SECURITIES LAW SERIES

FINRA Investigations
Rule 8210 & Beyond

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DISCLAIMER

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1. How can you become a target of a FINRA investigation?

The Financial Industry Regulatory Authority (FINRA) is a self-regulatory organization. Although it is not a government agency, its primary mission is to protect investors by regulating its members. All broker-dealers, down to the last firm employee, must abide by FINRA's rules.

Violation of FINRA's rules comes with serious consequences. FINRA is empowered to bar people or companies from the securities industry and assess monetary fines. Also, FINRA routinely refers matters outside its jurisdiction to government agencies, such as the Securities and Exchange Commission or the Department of Justice.

Receiving an investigatory letter from FINRA can cause a great deal of anxiety. Typically, FINRA sends out letters pursuant to Rule 8210, informing you that it has begun an inquiry, and demanding documents and information about your conduct.

Although there are many possible triggers for a FINRA inquiry, a Rule 8210 notice only means that FINRA is investigating possible rule violations; they haven't reached any conclusions yet. It is also advisable to communicate with FINRA only through your attorney.

Time and again, direct communication with FINRA's staff only serves to expand FINRA's investigation

2. FINRA investigation triggers

FINRA's Enforcement and Market Regulation departments are responsible for investigating and pursuing all disciplinary actions. Enforcement handles a broad range of cases and Market Regulation focuses more narrowly on trading and quality of markets cases. Market Regulation also provides regulatory services to equities and options markets operated by other self-regulatory organizations.

The department monitors approximately ninety-nine percent of the equities market and approximately seventy percent of the options market.

FINRA has a mandate to:

- Preserve market integrity,
- Protect investors, and
- Enhance confidence in the market.

In order to achieve these goals, FINRA maintains surveillance, examination, and enforcement programs. These are carried out by various units, including:

- The Surveillance Unit,
- The Examination Unit,
- The Enforcement Division, and
- The legal section of Market Regulation.

The Surveillance Unit reviews trading to ensure firms are meeting all regulatory requirements, the Examination Unit conducts on-site reviews of firms, and disciplinary actions are handled by the Enforcement Division and the legal section of Market Regulation.

A. Automated surveillance programs

FINRA often receives regulatory tips for investigation from automated surveillance reports that FINRA maintains.

These surveillance reports routinely analyze market activity. Simply put, they are akin to an exception-reporting system at a brokerage firm. Any unusual or suspicious trading may trigger a report that will instruct a FINRA examiner to look more closely at any particular product or trade.

FINRA's proprietary cross-market surveillance programs use advanced technology to collect and integrate trading data, looking for specific trading patterns. The system analyzes billions of market events every day.

It tracks each order as it moves along through the markets, running a variety of surveillance patterns to detect all manner of abusive activity, including layering, spoofing, algorithm gaming, wash sales, marking the close and open, and front-running.

B. Cycle examinations

FINRA's examination program complements the automated surveillance system with on-site examinations. Cycle examinations look regularly into the activities of a specific broker-dealer, branch office or product.

The examination program looks closely at how firms handle orders and sensitive client information, and how they execute those orders. It reviews compliance with regulations and reporting obligations, as well as each firm's overall operational structure.

FINRA conducts between 1,500-2,000 cycle examinations per year looking to identify risks and review adherence to securities laws and regulations. Based on its findings, FINRA may determine that a firm needs to be examined once a year, or less frequently but no less than once every four years.

C. Form U4 and Form U5

FINRA receives a significant number of tips from Form U4 and Form U5 filings.

Required Form U4 disclosure includes:

- Arrests,
- Bankruptcy filings,
- Litigation,
- Arbitration claims,
- Customer complaints, as well as
- Judgments or Liens.

Failure to timely file a Form U4 has serious consequences and can result in statutory disqualification (the functional equivalent of a bar) if the failure to file is deemed to be "willful."

Recently, FINRA initiated a massive sweep, looking for undisclosed judgments, liens or bankruptcies. As a result, it sent out hundreds of letters to brokers questioning why certain judgments, liens or bankruptcies were not disclosed on Form U4.

Since then, this has become a critical issue for brokers, because it became apparent that FINRA is constantly looking at discrepancies and missing disclosures on your Form U4. The consequences for failing to timely update a Form U4 can be dire.

If FINRA finds that your non-disclosure was "willful," you are statutorily disqualified from the securities industry.

Form U5, which is a registration termination notice, is also a traditional source of information to FINRA for purposes of initiating a regulatory review. Whenever you leave a brokerage firm and are no longer registered with them, the firm is required to submit a Form U5, typically within 30 days of your termination of registration.

For example, if you have been fired from a firm, having them mark down on Form U5 that the termination was voluntary would be entirely inappropriate, and no serious broker-dealer would agree to that.

However, firms are often willing to listen to reasonable proposals which can accurately describe the basis for the termination, simply using different language. In fact, the language used on Form U5, the

description of the termination or the internal review, if it appeared inaccurate, could trigger further investigation by FINRA.

