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Adding Insult to Injury: Regulatory Enforcement Following Broker-Dealer Operational Failures

Regulators are increasingly bringing enforcement actions against broker-dealers, and seeking ever higher penalties, for regulatory violations stemming from operational failures. Themes in reported cases point to several recurring situations where firms have encountered issues, including mergers and software upgrades.

By Lanny A. Schwartz and Kimberly N. Chehardy

Broker-dealers face continual pressure to automate their business processes. The impetus comes from multiple sources, including demands to improve profitability through cost-cutting and headcount containment, the sheer speed and automation of trading markets, and the increasing range and intricacy of regulatory compliance mandates. Firms also seek to add value to their customers, and to differentiate their product offerings, by providing ever more elaborate analytical and other automated tools for direct customer use. These themes are likely to intensify in the future, rendering broker-dealers progressively more dependent upon the performance of their systems and therefore making firms, their customers and the marketplace at large increasingly vulnerable to technology and operational failures.

Malfunctions are inevitable, no matter how careful and well-resourced the institution. It is impossible to test and retest every line of code and the integrity of each data input at every moment, or to shadow every step of each vendor and service provider on which an institution depends. At some level, a firm ultimately must decide that a given set of policies and procedures, and a given auditing and testing regime, provide a reasonable degree of assurance that the firm's systems incorporate all regulatory requirements and functions as designed.

It is the role of the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the exchanges and other self-regulatory organizations (SROs) to ensure that regulated entities do not set the bar too low where compliance with regulatory mandates depends upon the proper design and continuous operation of automated processes.[1] Traditionally,

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this has been accomplished by promulgating rules that promote comprehensive safeguards at firms and examining for compliance. Increasingly, however, the SEC and SROs also have resorted to aggressive enforcement and significant penalties for firms that experience operational failures that implicate legal requirements under the securities laws and SRO rules.

While regulators have long brought enforcement cases in connection with regulatory violations involving operational failures,[2] the trend appears to be accelerating. Since June 2015, the SEC has brought multiple enforcement actions (the 2015 SEC Actions) against firms for violations caused by operational failures,[3] including a $9 million penalty (plus disgorgement) for short sale "locate" violations stemming from the firms' failure to update "easy to borrow" lists in their automated execution platforms intraday[4] and a $15 million penalty relating to trade surveillance failures caused by technological errors.[5] Moreover, recent statements by senior regulators also evidence a conscious effort to use enforcement as a key tool in seeking to punish and deter securities law violations stemming from operational failures. For example, Director of Enforcement, Andrew Ceresney, has noted that: "Given the rapid pace of trading in today's markets and the potential massive impact of control breakdowns, broker-dealers must be held to the high standards of compliance necessary for the safe and orderly operation of markets."[6] In a similar vein, Daniel Hawke, former chief of the Enforcement Division's Market Abuse Unit, has stated: "Brokers and dealers must look at each component in each of their systems and ask themselves what would happen if the component malfunctions and what safety nets are in place to limit the harm it could cause."[7]

Common Operational Failures That Result in Regulatory Violations

While every enforcement case involves unique facts, the underlying causes of operational failures that have given rise to enforcement actions are surprisingly comparable. We have identified the following five common situations.

Software Updates

Many recent cases have involved technical glitches associated with updating software. The errors in question resulted in erroneous trading, failures to deliver disclosure documents, and failures to retain emails and information relevant to regulators' investigations.

FINRA recently has brought a number of enforcement actions against firms that fail to have risk management controls and supervisory procedures in place that are reasonably designed to detect and prevent the entry of erroneous orders. For example, in one case, a firm transmitted erroneous orders to NASDAQ on two occasions following software upgrades to the firm's trading system and sizing software that caused the release of untested software.[8] FINRA found the firm's actions to have violated the supervision rule (NASD Rule 3010), conduct rule (FINRA Rule 2010) and the SEC's "market access rule" (Exchange Act Rule 15c3-5).[9]

Many recent cases have involved technical glitches associated with updating software.

