Enforcement Developments

Tuesday, May 17, 2022
11:00 a.m. – 12:00 p.m.

This session provides an overview of new developments and trends in enforcement, including enforcement priorities. Panelists highlight noteworthy decisions and settlements that illustrate FINRA priorities and provide guidance on regulatory and compliance practices.

Moderator: Christopher Kelly
Senior Vice President and Deputy Head of Enforcement
FINRA Enforcement

Panelists: Melissa Hodgman
Associate Director, Division of Enforcement
U.S. Securities and Exchange Commission (SEC)

Jessica Hopper
Executive Vice President and Head of Enforcement
FINRA Enforcement

Enforcement Developments Panelists Bios:

Moderator:

Christopher Kelly serves as Senior Vice President and Deputy Head of Enforcement. In that role, he oversees the work of the Main Enforcement staff who work from FINRA's headquarters in Maryland and New York, as well as the Sales Practice Enforcement staff in FINRA's 14 offices throughout the country. He joined FINRA in 2014 and served as Chief Counsel in FINRA's North Region until early 2018. Prior to joining FINRA, Mr. Kelly served as Deputy Chief of the Criminal Division at the U.S. Attorney's Office for the District of New Jersey. In that role, Mr. Kelly supervised more than 35 Assistant U.S. Attorneys in the Office's white collar units: Economic Crimes, National Security, Healthcare and Government Fraud, and Cybercrime. Prior to his promotion to the position of Deputy Chief, Mr. Kelly served as the Chief of the Economic Crimes Unit at the U.S. Attorney's Office, where he oversaw the Office's prosecution of complex economic crimes, including crimes involving insider trading, securities fraud, tax evasion, bank fraud, corporate fraud and embezzlement. Mr. Kelly also served as the lead prosecutor on numerous criminal prosecutions. Mr. Kelly graduated from Duke University and Harvard Law School. Prior to joining the U.S. Attorney's Office, he was an associate at the law firm Dechert LLP. Mr. Kelly also clerked for the Honorable Joseph E. Irenas, U.S. District Court Judge for the District of New Jersey.

Panelists:

Melissa R. Hodgman is Associate Director in the Division of Enforcement at the U.S. Securities and Exchange Commission. She joined the Commission in 2008, became Senior Counsel in 2009, joined the newly formed Market Abuse Unit in 2010, was promoted to Assistant Director in 2012, and to Associate Director in 2016. Ms. Hodgman served as the Acting Director of the Division of Enforcement at the U.S. Securities and Exchange Commission from January 2021 until July 2021. She was an Associate at Milbank, Tweed, Hadley & McCloy. She obtained a BSFS in 1990, a J.D., *magna cum laude,* in 1994, and an LL.M in Securities with Distinction in 2007 from Georgetown University.

Jessica Hopper is Executive Vice President and Head of Enforcement, responsible for FINRA's disciplinary actions across the country. Prior to assuming this role in January 2020, she was Senior Vice President and Deputy Head of Enforcement for four years, and Senior Vice President in charge of the Regional Enforcement program in the 14 FINRA District Offices from 2011 to 2016. Ms. Hopper joined FINRA in 2004 and was a Director in FINRA's Washington D.C. office until 2011. Prior to joining FINRA, from 2000 to 2004, she was part of Legg Mason Wood Walker, Inc.'s Legal & Compliance team, where her responsibilities focused on retail sales compliance. She began her career as a litigation attorney in private practice. Ms. Hopper holds a J.D. from the University of Toledo College of Law and earned a B.A. from Hillsdale College.

Enforcement Developments

Panelists

- **Moderator**
  - Christopher Kelly, Senior Vice President and Deputy Head of Enforcement, FINRA Enforcement
- **Panelists**
  - Melissa Hodgman, Associate Director, Division of Enforcement, U.S. Securities and Exchange Commission (SEC)
  - Jessica Hopper, Executive Vice President and Head of Enforcement, FINRA Enforcement

Regulatory Notice 19-23

July 11, 2019

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topic
- Extraordinary Cooperation

Referenced Rules & Notices
- FINRA Rule 4530
- FINRA Rule 8210
- FINRA Rule 8313
- Regulatory Notice 08-70
- Regulatory Notice 11-32
- Regulatory Notice 19-04
- Sanction Guidelines

FINRA Investigations

FINRA Supplements Prior Guidance on Credit for Extraordinary Cooperation

Summary

FINRA is issuing this *Notice* to restate and supplement prior guidance regarding the circumstances under which a firm or individual may influence the outcome of an investigation by demonstrating extraordinary cooperation. This *Notice* incorporates FINRA's prior guidance and provides clarification and additional information about how FINRA assesses whether a potential respondent's cooperation is "extraordinary" and distinct from the level of cooperation expected of all member firms and their associated persons.

Questions concerning this *Notice* should be directed to:

- Lara Thyagarajan, Senior Vice President & Counsel to the Head of Enforcement, at (212) 858-4176 or *Lara.Thyagarajan@finra.org*; and
- Megan Davis, Senior Counsel, Enforcement, at (646) 315-7336 or *Megan.Davis@finra.org*.

Background & Discussion

FINRA recognizes extraordinary cooperation by respondents when making its enforcement determinations. In 2008, FINRA published *Regulatory Notice 08-70* to apprise industry participants of the factors FINRA considers in determining whether and how to award credit for extraordinary cooperation in a FINRA investigation. FINRA noted that the types of extraordinary cooperation by a firm or individual that could result in credit can be categorized as follows: (1) self-reporting before regulators are aware of the issue; (2) extraordinary steps to correct deficient procedures and systems; (3) extraordinary remediation to customers; and (4) providing substantial assistance to FINRA's investigation. The guidance set forth in *Regulatory Notice 08-70* is restated and incorporated into this *Notice*.