D. Tips and referrals

FINRA can also initiate an inquiry based on referrals from another securities regulator, such as the SEC or a State securities regulator. FINRA also maintains a whistleblower program and can initiate investigations based on anonymous tips.

3. What is Rule 8210?

The SEC has called Rule 8210 "an essential cornerstone" of FINRA's ability to "police the securities markets."

Rule 8210 enables FINRA to demand documents, information or testimony from broker-dealers or employees. Rule 8210 is expansive in scope and gives FINRA staff the right to inspect and copy virtually all of the books and records of member firms, associated persons and any other person over whom FINRA has jurisdiction.

FINRA's authority extends to all electronically stored data including email, IMs and the like. Once information is turned over, FINRA is permitted to share your documents with domestic federal agencies or foreign securities regulators.

When FINRA seeks sworn testimony during an investigation, it uses Rule 8210 as its authority to demand an "on-the-record interview."

Is there a limit to the Reach of Rule 8210?

In theory, the answer to the question is "yes" because FINRA's requests must "involve" an investigation, complaint, examination or proceed-

ing. But practically speaking, the answer is "no" because FINRA's staff has almost unfettered discretion to decide what does or does not "involve" an investigation, complaint, examination or proceeding.

If a company or individual refuses to produce documents because FINRA's staff is seemingly overreaching, the only recourse would be to defend the disciplinary action for refusing to produce the documents, and try to convince a FINRA hearing officer that FINRA's staff was in fact overreaching.

When sending a Rule 8210 request, FINRA is supposed to limit the request to information relating to the operation of the broker-dealer or the person's association with the member. Documents concerning certain outside business activities or private securities transactions are generally fair game.

Additionally, FINRA can demand virtually any conceivable document if FINRA believes an individual violated the "just and equitable principles" rule (Rule 2010). The "just and equitable principles" rule permits FINRA to punish "unethical" behavior.

Say, for example, FINRA believes you "churned" accounts to generate income to satisfy gambling debts. FINRA will demand that you produce all of your bank records and any other document relating to your gambling debts. This example highlights the flexibility of Rule 8210 to enable FINRA to obtain documents concerning activity (lawful gambling) which would otherwise seem to be outside of FINRA's purview.

4. What's in an 8210 Request?

An 8210 Request has similarities to a subpoena. It can require the production of documents or require written responses to requests for information. It can also require the recipient to appear for testimony on a date and location set by FINRA's staff. This is known as an "on the record interview" (OTR).

5. Responding to an 8210 Request

A. Documents and Information

Receiving an 8210 Request is a serious matter which requires a carefully considered response.

First, you need to make a thorough search of your hard copy and electronic documents for responsive documents.

Second, you need to preserve your documents to ensure that nothing is destroyed during the investigation.

Third, documents should be labeled sequentially in advance of production.

Fourth, you should keep a copy of all documents sent to FINRA.

Of course, all documents should be reviewed by your attorney for privilege and responsiveness in advance of production. If a request for production is particularly burdensome, your attorney should contact FINRA's staff to propose possible limitations on the scope of the 8210 request. Bear in mind, though, unlike a subpoena, the recipient of an 8210 Request has no ability to lodge objections to the scope of the request unless FINRA seeks attorney/client communications.

Unlike a subpoena, a Rule 8210 Request can also demand that you provide a written statement. For example, FINRA could ask you to describe your due diligence process in connection with a particular security or product. Providing a narrative statement to FINRA requires very careful consideration.

The decision to respond narrowly (meaning, providing the responsive information but offering nothing more) or broadly (meaning, providing the responsive information and including additional related information) is an important tactical decision requiring careful consultation with your lawyer.

Choose your words carefully because FINRA can use your words against you.

The consequences for failing to respond to an 8210 Request are

severe. FINRA will permanently bar you from the securities industry.

B. On the Record Interview

The OTR interview is very common, unless the documents you submit categorically disprove FINRA's original suspicions. FINRA can demand that you appear in-person or provide testimony by telephone or video link.

Preparation for an OTR is critical.

Seasoned attorneys will want to interview you thoroughly in advance of an OTR. You'll need to review the key documents produced to FINRA and discuss all possible rule violations with your attorney. You should keep in mind a few tips when testifying at an OTR:

- Listen carefully to the questions and make you sure you understand each question before answering.
- Be truthful and accurate but there is no need to guess. Sometimes the truthful answer is "I don't know" or "I can't remember."
- Once you provide a complete response, keep quiet and wait for the next question. Often times, people unnecessarily volunteer information which then leads to even more questions.
- If you need a break, ask for one. Testifying is draining experience and breaks are appropriate.
- If you realize that an earlier answer was incorrect or incomplete, take the opportunity to correct the record before leaving for the day.
- This goes without saying, but be truthful. You are providing information under oath and perjury is a crime.

6. Formal actions by FINRA

Once FINRA has completed its investigation, the staff performs a sufficiency of evidence review to determine whether a violation has occurred. If there is no violation, FINRA may issue a "no further action" letter. If a minor violation occurred, FINRA may issue a "cautionary action" letter which admonishes the individual to refrain from any future violations.