Faulty upgrades of operating systems also have led to enforcement actions when errors caused prospectuses not to be delivered. These cases tend to involve extended periods of non-compliance, and consequently the discovery of the failure to deliver prospectuses is not apparent and is not identified for several years. For example, the NYSE found that one member firm failed to deliver prospectuses involving tens of thousands of individual transactions to customers over a two-year period due to an operating system modification in 2002.[10] The NYSE found that the violations resulted from supervisory and operational failures at the firm prompted by the "absence of reasonable syndicate, trading and operations departments' procedures that would trigger the mailing of such materials as required."[11]

Finally, software upgrades have impacted broker-dealers' ability to retain emails, resulting in violations of books and records requirements. Such violations inhibit regulators' ability to conduct investigations and the firms' ability to identify misconduct. For example, when a firm failed to preserve its emails following an upgrade to its email archiving system from a backup tape-based system to a journaling-based system, which resulted in the loss of emails relating to at least five FINRA investigations, FINRA found that the firm failed to perform sufficient quality assurance tests prior to migrating information to its upgraded email archive system.[12]

Introduction of New Systems

The introduction of new systems software or hardware also has led to enforcement actions when those systems did not work as intended and caused compliance violations. For example, FINRA brought an enforcement action against MBSC, BNY Capital Markets, and BNY Securities when the firms implemented a new third-party system for email archiving and review that ultimately failed to ensure that emails were retained and timely reviewed.[13] The firms relied on their personnel to properly code new and existing email accounts in the new system, but when email accounts were incorrectly coded, the affected users' emails were not retained. FINRA found that the firm violated the SEC's and FINRA's books and records requirements (Exchange Act Section 17(a) and Rule 17a-4 thereunder and NASD Rule 3110) and FINRA's supervision and conduct rules (Rules 3010 and 2110, respectively).

Mergers and Systems/Account Acquisitions

Another common underlying cause of broker-dealer operational failures involves the consolidation of different systems following a merger of two companies or the acquisition of systems or accounts. Naturally, the problem of systems integration is a particularly thorny one, since many times the economic hypothesis of a transaction is based upon achieving economies of scale, and using a single backbone from one of the legacy entities to run all or part of the combined business. In addition, the combined firm may want to ensure that there is unified branding and a consistent customer experience as quickly as possible. Thus, there can be strong, legitimate business pressures to combine processes and transition to the ultimate systems and to combine other operating processes as quickly as possible, which may put pressure on conducting comprehensive testing, quality assurance and the like.

In one instance, FINRA brought an enforcement action when a firm acquired approximately 557,000 customer accounts, but failed to identify 80,000 customers whose log-in information was not compatible, resulting in customers being unable to access their accounts following the account acquisition.[14] FINRA found that the firm violated NASD Rules 3010 and 2110 by failing to establish a system reasonably designed to supervise, and written procedures reasonably designed to ensure, customers' ability to enter orders online.

In another reported case, failure to remedy incompatible software systems between two companies resulted in many trades being reported by multiple technology systems and the firm's aggregate trade volume for one equity security being advertised as exceeding approximately 118 percent of the firm's actual executed trade volume for the security.[15] FINRA found that the firm violated NASD Rule 3310, which sets forth the standards for publication of transactions and quotations,[16] and FINRA's conduct rule, Rule 2010.

Human Error

Many operational failures arise at the interface of humans and machines. Human error can result when an employee has not received the necessary training to perform a task or is not adequately supervised. Compliance failures resulting from human errors are likely to end in an enforcement action where the SEC, FINRA or an exchange finds that the firm failed to adopt controls and procedures that would have prevented foreseeable human errors from occurring.

For example, in June 2015, the SEC entered into a settlement with Goldman Sachs relating to a configuration error caused by an employee who did not fully understand the technical operation of a new options order router system and caused the inadvertent conversion of the firm's "contingent orders" for various options series into live orders and assigned them all a price of $1.[17] These orders were then sent to the options exchanges during premarket trading, and approximately 1.5 million options contracts were executed within minutes after the opening of regular market trading. The SEC found that the employee's work had not been reviewed, as was required by the firm's written policies regarding software change management.