FINRA
Financial Industry Regulatory Authority

Subsequent changes to FINRA's rules, including the adoption of FINRA Rule 4530(b)—which requires member firms to report internal conclusions of violations of certain laws, rules, regulations or standards of conduct—may have created uncertainty around the continued impact that self-reporting may have on a potential respondent's ability to receive credit for extraordinary cooperation. In addition, other FINRA rules and policies—such as FINRA Rule 8210 and FINRA's *Sanction Guidelines*—expect certain levels of cooperation in every case.

To provide further clarity on the differences between required cooperation and extraordinary efforts, and in response to comments from the industry requesting further transparency,[1] FINRA is issuing this *Notice*, which incorporates its prior guidance and provides additional information regarding the circumstances under which credit for extraordinary cooperation will be awarded and the nature of credit available. In doing so, FINRA hopes to incentivize firms and associated persons to voluntarily and proactively assist FINRA. This, in turn, will aid FINRA in meeting its objectives of investor protection and market integrity by quickly identifying and remediating misconduct.

What Is Extraordinary Cooperation?

FINRA's *Sanction Guidelines* state, "Sanctions in disciplinary proceedings are intended to be remedial and to prevent the recurrence of misconduct."[2] While disciplinary actions are an important tool that FINRA uses to achieve the goals of remediation and prevention, actions taken by member firms and associated persons are also an important part of that effort. Action by member firms and associated persons that demonstrates their commitment to remediating past misconduct and preventing recurrence is essential to furthering FINRA's mission of investor protection and market integrity.

Therefore, FINRA always considers factors such as corrective measures and payment of restitution in assessing whether a disciplinary action is necessary, and, if so, what sanctions are appropriate. FINRA's *Sanction Guidelines* direct Enforcement to consider whether a respondent:

i. accepted responsibility for and acknowledged the misconduct prior to detection and intervention by the firm or a regulator;[3]

ii. voluntarily employed subsequent corrective measures, prior to detection or intervention by the firm or by a regulator, to revise general and/or specific procedures to avoid recurrence of the misconduct;[4]

iii. voluntarily and reasonably attempted, prior to detection and intervention by a regulator, to pay restitution or otherwise remedy the misconduct;[5] and

iv. provided substantial assistance to FINRA in its examination and/or investigation of the underlying misconduct.[6]

FINRA has and will continue to look to these factors when assessing sanctions in disciplinary matters.[7] For example, Enforcement may recommend a sanction that is on the low end of the specified range in the *Sanction Guidelines* based on the presence of these mitigating factors. In certain circumstances, Enforcement also may determine to forgo recommending formal disciplinary action entirely.

Enforcement may recommend a sanction that is **well below** the range set forth in the *Sanction Guidelines* or comparable precedents when respondents have voluntarily provided such material assistance to FINRA in its investigation, or effected such expedient and effective remediation, that FINRA deems these steps to constitute "extraordinary cooperation" beyond what it requires of any member firm or associated person. Member firms and associated persons who take proactive and voluntary steps well beyond those required under FINRA rules materially assist FINRA in meeting its goals of investor protection and market integrity. To recognize and incentivize such conduct, FINRA weighs these mitigating factors so heavily that the outcome of the matter is materially different than it would have been absent the respondent's extraordinary conduct.

In several matters in recent years, FINRA has granted substantial credit to firms based on their extraordinary cooperation:

- Beginning in 2015 through 2018, FINRA ordered a number of firms to pay more than $75 million in restitution, including interest, to affected customers for failing to waive mutual fund sales charges for certain charitable and retirement accounts. FINRA did not impose fines in those matters based on the firms' extraordinary cooperation. Firms initiated, prior to detection or intervention by a regulator, investigations to identify whether the misconduct existed; promptly established a plan of remediation for affected customers; promptly self-reported the conduct to FINRA; promptly took action and remedial steps to correct the violative conduct; and employed subsequent corrective measures, prior to detection or intervention by a regulator, to revise their procedures to avoid recurrence of the misconduct.

- In September 2017, FINRA ordered a respondent firm to pay approximately $9.8 million in restitution to customers who were affected by the firm's failure to establish and maintain a supervisory system reasonably designed to detect and prevent unsuitable short-term trading of unit investment trusts. While FINRA fined the firm $3.25 million, this reflected substantial credit for the firm's extraordinary cooperation and remediation to customers. The firm initiated, prior to intervention by a regulator, a firm-wide investigation to identify the scope of potentially unsuitable trades, which included the interview of a substantial number of firm personnel and the retention of an outside consultant to conduct a statistical analysis; identified harmed customers and established a plan to provide remediation; and provided substantial assistance to FINRA in its investigation.

- In October 2018, FINRA sanctioned a firm for failures to supervise firm functions it outsourced to a vendor. FINRA did not impose a fine, acknowledging, among other things, the firm's self-report, which extended beyond its obligation to self-report pursuant to FINRA Rule 4530; the extraordinary steps the firm took to remediate, including weekly meetings with the vendor's CEO and COO, hiring two full-time employees to implement controls, and assigning a dedicated manager to oversee the vendor; changing its billing structure to avoid similar issues; and conducting a comprehensive review of all its wealth management accounts to identify impacted investors, whom it voluntarily paid $4.6 million in restitution.

FINRA resolved these matters in consideration of the factors set forth in both the *Sanction Guidelines* and *Regulatory Notice 08-70*, including a consideration of both the timeliness and quality of the respondents' corrective measures and cooperation. FINRA believes these cases are good examples of its existing policy. Although the impact of extraordinary cooperation depended upon the facts and circumstances of each particular case, these matters demonstrate, among other things, that the receipt of substantial credit depended on corrective measures and cooperation aimed at broadly and quickly remediating harm.