If a serious violation occurred, FINRA will typically call you and provide the unfortunate news that FINRA intends to move forward with charges.

A. Wells Process

FINRA's pre-complaint phone call is known as a Wells call. During this call, FINRA will summarize the charges they intend to file. The Wells call is followed with a letter (known as a Wells notice) confirming the substance of the conversation.

You have the right to respond in writing to FINRA's proposed charges (known as a Wells submission) and explain why formal charges would not be appropriate. The decision of whether or not to make a Wells submission is important and requires consultation with your attorney.

B. Letter of Acceptance, Waiver and Consent (AWC)

Before FINRA brings charges, you have the opportunity to resolve the proposed charges. The settlement agreement itself is called an AWC. By signing an AWC, you are "accepting" FINRA's finding that a violation occurred, "waiving" your right to a hearing where you could challenge FINRA's allegations and waiving your right to appeal a hearing panel decision, and "consenting" to the imposition of sanctions.

Settlements with FINRA are generally consistent with the range of sanctions contained in FINRA's Sanction Guidelines.

Depending on the violation, FINRA has the right to issue monetary sanctions and non-monetary sanctions. Sanctions can include the suspension or expulsion of a firm from FINRA membership, the suspension or bar of an individual, fines, censures and the like.

7. The disciplinary hearing

Disciplinary hearings are conducted by FINRA's Office of Hearing Officers. Hearing Officers are attorneys employed by FINRA and assigned to the Office of Hearing Officers. Generally, disciplinary hearings are heard by a three-person panel consisting of one Hearing Officer and two industry panelists.

Complaints are issued by FINRA's Enforcement Department or Market Regulation Department and filed with the Office of Hearing Officers. The Complaint identifies the charges at issue and describes the conduct which supposedly caused the rule violations.

Once you receive the Complaint, you are required to answer the allegation in writing and request a hearing. The balance of the hearing process unfolds in a manner similar to litigation. FINRA is required to turn over much of its investigatory file and the Hearing Officer resolves all pre-hearing motions.

Hearings are held by FINRA throughout the United States. At the hearing, the parties present opening statements, submit relevant documents and question all witnesses. After the hearing, the Hearing Officer may ask the parties to file proposed findings of fact and conclusions of law.

The Hearing Panel will then issue a written decision, generally within sixty days after the hearing concludes.

8. Appeals

Either you or FINRA may appeal the Hearing Panel's decision to the National Adjudicatory Council (NAC) which has discretion to affirm or reverse the Hearing Panel's decision. NAC decisions can be appealed to the SEC and the SEC's decision can be appealed to a federal court of appeals.

Questions about FINRA Investigations? Or other Securities Law matters?

Please contact Robert Herskovits with any questions or concerns relating to a FINRA investigation or other Securities Law matters.

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Or visit our website at www.HerskovitsLaw.com

ABOUT THE AUTHOR

Since he began practicing law in 1996, Robert Herskovits has represented securities industry participants in a variety of litigation, arbitration and enforcement actions, first as associate general counsel to an NYSE broker-dealer firm, and later as an attorney and partner at various law firms.

Rob is a certified arbitrator for FINRA, AAA, and the NFA, and has participated in an estimated 200 arbitration proceedings before FINRA.

At the end of 2011, Robert formed Herskovits PLLC to provide legal representation to broker-dealers, investment advisors, securities industry professionals, and investors in securities litigation, securities arbitration and securities industry regulatory defense for matters appearing before FINRA and other self-regulatory bodies, as well as before the SEC, state securities authorities, and state and federal courts. In addition to dealing with regulatory matters, Robert provides representation in employment, contract, and general commercial litigation for these same financial services clients.

The impetus for founding his own firm was Robert's recognition that securities and financial services industry clients were not always being well-served by some of the larger law firms, particularly with regard to billing inefficiencies. He recognized that, sometimes, their large size and broad practice structure actually hindered them from constructing the hands-on, personal relationships necessary to truly understand their client's priorities and goals in representative matters.

He formed Herskovits PLLC to fill a void in the marketplace by offering clients involved in the securities profession experienced legal services while still recognizing and appreciating the budgetary limitations imposed on these businesses by a weak economy and a

constrained market.

Robert's insight is to provide a broad range of business-related services in a small-firm atmosphere, so that his clients do not have to deal with multiple firms or, alternatively, work with multiple attorneys at a single large firm who are unfamiliar with the particular concerns that securities industry participants face. Herskovits PLLC knows its clients, understands its clients' business, and provides its clients with offer cost-effective representation.

Robert is dedicated to providing legal expertise and advocacy that will empower his securities and financial services clients to operate their businesses and pursue their professions with as little disruption and cost as possible when faced with problems, whether they are customer or employee disputes, enforcement actions, or regulatory investigations.

Prior to forming Herskovits PLLC, Robert was a partner with Gusrae Kaplan Nusbaum PLLC, for more than five years.

Robert is the Co-Chair of the Committee for Securities and Exchanges of the New York County Lawyers' Association, and is admitted to practice in the States of New York and Mississippi and before various federal courts throughout the country, including the U.S. Supreme Court.