In another representative case, FINRA brought enforcement action against a firm that failed to reasonably supervise its ETF prospectus delivery when it relied on its employees to manually review the websites of the different stock markets for newly listed ETFs and enter the code into the firm's automated system to trigger the prospectus delivery system whenever an ETF was sold.[18] FINRA alleged that the firm violated NASD Rule 3010(a) by failing to design and implement an adequate compliance program to comply with the securities laws that relate to prospectus delivery, and that the manual process resulted in foreseeable procedural and human errors that should have been detected and prevented by the firm's supervisory system.

Third-Party Vendors

Compelling business logic often drives broker-dealers to outsource a range of services to specialized service providers, rather than develop systems and processes in-house and maintain internal staff. Firms commonly outsource prospectus and confirmation delivery, trade reporting and even certain compliance-related functions. Nonetheless, it is a consistent regulatory position that a firm contracting with a third-party vendor to perform a component process of a regulated function will not absolve the broker-dealer from liability if the service provider fails to perform and firms must ensure adequate testing and supervision when relying on a third-party vendor for various compliance functions.[19]

Firms have been charged with failure to supervise vendors when outsourcing such responsibilities as determining customer breakpoints[20] and retaining emails.[21] In one illustrative case, FINRA found PlanMember Securities Corporation liable for failing to supervise a third-party vendor's breakpoint determinations where, due to a software programming error, the vendor failed to take certain B shares into consideration when determining the firm's customers breakpoints and customers were overcharged for their mutual fund purchases.[22]

In a second case, FINRA found that Van Clemens & Co. Inc. failed to adequately monitor its third-party vendor's retention of its emails.[23] Due to a technical glitch, the third-party vendor failed to maintain and preserve the firm's outgoing emails for approximately 18 months.

In yet another case, FINRA took action against Chase Investment Securities for failing to deliver over a million prospectuses to its customers for certain mutual fund and ETF transactions.[24] Chase outsourced its mutual funds and ETF prospectus delivery obligation by contracting with a third-party vendor. Due to a configuration error in the automated systems used by Chase for prospectus delivery, Chase directed its vendor to deliver the prospectuses to the funds' investment adviser, a Chase affiliate, instead of to its customers. FINRA noted that Chase failed to establish a supervisory system reasonably designed to achieve compliance with prospectus delivery requirements and did not have a formal procedure in place for reviewing or assigning personnel to review the service provider's prospectus delivery reports.

Impact of the Operational Failures

Broker-dealer operational failure cases[25] tend to fall into one (or more) of three categories in terms of impact.

Operational Failures with Market Impact

Erroneous trades often have led to large scale market impacts. For example, with the expanded use of algorithmic trading strategies by high-frequency traders and broker-dealers, the number of enforcement actions relating to erroneous trades has grown over the last several years. The SEC and FINRA have particular motivation to pursue erroneous trades cases because of the potential impact such violations have on the marketplace.

In one case, in 2014, Citadel settled charges with FINRA for allegedly failing to prevent the transmission of erroneous orders that affected the price of the related securities, including in one instance where the price of the securities increased by 132 percent. Though Citadel had controls in place to prevent erroneous orders, the erroneous orders did not exceed the size and volume parameters; therefore, the security or order type was excluded from the pretrade control review. FINRA found that Citadel violated NASD Rule 3010, FINRA Rule 2010, and Rule 15c3-5 of the Exchange Act, and Citadel agreed to an $800,000 fine, a censure and review of the firm's written supervisory procedures and risk-management controls.[26]

In some cases, the rules of the exchanges in which the erroneous trades occurred may act to mitigate damage to market participants by invoking rules that provide for the cancellation and price adjustments of erroneous trades in certain circumstances. However, if the trades cannot be cancelled or the price adjusted, a firm may have to absorb enormous trading losses and compensation payments, as well as steep fines from its regulators in connection to the related enforcement actions. For example, in one case, an operational failure caused by human error at Goldman Sachs resulted in the firm incorrectly pricing 16,000 option contract orders, resulting in a loss of $38 million in profits and a $7 million fine from the SEC.[27]