Most recently, in January 2019, FINRA announced in *Regulatory Notice 19-04* its 529 Plan Share Class Initiative, encouraging firms to review their supervision of 529 plan sales. FINRA described common supervisory issues it had observed concerning share class recommendations and stated that it would recommend settlements with no fines for firms that choose to review their supervisory systems and procedures, self-report supervisory violations, and provide FINRA with a plan to remediate harmed customers. This initiative was announced to promote firms' compliance with the rules governing 529 plan recommendations, to promptly remedy violations, and to return money to harmed investors as quickly and efficiently as possible.

As in these prior matters, FINRA will continue to consider the factors that are set forth in the *Sanction Guidelines* and *Regulatory Notice 08-70* when determining whether credit will be given for extraordinary cooperation. Those factors are reiterated below, with additional guidance regarding how they impact FINRA's decision making:

1. Providing Credit for Steps Taken to Correct Deficient Procedures and Systems

When a firm identifies a problem involving deficient supervisory systems, procedures and controls, the firm must take corrective steps to fully remediate the problem. In considering whether to provide substantial credit for extraordinary cooperation, FINRA will consider whether a firm's steps to correct deficient systems and procedures go beyond these baseline requirements. Examples of corrective steps that may result in credit for extraordinary cooperation include:

- Engaging or conducting an independent audit or investigation that is thorough and far-reaching in scope beyond the immediate issue, with an eye toward identifying and remediating all related misconduct that may have occurred.
- Hiring independent consultants to ensure the adoption and implementation of improved supervisory systems, procedures and controls.
- Where the root cause of a violation relates to organizational weaknesses such as where a firm dedicated inadequate staff to the supervision of a particular business line, making organizational changes by, for example, creating new supervisory positions, adjusting reporting lines or, if necessary, removing or disciplining responsible individuals, including those in supervisory roles (although personnel changes are not necessarily required to achieve extraordinary cooperation).

FINRA will consider whether the firm took these or other corrective steps promptly following its discovery of the misconduct, prioritizing the remediation of any deficiencies. Additionally, FINRA will consider whether the firm maintained an open dialogue with FINRA staff regarding improvements to supervisory systems, procedures and controls, and provided FINRA with ready access and information to evaluate whether new systems, procedures and controls are reasonable.

FINRA staff will also consider the breadth of a firm's remediation. For example, if a firm identifies deficient procedures that affect a particular department or product line, the firm must review and correct the identified procedures. In contrast, FINRA may consider the firm's responses "extraordinary" when the firm conducts a broader assessment, which goes beyond the scope of the original investigation, and looks for and remediates similar deficiencies in procedures that govern other aspects of its business.

Although FINRA will, consistent with the *Sanction Guidelines*, take into consideration the timing of steps taken to correct deficient systems or procedures when deciding whether to award credit,[8] FINRA recognizes that there is some tension between expecting firms to report misconduct promptly and, at the same time, giving priority to corrective measures that a firm takes prior to detection by FINRA or other regulators (*e.g.*, prior to any self-report). For that reason, and in order to encourage the timely self-reporting of misconduct, FINRA will consider, in appropriate circumstances, giving credit for corrective measures taken promptly **after** a firm reports the misconduct.

2. Providing Credit for Restitution to Customers

FINRA's overarching mission is to protect investors and promote vibrant markets. As FINRA has previously stated, when a member firm or registered representative engages in misconduct, restitution for harmed customers is our highest priority. Therefore, if a respondent's misconduct has caused customer harm, it will be difficult for that respondent to obtain credit for extraordinary cooperation without making complete and timely restitution to injured customers.

The *Sanction Guidelines* recognize the importance of prompt restitution and treat as a mitigating factor for sanctions purposes the fact that a firm or associated person voluntarily paid restitution prior to detection or intervention by a regulator.[9] Because FINRA expects firms and associated persons to make full restitution to injured customers[10] in all cases, the mere payment of restitution will not result in credit for extraordinary cooperation. Rather, as with other corrective measures, FINRA will consider whether a firm or associated person has proactively and voluntarily taken extraordinary steps to ensure that restitution is paid as quickly as possible, in a manner that ensures all harmed customers are made whole.

This is particularly relevant in matters involving widespread, systemic failures, where identifying injured customers and calculating each individual's losses can be complex and time consuming. For example, where a firm's failure to supervise compliance with its suitability obligations has resulted in customer losses, it could review the recommendations made in each of its customer's accounts, calculate individual losses resulting from the failure to comply with the suitability duty, and pay restitution to the customers who were harmed. This complex process can take significant time. An extraordinary step, in contrast, could be one that significantly accelerates the process in order to return money to investors sooner. For example, implementing a methodology to efficiently identify customers for restitution, such as a statistical approach, could meaningfully reduce the time it would take for investors to receive restitution. Similarly, taking steps to accelerate a trade-by-trade review (such as dedicating staff members, hiring temporary help, paying for overtime, or re-prioritizing other projects) may constitute extraordinary efforts.

When assessing whether a respondent has exceeded expectations regarding restitution, FINRA will consider whether the respondent is proactive about identifying and proposing an expeditious methodology, and willing to engage in a dialogue with FINRA and other regulators about the appropriate way to identify the pool of affected customers and to calculate the amount of restitution to pay back customers as swiftly as possible.

Even where restitution is paid after FINRA becomes aware of the misconduct (for example, if the firm reports the misconduct within 30 days of discovery as required by Rule 4530), FINRA will consider whether to award credit when the restitution remediated all potential harm and was paid promptly at the initiative of the firm, prior to any order by FINRA or another regulator.

