technology-driven tools by broker-dealers and investment advisors to optimize and forecast investment-related behaviors. While these technologies can enhance market access and efficiency, concerns arise when they are employed in ways that may harm investors by elevating the firm’s interests above those of their customers. The proposed rules aim to strike a balance by promoting technological innovation while ensuring investor protection.

Based on existing guidelines, the proposed rules generally would require firms to evaluate, and then either eliminate or neutralize, the effect of any conflicts of interest. The proposed rules would also direct firms to have written policies and procedures reasonably designed to achieve compliance with the new regulations, as well as to make and keep necessary books and records.

The [*public comment period*](#) for the proposed rule runs through October 10, 2023.

Proprietary Traders Now Required to Register with FINRA

Last month, the SEC [*adopted amendments*](#) to Exchange Act Rule 15b9-1, which would require certain broker-dealers engaged in proprietary trading to register with FINRA. Before these amendments, traders using their own capital were permitted to engage in unlimited trading on any exchange of which they were not members, or in the off-exchange market, without FINRA oversight.

Under the new amendments, SEC-registered brokers or dealers will be required to join FINRA if they carry out off-member-exchange securities transactions. Firms, however, will continue to be exempt from this requirement if they are members of a national securities exchange and have no customer accounts, among other things. According to the SEC, the amendments to Rule 15b9-1 (which had remained unchanged for several decades) are necessary due to the

proliferation of off-member-exchange proprietary trading, and the explosion of highly automated and complex technologies for generating, routing and executing orders.

The SEC's adoption of the new amendments was not without disagreement, however. Two of the five SEC commissioners dissented from the final rule, arguing that the one-year implementation period is too short and that FINRA is the wrong entity to impose the new regulatory framework for off-member-exchange securities transactions. Instead, the dissenters called for oversight directly by the SEC itself or the creation of a new self-regulatory organization.

Prejudgment Relief in a FINRA Arbitration

In an interesting legal maneuver, Connecticut financial services company Smith Brothers Financial LLC is **asking** a state superior court judge to award a prejudgment remedy with respect to an arbitration separately proceeding in FINRA.

In the underlying arbitration, Smith Brothers alleges that two former associates attempted to take clients with them when leaving the firm, in violation of their non-solicitation agreements. Under those agreements, disputes were to be settled via arbitration before a FINRA panel. FINRA arbitration panels, however, lack the authority to award prejudgment relief.

Smith Brothers, allegedly concerned that a future FINRA award would be uncollectable, filed an application in Connecticut state superior court for a \$1.4 million prejudgment remedy against one of the FINRA respondents. In its application to attach the respondent's assets, Smith Brothers was required to attest that the amount of debt was valid and that it was likely to prevail in FINRA. It remains to be seen whether this dual-pronged approach will be successful.

FINRA Issues Multi-Million Dollar Fine in First CAT Reporting Case

On August 16, 2023, brokerage firm Instinet LLC agreed to a fine of \$3.8 million to settle an enforcement action with FINRA arising out of Instinet's alleged failure to timely and accurately report tens of billions of orders to the Consolidated Audit Trail (CAT) Central Repository. This is the first time FINRA has initiated an enforcement action against a brokerage firm for failing to comply with its CAT reporting obligations. FINRA's enforcement action serves as a reminder to member firms to reexamine the effectiveness of their CAT compliance protocols.

What is CAT? CAT is a central repository that was created by the SEC in the wake of the May 2010 "flash crash," a trillion-dollar stock market crash that lasted for thirty-six minutes. In an effort to avoid another "flash crash," the SEC implemented CAT to address the audit trail of all transactions. The SEC adopted CAT, also known as Rule 613, in order to "create a comprehensive consolidated audit trail that would allow regulators to efficiently and accurately track all activity throughout the US markets in National Market System (NMS) securities." In the years since CAT became effective, FINRA has used this data as part of its automated market surveillance system to detect manipulative activity and other violations. FINRA Rule 6830(a) requires that member firms record and electronically report certain data for each order and then report that information to the CAT Central Repository.

The CAT Central Repository was officially rolled out in June 2020, under the supervision of the SEC. In early June 2020, Instinet notified FINRA that it expected to experience CAT reporting difficulties. According to FINRA, Instinet had retained a third party to act as its CAT reporting agent, but the agent had difficulty converting Instinet's data into a CAT-reportable format due

to inadequate and confusing technical specifications. FINRA claimed that this conversion issue resulted in Instinet failing to timely report over 5.2 billion equities and options order events to the CAT Central Repository. Instinet also identified approximately 180 different types of CAT reporting errors that FINRA claims caused the firm to inaccurately report data for tens of billions of order events.