Likewise, a faulty system upgrade at Knight Capital caused the firm to route millions of erroneous orders into the market,[28] resulting in a loss of approximately $460 million for Knight. The SEC also took enforcement action against Knight and the firm was eventually fined $12 million.[29]

Operational Failures with Direct Impact on the Firm's Customers

Many types of operational failures can directly harm a firm's own customers. For example, broker-dealers are legally required to seek the best execution reasonably available for their customers' orders.[30] To ensure that a customer receives best execution, broker-dealers are required to evaluate the orders they receive from all customers and assess which competing markets, market-makers or ECNs offer the most favorable terms of execution.[31] When broker-dealers fail to provide best execution to their customers, whether through malicious intent or by accident, such as in the case of an operational failure, customers are directly impacted.

In one representative case, FINRA initiated a proceeding against Citigroup Global Markets, Inc. when the firm failed to use reasonable diligence to ascertain the best interdealer market due to flawed pricing logic in the firm's proprietary order execution system, resulting in 7,204 instances where trades were executed at prices inferior to NBBO.[32] During the review periods, the supervisory system did not include WSPs for a best execution review of nonconvertible preferred transactions. For its best execution violations, Citigroup was sanctioned $1.4 million, and $450,000 for supervision violations.[33]

Similarly, other operational failures have resulted in customers not receiving disclosures, such as prospectuses, account statements and trade confirmations.[34]

Operational Failures Resulting in No Direct Market or Customer Impact

Not all operational failures resulting in regulatory violations entail tangible harm to the market or (in any direct way) to customers. For example, certain failures to retain email cases impair the regulatory process and hamper investigations. Nonetheless, FINRA has made clear that accurate recordkeeping, in particular, is essential to regulation[35] and has brought many enforcement actions relating to failure to retain email. One representative case against Citigroup Global Markets, Inc. involved the transferring of its email archiving system from a backup tape-based system to a journaling system that resulted in the firm losing emails on three of its email servers that related to five FINRA investigations. While this operational error did not result in investors being harmed, FINRA found that this conduct violated FINRA rules and resulted in Citigroup agreeing to $750,000 in sanctions.[36]

In addition to failures to retain email, operational failures may create document retention lapses. For example, FINRA found that when Frost Brokerage Services implemented a new email retention system created by a third-party vendor to retain registered representatives' emails, there was a difference in the time the firm's registered representative sent or received the email and the time stamp on the email as saved in the archive of the new system for an unknown number of emails.[37] While attempting to gather emails in response to a FINRA investigation, the firm also discovered that, due to a problem with the new email retention system, certain emails were being held in a database of the new system and were not moving to the archive portion of the system.

In another case, Barclays Capital, due to various inadequacies with its order management system, was unable to provide accurate order tickets involving options transactions that occurred on NYSE Arca's Trading Floor, and consequently, the review could not be completed.[38] FINRA found that, during an approximately four-year period, Barclays Capital failed to make and keep current and preserve in an easily accessible place approximately 250,000 brokerage order and dealer tickets, consisting of approximately 10 percent of all options orders executed by Barclays Capital during that period.

Operational failures also can directly impact a compliance department's ability to perform its role within the broker-dealer. FINRA's enforcement action against Commonwealth Financial Network involved a software upgrade that affected Commonwealth's surveillance software that was responsible for conducting daily reviews of associated persons' emails and forwarding emails to compliance for review. Following the software upgrade, the surveillance software stopped functioning properly, resulting in a failure to monitor approximately 90 percent of the emails sent by the firm's registered representatives through their DBA email accounts and approximately 474,380 emails sent/received by some of its registered representatives.[39]

In a similar vein, both FINRA and the SEC have brought enforcement actions where firms failed to provide FINRA, the SEC and other regulators with complete and accurate information about trades performed by the firms and their customers, commonly known as "blue sheet" data, due to operational failures. In 2014, FINRA brought a series of enforcement actions against Barclays Capital, Goldman Sachs and Merrill Lynch for submitting inaccurate blue sheet data, which resulted in $1 million fines against each firm.[40] In each case, the violations arose from problems with the firms' electronic systems used to compile and produce the blue sheet data.[41]