3. Self-Reporting of Violations

One reason for this updated guidance is to clarify how FINRA considers self-reporting in light of the adoption of Rule 4530. Rule 4530 replaced NASD Rule 3070 in February 2011 and, in subsection (b), unlike its predecessor, requires member firms to self-report internal conclusions regarding violations of certain laws, rules, regulations or standards of conduct. Although self-reporting of such internal conclusions was already required for NYSE member firms under NYSE Rule 351(a)(1), FINRA Rule 4530(b) represented a significant change for many firms.

As noted previously in the Rule 4530 Frequently Asked Questions, to be considered "extraordinary cooperation," self-reporting must, at a minimum, "go significantly beyond" what is required to comply with regulatory obligations.[11] Credit will not be awarded to firms merely for complying with their reporting obligations under Rule 4530. Nor will firms and associated persons be given credit for merely complying with their obligations to provide information or testimony in response to regulatory requests made pursuant to Rule 8210. If, however, a firm self-reports misconduct that does not fall within the reporting requirements of Rule 4530, then self-reporting will be considered in determining whether to award credit.

In matters where a self-report is required pursuant to Rule 4530, FINRA will consider whether the firm self-reports information beyond that which is required by the rule. For example, a firm exceeds its regulatory obligation when it proactively and voluntarily asks to meet with FINRA staff, provides summaries of key facts, and identifies and explains key documents. This type of substantial assistance is further described below.

FINRA also will consider whether the firm proactively detected the misconduct through compliance, audits or other surveillance, as opposed to identifying the misconduct only after receiving notice from customers, counterparties or regulators. FINRA also will consider whether the firm made diligent efforts to identify and inform FINRA of the relevant facts as soon as it discovered the issue, and kept FINRA updated as it learned new facts through continuing investigation.

Finally, FINRA will consider whether the firm reported the misconduct to the public and other regulators, as appropriate. FINRA also may consider the level of the firm's cooperation with other regulators and, if appropriate, law enforcement bodies, particularly in matters where multiple agencies are investigating the misconduct.[12]

4. Providing Substantial Assistance to FINRA Investigations

In addition to the above factors, FINRA also will consider giving credit to firms or associated persons for providing substantial assistance to FINRA in its investigation of the underlying misconduct.[13] In assessing whether firms have provided substantial assistance, FINRA will consider the degree of assistance that might be expected given a firm's size and resources, as well as the scope of the misconduct within the organization and the steps taken to address systemic deficiencies; there is no one-size-fits-all approach to the steps that FINRA would consider substantial assistance. Credit is potentially available to any firm or individual that cooperates substantially, including the largest broker-dealers and single-employee firms.

To constitute substantial assistance, industry participants should fully inform FINRA about the potential misconduct—including all relevant issues, products, markets and industry participants—in ways that go far beyond merely responding to requests made under Rule 8210. For example, substantial assistance deserving of credit might include:

- volunteering relevant information that the firm believes would be helpful even if FINRA did not directly request the specific documents or information;
- providing analysis of trading or other activity that assists FINRA in understanding the conduct at issue;
- volunteering facts related to the involvement of particular parties who may have committed violations;
- providing demonstrations of trading or other systems at issue;
- after identifying misconduct by an individual employee, conducting a thorough and expeditious review of the employee's misconduct and promptly sharing the findings with FINRA;
- volunteering relevant industry knowledge to help FINRA quickly assimilate information about a complex product or practice. Examples could include providing information about the considerations or issues that affect an industry-wide common practice;
- providing detailed summaries or chronologies of relevant events prior to receiving a Rule 8210 or other regulatory request;
- voluntarily assisting FINRA in obtaining effective access to firm offices, records or computer systems prior to receiving a Rule 8210 or other regulatory request;
- identifying witnesses who possess relevant information, including witnesses over whom FINRA lacks jurisdiction, and making those witnesses available for interviews; and
- conducting a thorough and independent audit or investigation, using counsel or consultants where appropriate, and fully disclosing the findings to FINRA.[14]

What Type of Credit Will Be Given in Return for Extraordinary Cooperation?

When FINRA determines that a firm should be given credit for extraordinary cooperation, that credit may take many forms. For example, where a problem has been fully remediated, FINRA often concludes that no enforcement action is warranted and closes an investigation with no further action or with a Cautionary Action Letter.

In other cases, FINRA might determine that an enforcement action is appropriate to remedy or prevent harm, even where a firm has provided extraordinary cooperation. In those matters, FINRA may provide credit by reducing the sanctions imposed. When credit is given in the form of a reduced fine, the reduction normally will be substantial. Indeed, in appropriate cases, as illustrated in several of the examples above, FINRA may consider imposing formal discipline without any fine. FINRA also may give credit by declining to require an undertaking. For example, FINRA may forego requiring a firm to hire an independent consultant where, although a systemic deficiency is in an extended period of remediation, the firm is taking other extraordinary steps to address the problem.

How Does FINRA Plan To Be More Transparent About Credit for Extraordinary Cooperation?

In each case where the applicable principal considerations and the factors set forth in this *Regulatory Notice* result in a respondent receiving credit for extraordinary cooperation, FINRA will include in the Letter of Acceptance, Waiver and Consent (AWC) memorializing the settlement a new section titled, "Credit for Extraordinary Cooperation." FINRA will describe the factors that resulted in credit being given, as well as the type of credit.