This significant fine should come as no surprise to member firms, as FINRA previously highlighted CAT compliance in its [2023 Report on FINRA's Examination and Risk Monitoring Program](#). FINRA member firms subject to CAT reporting should make sure that all data is timely and accurately reported to the CAT Central Repository and should separately assess whether their current supervisory reviews effectively and comprehensively satisfy all CAT reporting requirements.

SEC Approves Rule Changes to Arbitrator Selection Process

As we reported [previously](#), on June 29, 2022, FINRA published a 37-page report from independent counsel retained by FINRA's Audit Committee of the Board of Governors. The report set forth a series of recommendations designed to "better reflect the neutrality of the dispute resolution services forum ["DRS"] and to further promote uniformity and consistency among the different DRS regions." Seeking to address those recommendations, on December 23, 2022, FINRA filed with the SEC SR-FINRA-2022-033 to make certain modifications to the arbitrator selection process. On September 7, 2023, the SEC approved the rule in [Release No. 34-98317](#), and it is expected to go into effect in the coming months.

Among other things, the new rule provides that: (i) the FINRA director must explain in writing her decision to grant or deny a party's request to remove an arbitrator; (ii) a challenge for cause may be filed at any point after a party receives the arbitrator ranking lists generated by the list selection algorithm until the start of the first hearing session; and (iii) the director will exclude arbitrators from the lists based on a review of current conflicts of interest not identified within the list selection algorithm.

New Expungement Rules to Go into Effect Next Month

As we reported [previously](#), on April 12, 2023, the SEC approved a FINRA proposal designed to make it more difficult for brokers to rid their records of customer disputes. On August 11, 2023, the SEC formally approved FINRA's proposed rule changes in [Regulatory Notice 23-12](#) and noted that the amendment would become effective on October 16, 2023. The rule changes include, among other things: (i) time limits on when expungement requests can be filed; (ii) the creation of a special roster of arbitrators who have been approved to hear expungement requests; (iii) a requirement that all expungement decisions be unanimous; (iv) preclusion of requests for expungement in cases where a court had already found a broker liable; and (v) earlier notification of customers and state regulators when brokers seek expungement.

These new rules will make the process of obtaining expungements considerably more difficult. Registered representatives should consider filing an expungement request before the new rules go into effect if they believe their CRDs contain false customer complaints or disclosures.

FINRA Notices

- [Regulatory Notice 23-13](#) – FINRA amended its rules to allow for video conference hearings in matters before the Office of Hearing Officers and the National Adjudicatory

Council. While FINRA noted that in-person hearings remain the default, it now allows video hearings under specific circumstances where an in-person proceeding could endanger the health or safety of the participants or would be impracticable. This rule change makes permanent an existing, temporary amendment for video hearings during the COVID-19 pandemic, and modifies it to extend to other health risks beyond COVID-19.

- ***Regulatory Notice 23-14*** – FINRA amended the requirements related to Covered Agency Transactions, first enacted by FINRA in 2016. The rule implemented in 2016 defines “Covered Agency Transaction” to mean three types of transactions: (1) “To Be Announced” transactions, as defined by FINRA Rule 6710(u) (including adjustable rate mortgages); (2) Specified Pool Transactions, as defined by FINRA Rule 6710(x); and (3) Transactions in Collateralized Mortgage Obligations, as defined by FINRA Rule 6710(dd).

The amendments announced in Regulatory Notice 23-14 encompass three changes. First, FINRA has eliminated the two percent maintenance margin requirement that the 2016 rule applied to Covered Agency Transactions by non-exempt accounts. Second, FINRA now permits members (in certain circumstances) to take a capital charge in lieu of collecting margin for excess mark to market losses on Covered Agency Transactions. Third, FINRA made revisions to the rule language to streamline, consolidate and clarify the rule.

- ***Regulatory Notice 23-15*** – In connection with the recent SEC amendment to Exchange Act Rule 15c6-1(a), which shortens the standard settlement cycle for most broker-dealer transactions from two business days to one business day after the trade date, FINRA is updating the Regulatory Extension (REX) system to enable firms to file extension of time requests under the shortened settlement cycle. The update is intended to aid firms in preparing for the transition under the SEC rule amendment.