Likewise, in an enforcement case against Scottrade, the SEC found that Scottrade had violated Section 17(a) of the Exchange Act and Rules 17a-4(j), 17a-25 and 17a-4(f)(3)(v)[42] after a code change to a program used in the back office data processing system responsible for the handling of blue sheet requests caused Scottrade to fail to report in its blue sheet responses to the SEC trades transferred from its customers' accounts to its error accounts.[43]

In a very recent case involving OZ Management, the SEC alleged that the firm implemented a functionality that enabled its system to route trade files to prime brokers, but in a number of circumstances provided fund prime brokers with trade files that inaccurately listed the trade type (long or short) of sales. While trade settlement was unaffected, the erroneous data had a significant impact, causing the four prime brokers to inaccurately list approximately 552 million shares in their books and records, which was also incorporated into data that the brokers provided electronically to the regulators, resulting in approximately 14.4 million shares being inaccurately reported in response to the SEC's blue sheet request.[44]

> ***The agency's enforcement priorities at the time may weigh heavily on how a firm fares.***

Most recently, in September 2015, the SEC brought an enforcement action against Credit Suisse for failure to provide the required accurate and complete blue sheet submissions, resulting in at least 593 deficient blue sheet submissions and the omission of more than 553,400 reportable trades representing 1.3 billion shares. The SEC alleged that the violation was caused by technical and human errors.[45]

A final example of where operational failures can undermine regulatory processes is where a firm's (or service provider's) faulty systems result in failure to make regulatory filings. Although one might take the view that such lapses indirectly affect investors in some instances by compromising public disclosures that theoretically inform investor choices (such as those made available through FINRA's BrokerCheck system), these failures mainly serve to undermine regulatory processes. For example, in 2012, Merrill Lynch was sanctioned $500,000 when an operational failure caused the firm to fail to file hundreds of reports to FINRA, which included reports of customer complaints, criminal allegations against the firm's brokers and arbitrations that the brokers were involved in with FINRA.[46] Due to this failure to disclose, regulators and investors alike were not able to see that there had been complaints against the firm's brokers through BrokerCheck.[47]

Themes and Trends in Sanctions

Determining why regulators choose to pursue certain actions, and how various factors are weighed in relation to the aggravation and mitigation of penalties, is an art rather than a science, since this and other aspects of the enforcement process are often matters of regulator discretion. Moreover, a regulator's perception of such things as the overall culture of compliance at the firm, the firm's regulatory history, the extent of the firm's cooperation, and the firm's willingness to settle a particular matter quickly or slowly in light of pending corporate transactions may influence the regulator's decisions during settlement. Additionally, the agency's enforcement priorities at the time may weigh heavily on how a firm fares. The likely impact of a sanction on the firm's continued viability, the quality of available proof and the skill of the firm's counsel may also factor into the mix.

Nonetheless, we believe that the cases that we reviewed, in the aggregate, provide insight into how the SEC and FINRA are approaching cases involving operational failures at broker-dealers.

FINRA's Approach Versus the SEC's

The vast majority of cases brought for violations caused by operational failures were brought by FINRA, rather than the SEC.[48] The types of violations, with several notable exceptions, tend to be smaller violations that were likely discovered during the course of a FINRA examination.

Prior to 2015, the SEC typically pursued enforcement against firms for violations involving operational failures that resulted in large market impact or were headline grabbing.[49] However, the impact of technology on markets has been a theme of the SEC's and Chair White's public pronouncements,[50] rulemaking[51] and other initiatives, so it is not surprising that this focus should have found its way to the Division of Enforcement.

Types of Charges Used in Operational Failure Cases

There are three significant themes in the types of violations charged by FINRA in cases involving operational failures. First, the majority of operational failure cases brought by FINRA were for violations of specific substantive requirements (*e.g.,* failure to create or maintain required books and records, failure to deliver required disclosure documents or confirmations, or failure to comply with specific reporting obligations). Second, Rule 2010, FINRA's conduct rule, requires member firms to "observe high standards of commercial honor and just and equitable principles of trade"[52] and it has been included in almost every case involving operational failures that we reviewed.[53] Finally, Rule 3110, which requires firms to have in place supervisory systems that are reasonably designed to achieve compliance with the securities laws,[54] has been invoked in cases involving operational failures.