In order to provide more useful guidance to the industry, FINRA will take additional steps to distribute information about instances when it has deemed cooperation to be extraordinary, in ways that are more accessible and easier to identify. For example, FINRA occasionally issues press releases in connection with individual cases to highlight matters deemed worthy of public attention.[15] In press releases, FINRA will note factors that led the respondent to receive credit, as well as the type of credit. Similarly, when FINRA proceeds without formal action in connection with an investigation, traditionally FINRA has not made public a statement regarding the action. Going forward, when FINRA gives credit for extraordinary cooperation that results in FINRA electing to proceed without formal action, FINRA will determine, on a case-by-case basis, whether it would be useful to provide additional transparency regarding the factors that led to FINRA's decision and, when appropriate, publish information about those individual cases. Unless the firm or associated person gives permission to be named, FINRA will preserve their anonymity by describing the respondents' extraordinary cooperation at a sufficiently high level to shield their identities.

FINRA also seeks to provide clear guidance on the difference between matters characterized by extraordinary cooperation, and matters in which the respondent's conduct did not exceed its regulatory obligations but sanctions determinations were materially affected by other considerations. As described above, FINRA always considers factors such as corrective measures and payment of restitution in assessing whether a disciplinary action is necessary and what sanctions are appropriate. For example, the Principal Considerations in the *Sanction Guidelines* include "Whether the respondent voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct." Accordingly, Enforcement may consider a firm's voluntary payment of restitution to be mitigating and recommend a sanction on the low end of the specified range in the Sanction Guidelines. In contrast, Enforcement may consider it "extraordinary" if a firm takes significant steps to effect speedy restitution, such as re-prioritizing other projects or developing a rules-based approach to accelerate the process. Under those circumstances, FINRA may consider these additional steps so extraordinary that it recommends a sanction well below the *Sanction Guidelines* or other similar cases.

At other times, the presence of aggravating factors may materially affect the sanction determination. For example, even if a respondent remediates the problem and makes restitution as expected, FINRA may recommend a more severe sanction due to aggravating factors in the matter, such as prior disciplinary history;[16] the nature of the underlying misconduct, including whether the misconduct was intentional or reckless,[17] involved numerous acts or a pattern of misconduct, and continued over an extended period of time;[18] the nature and extent of injury to the investing public, a member firm and other market participants;[19] whether the respondent profited from the misconduct;[20] and whether the respondent engaged in the misconduct notwithstanding prior warnings from FINRA, another regulator or a supervisor.[21]

In general, the factual findings set forth in an AWC should always include any facts that were considered as aggravating or mitigating for sanctions purposes. However, where appropriate an AWC may also include a new section titled, "Sanctions Considerations." In that section, FINRA may identify mitigating or aggravating factors (such as those discussed in the relevant Principal Considerations from the *Sanction Guidelines*) that affected FINRA's sanction determination.

Can Individuals Also Receive Credit for Extraordinary Cooperation?

Credit for extraordinary corrective measures and cooperation is available to individuals as well as firms. FINRA believes many of the principles discussed above may apply equally to individuals. For example, although individuals may not be able to correct deficient firm procedures and systems, they may still self-report misconduct, provide substantial assistance during an investigation, and pay restitution to customers with appropriate notice to and involvement by a member firm. However, the presence of aggravating factors may weigh against credit for extraordinary cooperation, and certain aggravating factors are more likely to be present in cases involving individuals, such as intentional or reckless misconduct,[22] attempts to conceal misconduct from a member firm,[23] and misconduct notwithstanding prior warnings from a supervisor.[24]

In evaluating whether to give credit to an individual, FINRA also will consider the same four general factors outlined in the SEC's policy regarding cooperation by individuals: (1) the assistance provided by the individual; (2) the importance of the underlying matter in which the individual cooperated; (3) the societal interest in holding the individual accountable for his or her misconduct; and (4) the appropriateness of credit based upon the profile of the cooperating individual.[25]

Endnotes

1. *See* May 8, 2017, letter from the Securities Industry and Financial Markets Association to FINRA in response to Special Notice – Engagement Initiative (Mar. 21, 2017), at 8 (urging FINRA to, among other things, "publicize when good credit is given").
2. *Sanction Guidelines* (March 2019 version), at 3.
3. Principal Consideration No. 2.
4. Principal Consideration No. 3.
5. Principal Consideration No. 4.
6. Principal Consideration No. 12.
7. As was the case with *Regulatory Notice 08-70*, this *Notice* is intended to provide the industry with additional guidance concerning the factors that FINRA considers in assessing whether formal discipline is warranted and, if so, the appropriate sanctions in the context of settlement discussions prior to initiation of a disciplinary proceeding. Nothing herein is intended to alter the *Sanction Guidelines*, FINRA rules or other applicable requirements.
8. *See* Principal Consideration No. 3 (treating as a mitigating factor corrective measures taken "prior to detection or intervention" by a regulator).
9. Principal Consideration No. 4.
10. FINRA reminds associated persons that paying restitution or otherwise settling a customer complaint without notice to the firm is a violation of FINRA Rule 2010, and can result in sanctions of up to two years or, in egregious cases, a bar. *Sanction Guidelines*, at 34.
11. *Regulatory Notice 11-32*, A6.
12. *Cf.* General Principles Applicable to All Sanction Determinations, No. 7 (directing adjudicators to consider, where appropriate, sanctions previously imposed by other regulators for the same conduct).
13. Principal Consideration No. 12.
14. Nothing has changed about FINRA's approach with respect to attorney-client privilege. The waiver or non-waiver of privilege itself will not be considered in connection with granting credit for cooperation. *See* endnote 9 in *Regulatory Notice 08-70*.

15. *See www.finra.org/newsroom/newsreleases*.
16. Principal Consideration No. 1.
17. Principal Consideration No. 13.
18. Principal Consideration Nos. 8, 9.
19. Principal Consideration No. 11.
20. Principal Consideration No. 16.
21. Principal Consideration No. 14.
22. Principal Consideration No. 13.
23. Principal Consideration No. 10.
24. Principal Consideration No. 14.
25. SEC Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, Release No. 34-61340, 17 CFR Part 202 (Jan. 19, 2010).

Regulatory Notice 22-10

Supervision

FINRA Reminds Member Firms of the Scope of FINRA Rule 3110 as it Pertains to the Potential Liability of Chief Compliance Officers for Failure to Discharge Designated Supervisory Responsibilities

Summary

Chief Compliance Officers (CCOs) at member firms play a vital role. For example, CCOs and their compliance teams help design and implement compliance programs, help educate and train firm personnel, and work in tandem with senior business management and legal departments to foster compliance with regulatory requirements. In this way, CCOs help promote strong compliance practices that protect investors and market integrity, as well as the member firm itself.[1]

Rule 3110 (Supervision) imposes specific supervisory obligations on member firms.[2] The responsibility to meet these obligations rests with a firm's business management, not its compliance officials. The CCO's role, in and of itself, is advisory, not supervisory. Accordingly, FINRA will look first to a member firm's senior business management and supervisors to determine responsibility for a failure to reasonably supervise. FINRA will not bring an action against a CCO under Rule 3110 for failure to supervise except when the firm conferred upon the CCO supervisory responsibilities and the CCO then failed to discharge those responsibilities in a reasonable manner.[3] As a result, charges against CCOs for supervisory failures represent a small fraction of the enforcement actions involving supervision that FINRA brings each year.[4]

Questions regarding this *Notice* should be directed to:

- Christopher Perrin, Counsel to the Head of Enforcement, Enforcement, at (415) 217-1121 or christopher.perrin@finra.org; and
- Philip Shaikun, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8451 or Philip.Shaikun@finra.org.

March 17, 2022

Notice Type
- Reminder

Suggested Routing
- Compliance
- Legal
- Senior Management

Key Topics
- Compliance
- Supervision

Referenced Rules & Notices
- FINRA Rule 0140
- FINRA Rule 1220
- FINRA Rule 3110
- FINRA Rule 3130
- FINRA Rule 3310
- Notice to Members 99-45
- Notice to Members 01-51
- Regulatory Notice 18-15

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Background and Discussion

I. THE SCOPE OF RULE 3110 REGARDING INDIVIDUAL LIABILITY

Rule 3110 sets out a comprehensive set of supervisory obligations for member firms and requires firms to designate individual supervisors and identify their responsibilities. The rule requires each member firm to establish and maintain a system, including written procedures, to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.[5] The rule also requires each member firm to designate an appropriately registered principal or principals with authority to carry out the supervisory responsibilities of the member for each type of broker-dealer business in which it engages, to designate one or more appropriately registered principals in branch offices with authority to carry out the supervisory responsibilities assigned to that office, and to assign each registered representative to an appropriately registered person who is responsible for supervising that representative's activities.[6] Individual liability under Rule 3110 is predicated upon the firm's express or implied designation of supervisory personnel and the delegation of supervisory responsibility to the designated individuals.[7] Individual supervisors have an additional duty under Rule 3110 to investigate "red flags" that suggest misconduct at the firm may be occurring and to act reasonably upon the results of the investigation.[8] FINRA can bring enforcement actions under Rule 3110 against individual supervisors when they fail to discharge reasonably their supervisory responsibilities.[9]

A firm's supervisory obligations under Rule 3110 rest with the firm and its president (or equivalent officer or individual, *e.g.,* CEO) and flow down by delegation to the firm's designated supervisors.[10] The firm's president (or equivalent officer or individual), not its CCO, "bears ultimate responsibility for compliance with all applicable requirements unless and until he [or she] reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient."[11] Accordingly, the president (or equivalent officer or individual) and designated principals are responsible for fulfilling the firm's supervisory obligations under Rule 3110.

II. THE ROLE OF A CCO WITHIN A MEMBER FIRM

A CCO's role at a member firm, by contrast, is advisory, not supervisory. FINRA recognizes that compliance and supervision are separate, if related, functions. In *Notice to Members 99-45*, FINRA stated that "[i]t is important [to] recognize the distinction between written compliance guidelines and written supervisory procedures."[12] A CCO and the compliance team is, in the normal course, responsible for the former, not the latter. "Compliance guidelines generally set forth the applicable rules and policies that must be adhered to and describe specific practices that are prohibited."[13] By contrast, written supervisory procedures document the supervisory system to ensure that compliance guidelines are being followed.

To fulfill the compliance function, FINRA requires firms to designate one or more appropriately registered principals as a CCO.[14] As set forth in FINRA Rule 3130, Supplementary Material .05, "A [CCO] is a primary advisor to the member on its overall compliance scheme and the particularized rules, policies and procedures that the member adopts."[15] Neither Rule 3110 nor Rule 3130, by themselves, attach supervisory responsibilities to a CCO.[16]

A CCO can and often does occupy another position at a firm, such as CEO.[17] In such circumstances, CCOs likely would fall within the scope of Rule 3110 because of the supervisory authority designated to them based on another non-CCO position they hold within a firm's business management. When an individual's sole position at a firm is that of CCO, a more extensive assessment of liability under Rule 3110 may be needed, as outlined in the following section.

III. ASSESSING LIABILITY UNDER RULE 3110 AGAINST A CCO

A. Designation of Supervisory Responsibility

A CCO is not subject to liability under Rule 3110 because of the CCO's title or because the CCO has a compliance function at a member firm. A CCO will be subject to liability under Rule 3110 only when—either through the firm's written supervisory procedures or otherwise—the firm designates the CCO as having supervisory responsibility. This designation can occur in several ways. First, the member's written procedures might assign to the CCO the responsibility to establish, maintain and update written supervisory procedures, both generally as well as in specific areas (*e.g.,* electronic communications). Second, the written procedures might assign to the CCO responsibility for enforcing the member's written supervisory procedures or other specific oversight duties usually reserved for line supervisors. Third, apart from the written procedures, a member firm, through its president or some other senior business manager, might also expressly or impliedly designate the CCO as having specific supervisory responsibilities on an ad hoc basis. Or the CCO may be asked to take on specific supervisory responsibilities as exigencies demand, such as the review of trading activity in customer accounts or oversight of associated persons. Only in circumstances when a firm has expressly or impliedly designated its CCO as having supervisory responsibility will FINRA bring an enforcement action against a CCO for supervisory deficiencies.