As noted above, FINRA often includes a Rule 2010 violation in its enforcement actions, which is not surprising since Rule 2010 is expansive and nebulous in scope, and FINRA has broad discretion in determining its applicability. Interestingly, in the cases surveyed, FINRA did not bring an enforcement action solely on the basis of a violation of Rule 2010. Further, FINRA's use of the just and equitable principles of trade provision is not explained, but rather simply tied to other violations, such as failure to supervise charges.[55] In other cases, FINRA applies the just and equitable violations to more substantive charges, such as a books and records violation.[56]

The vast majority of FINRA enforcement actions that were brought in response to operational failures at broker-dealers also included an allegation of a lapse in the firm's supervisory system, violating FINRA Rule 3110. For example, in July 2015, in connection with data reporting errors caused by a failure to properly update its systems, FINRA found that Barclays Capital's supervisory system was not reasonably designed to achieve compliance with certain securities laws and regulations relating to accurately reporting the executing parties.[57] Likewise, FINRA found Royal Bank of Scotland to have failed to enforce its supervisory system and written procedures concerning review of electronic communications due to the limitations of the third-party surveillance application used to review emails.[58] By using a failure to supervise charge in connection with such violations, FINRA is reinforcing its position that the firms have a duty to properly supervise their systems and employees to ensure compliance with the securities laws.

The vast majority of FINRA enforcement actions also included an allegation of a lapse in the firm's supervisory system.

Unlike the FINRA cases, there was no noticeable trend in the types of violations that the SEC alleged in the 2015 SEC Actions. For example, while the SEC charged Merrill Lynch for violations of Regulation SHO, the SEC settled with Goldman Sachs and Latour Trading for violating the market access rule.[59] OZ Management was charged with causing the blue sheet violations of four prime brokers, while Credit Suisse was charged with submitting inaccurate blue sheets to the SEC.[60] The SEC's focus on substantive Exchange Act violations, rather than "just and equitable principles of trade" and other SRO rule violations, may stem from a number of factors, including the fact that: (1) the Exchange Act does not contain a "just and equitable trade" requirement similar to FINRA Rule 2010;[61] and (2) the SEC is limited in its ability to enforce FINRA or other SRO rules, except under specific circumstances.[62]

Amount of Sanctions

Another identifiable trend in FINRA enforcement actions is the amount of the sanction, which is usually below $1 million.[63] FINRA fines have historically been smaller than those levied by the SEC. However, some FINRA cases have resulted in larger fines, at times surpassing the $1 million mark. FINRA cases involving operational failures that drew larger monetary penalties often involved: (1) the loss of records that impaired the ability of FINRA to exercise its oversight over its members;[64] (2) failures to make disclosures which potentially limited information that was available to the firm's investors;[65] and (3) the lack of or inadequate policies and procedures that could have prevented the underlying operational failure from occurring.[66] The FINRA enforcement actions caused by operational failures that drew the lowest fines involved third-party vendors.[67] A notable exception to this trend is FINRA's enforcement action against Chase in 2013 where a configuration error in a computer system maintained by a third-party vendor caused over 1 million ETF prospectuses not to be delivered to the firm's customers, resulting in an $825,000 penalty against the firm.[68]

Though not absolute, FINRA's Sanctions Guidelines provide insight into what FINRA may look to when determining the size of a sanction. Throughout the guidelines, FINRA provides leeway to the regulator, in cases involving egregious behavior. For example, according to FINRA's Sanction Guidelines, higher fines require that the violative conduct be "egregious."[69] Illustrative of this point, the Sanctions Guidelines provide that the sanctions for a best execution violation only exceed $292,000 if the violation resulted from egregious conduct. Recordkeeping violations involving egregious conduct may result in a fine between $10,000 and $146,000.[70] Therefore, it appears that operational failures causing large scale market disruption, impeding FINRA's investigations, or causing investor harm will likely result in a larger fine, especially if FINRA can categorize the conduct committed by the firm as egregious.