B. Applying the Reasonableness Standard

Even when a CCO has been designated as having supervisory responsibilities, FINRA will bring an action under Rule 3110 against the CCO only if the CCO has failed to discharge those responsibilities in a reasonable manner—as it would with any individual who has supervisory responsibility. Accordingly, once FINRA has found that the CCO has been designated by the firm as having supervisory responsibilities—including responsibility for establishing, maintaining and enforcing the firm's written supervisory procedures that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules—the next question is whether the CCO reasonably discharged his or her designated supervisory responsibilities.

For example, if the CCO is responsible for establishing, maintaining and enforcing the firm's written supervisory procedures, FINRA will ask whether the procedures were reasonably tailored to the firm's business and whether they addressed the specific activities of the firm's personnel. Whether a CCO's performance of these responsibilities was reasonable depends upon the facts and circumstances of a particular situation. When assessing potential liability under Rule 3110, FINRA will evaluate whether the CCO's conduct in performing designated supervisory responsibilities was reasonable in terms of achieving compliance with the federal securities laws, regulations, or FINRA rules.

C. Factors For and Against Charging a CCO under Rule 3110

Not every violation of a FINRA rule results in a formal disciplinary action, so even when FINRA finds that a CCO failed to reasonably perform a designated supervisory responsibility, FINRA will consider whether charging the CCO under Rule 3110 in a formal disciplinary action is the appropriate regulatory response to address the violation. Factors that might weigh in favor of charging a CCO are the same factors that could apply to any individual who has supervisory responsibility under Rule 3110 and include, but are not limited to, the following: (1) the CCO was aware of multiple red flags or actual misconduct and failed to take steps to address them;[18] (2) the CCO failed to establish, maintain, or enforce a firm's written procedures as they related to the firm's line of business;[19] (3) the CCO's supervisory failure resulted in violative conduct (*e.g.,* a CCO who was designated with responsibility for conducting due diligence failed to do so reasonably on a private offering, resulting in the firm lacking a reasonable basis to recommend the offering to its customers);[20] and (4) whether that violative conduct caused or created a high likelihood of customer harm.[21]

Factors that might weigh against charging the CCO include, but are not limited to, the following: (1) the CCO was given insufficient support in terms of staffing, budget, training, or otherwise to reasonably fulfill his or her designated supervisory responsibilities;[22] (2) the CCO was unduly burdened in light of competing functions and responsibilities;[23] (3) the CCO's supervisory responsibilities, once designated, were poorly defined, or shared by others in a confusing or overlapping way;[24] (4) the firm joined with a new company, adopted a new business line, or made new hires, such that it would be appropriate to allow the CCO a reasonable time to update the firm's systems and procedures; and (5) the CCO attempted in good faith to reasonably discharge his or her designated supervisory responsibilities by, among other things, escalating to firm leadership when any of (1)–(4) were occurring.[25]

In addition to the above factors, FINRA also will consider whether it is more appropriate to charge the firm or its president with failure to reasonably supervise rather than the CCO. Likewise, FINRA will consider whether it is more appropriate to charge another individual at the firm, such as an executive manager or a business line supervisor, who had more direct responsibility for the supervisory task at issue, or who was more directly involved in the supervisory deficiency. Finally, FINRA also will consider whether, based on the facts and circumstances of a particular case, it is more appropriate to bring informal, as opposed to formal, action against the CCO for failure to supervise. In some cases, it may be more appropriate to issue a Cautionary Action Letter, particularly in cases involving a CCO's first-time violation of Rule 3110.

Endnotes

1. *See also* FINRA Rule 3130, Supplementary Material .05 (Role of the Chief Compliance Officer).

2. This *Notice* is limited to FINRA Rule 3110. It does not address other supervisory requirements under federal securities laws. *Cf.* SEC, Division of Trading and Markets, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act, Sept. 30, 2013; *Compliance Programs of Investment Companies and Investment Advisers*, Release Nos. IA-2204, IC-26299, 2003 SEC LEXIS 2980, at n.73 (Dec. 17, 2003) (discussing when a CCO might be subject to Section 203(e)(6) of the Investment Advisers Act of 1940).

3. This *Notice* focuses on CCOs and does not encompass anti-money laundering compliance personnel. *See* FINRA Rule 3310(d); Rule 3310, Supplementary Material .02 (Review of Anti-Money Laundering Compliance Person Information). It also does not address enforcement actions against CCOs for misconduct unrelated to designated supervisory responsibilities, such as providing false documents to FINRA or failing to timely update their Uniform Application for Securities Industry Registration or Transfer (Form U4). *See, e.g., Merrimac Corporate Securities, Inc.*, Exchange Act Release No. 86404, 2019 SEC LEXIS 1771, at *9 (July 17, 2019); *Allen Holeman*, Exchange Act Release No. 86523, 2019 SEC LEXIS 1903, at *16-17 (July 31, 2019).

4. For example, from 2018–2021, of the nearly 440 FINRA enforcement actions involving violations of Rule 3110 for supervisory failures, CCOs were charged in only 28 instances. And in only 10 of these matters did FINRA charge a CCO who was not also the chief executive officer (CEO) or president of the firm. For each of these 10 matters, FINRA found that the firm had conferred upon the CCO specific supervisory responsibilities which the CCO failed reasonably to perform, in violation of Rule 3110.

5. *See* Rules 3110(a) and (b). Rule 3110 applies to persons associated with a member firm as much as it applies to a member firm. *See* FINRA Rule 0140(a) ("Persons associated with a member shall have the same duties and obligations as a member under the Rules."). Thus, FINRA may bring an action against an associated person, including a CCO, when FINRA finds the individual has violated Rule 3110.

6. *See* Rules 3110(a)(2), (4) and (5). Rule 3110(b)(6)(A) requires a firm's written supervisory procedures to include "the titles, registration status, and locations of the required supervisory personnel and the responsibilities of each supervisory person."

7. Importantly, to bring a case under Rule 3110, FINRA does not have to establish an underlying violation of the federal securities laws or other FINRA rules. *Dep't of Enforcement v. Lek Securities Corp.,* No. 2009020941801, 2016 FINRA Discip. LEXIS 63, at *35-36 (NAC Oct. 11, 2016).

8. *Ronald Pelligrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec. 19, 2008) ("'Once indications of irregularities arise, supervisors must respond appropriately.'") (*quoting La Jolla Capital Corp.*, 54 S.E.C. 275, 285 (1999)). *See also Regulatory Notice 18-15* (April 2018) ("Member firms should be reviewing and updating their supervisory systems and procedures for hiring practices, monitoring brokers and investigating red flags suggestive of misconduct.")

9. *See, e.g., Dep't of Enforcement v. Clements,* No. 2015044960501, 2018 FINRA Discip. LEXIS 11, at *50 (NAC May 17, 2018) (supervisor should have "discharged [his] responsibilities reasonably").

10. *See Wedbush Securities, Inc.,* Exchange Act Release No. 78568, 2016 SEC LEXIS 2794, at *34 (Aug. 12, 2016).

11. *Id.* at *29 (quotation marks omitted). *See also John B. Busacca, III,* Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *37-38 (Nov. 12, 2010) (finding that the president's supervision was deficient during the period that he assumed overall responsibility for the firm's operations and did not delegate this responsibility).

12. *Notice to Members 99-45* (June 1999).

13. *Id.*

14. *See also* FINRA Rule 1220(a)(3) (Compliance Officer).

15. Rule 3130, Supplementary Material .05.

16. *See Notice to Members 01-51* (August 2001) ("The chief compliance officer registration requirement does not create the presumption that a chief compliance officer has supervisory responsibilities or is otherwise a control person. As in the past, NASD Regulation will hold a chief compliance officer responsible for supervision only where supervision is his or her responsibility. Many chief compliance officers are already registered as principals. NASD Regulation does not presume that these individuals have supervisory responsibility by virtue of their title. NASD Regulation will continue to determine whether a chief compliance officer is acting in a supervisory capacity based on the actual responsibilities and functions that the chief compliance officer performs for the firm."). *See also* Rule 3130, Supplementary Material .07 (Certification of Business Line Responsibility) ("The FINRA Board of Governors recognizes that supervisors with business line responsibility are accountable for the discharge of a member's compliance policies and written supervisory procedures. The signatory to the certification is certifying only as to having processes in place to establish, maintain, review, test and modify the member's written compliance and supervisory policies and procedures and the execution of this certification and any consultation rendered in connection with such certification does not by itself establish business line responsibility.").

17. *See* Rule 3130, Supplementary Material .08 (Ability of Chief Compliance Officer to Hold Other Positions). *See also* note 4.

18. *Dep't of Enforcement v. Cantone Research, Inc.,* No. 2013035130101, 2019 FINRA Discip. LEXIS 5, at *99-100 (NAC Jan. 16, 2019) (finding that firm designated its CCO, who also had the title of Vice President, as a supervisor of registered representatives and that the CCO was "aware of numerous red flags," failed to address the red flags, and therefore failed to discharge supervisory obligations); *Dep't of Enforcement v. Fox Financial Management Corp.,* No. 2012030724101, 2017 FINRA Discip. LEXIS 3, at *17-18 (NAC Jan. 6, 2017).

19. *See Merrimac,* 2019 SEC LEXIS 1771 at *80-84 (finding a CCO liable for his failure "in any meaningful way to develop the procedures that FINRA's rules required" for a line of business at the firm); see also *Ryan Carlson et al.,* Letter of Acceptance, Waiver, and Consent (FINRA Case No. 2018060267902) (Mar. 29, 2021).

20. *Matthew Bahrenburg,* Letter of Acceptance, Waiver, and Consent (FINRA Case No. 2018057457101) (Aug. 24, 2020).

21. *Id.*
22. *Thaddeus North,* Exchange Act Release No. 84500, 2018 SEC LEXIS 3001, at *34-35 (Oct. 29, 2018), *aff'd,* 828 F. App'x 729 (D.C. Cir. 2020).
23. *Id.* at *28-29 ("[The Commission] found a compliance director's failure to respond to NASD's requests for information mitigated by the 'extraordinary demands on the compliance group' during the relevant time.").
24. *Id.* at *28 ("[The Commission has] dismissed proceedings against an individual with compliance responsibilities that alleged liability for causing his firm's violations of the securities laws where another official at the firm had responsibility for overseeing the relevant activities and the respondent was never asked to evaluate the relevant regulatory issues.").
25. *Id.* ("[The Commission has] dismissed proceedings alleging supervisory failures where the respondent conducted his own independent investigation in response to indications of wrongdoing and recommended responsive action."); *Merrimac,* 2019 SEC LEXIS 1771, at *73 (liability should not attach "where a CCO made a reasonable inquiry and determined erroneously that no further action needed to be taken in light of that inquiry").