The 2015 SEC Actions, by contrast, each resulted in a seven-figure penalty (at a minimum). During the summer of 2015, the penalties for enforcement cases brought by the SEC reached a high of $15 million for violative behavior caused by operational failures.[71] The fact patterns themselves were not atypical of enforcement actions brought by FINRA, but the multi-million dollar penalties in each case is a new development. For example, the SEC's case against Credit Suisse for blue sheet violations resulted in a $4.25 million sanction.[72] The Credit Suisse case was similar to the 2014 FINRA blue sheet cases that resulted in a $1 million fine for each firm charged.

The multi-million dollar penalties in each case is a new development.

Firms are at a disadvantage when negotiating sanctions with the SEC because, unlike FINRA, the SEC does not issue a uniform set of guidelines for how sanctions are calculated.[73] Therefore, when examining the size of sanctions, one must look to the facts and circumstances of the case and what the SEC might have considered, such as the length of the violative activities, the size of the firm and whether the firm self-reported and cooperated during the course of the investigation.

Correlation Between Length of Violative Activities and Settlement Terms

Oddly, a review of FINRA cases did not result in the identification of a correlation between the length of the violation and the type of sanction or size of the fine as one might expect to see. For example, from May 2008 to October 2010, Chase failed to deliver approximately 1,101,271 prospectuses to its customers for certain mutual fund and exchange traded fund transactions, resulting in a fine of $825,000.[74] When Citigroup failed to deliver prospectuses for approximately 255,000 customer purchases of approximately 160 ETFs from 2009 through April 2011—a length of time similar to Chase's violations—Citigroup was fined $3 million.[75] While the duration of the violative behavior is consistent in both cases, Citigroup may have received the higher sanction due to the recidivist nature of its activities.[76]

With respect to the 2015 SEC Actions, there are again no clear trends suggesting a correlation between the length of the violative activities and the settlement terms. For example, the SEC alleged that Oz Management misidentified trades in data provided to four of its prime brokers for nearly a six-year period, fining the firm $4.25 million to settle the charges,[77] while the SEC settled similar charges for the same amount with Credit Suisse for violations over a two-year period.[78] There is no clear indication as to why the SEC sanctioned two firms the same amount for similar violations over largely different durations of time.

Regardless of the duration of a violation, if a firm discovers an error causing a violation and does not take prompt action, the firm's inaction is likely to be weighed against it during the course of settlement negotiations. Illustrative of this point is a recent CFTC action against Deutsche Bank in which the firm was sanctioned $2.5 million for failing to address reporting issues related to swap transactions until the CFTC's Division of Enforcement contacted the firm, even though the firm was aware of the issues.[79]

Consideration of Firm Size

When assessing the appropriate amount of a disciplinary sanction, FINRA has stated that such sanctions should be designed to protect the investing public by deterring misconduct and upholding high standards of business conduct.[80] When applying this principle and tailoring its sanctions, FINRA has advised adjudicators to consider a firm's size with a view towards ensuring that the sanctions are remedial in nature and designed to deter misconduct instead of being punitive, specifically considering: (1) financial resources; (2) nature of the firm's business; (3) number of individuals associated with the firm; and (4) level of trading activity at the firm.[81] However, though adjudicators are given leeway to consider the firm's size, FINRA also notes that if a violation is egregious in nature, the firm size should not be considered.[82]

If a violation is egregious in nature, the firm size should not be considered.

A review of FINRA cases reflects many fines that are relatively modest given to small firms that violated FINRA rules or the Exchange Act due to an operational failure.[83] This is not to say that all FINRA sanctions against larger firms are massive. FINRA also punished larger firms with small sanctions as well. For example, FINRA fined Merrill Lynch $10,000 for Regulation NMS violations caused by a coding error.[84] FINRA fined J.P. Morgan $50,000 for violations of NASD Rule 3310 and FINRA Rule 2010 due to violations caused by a systems merger following an acquisition.[85]

The SEC does not have a written rule on whether it considers the firm's size when determining sanctions, though one can imagine that this is a factor raised by the defense bar during the settlement process. In terms of recent SEC sanctions for securities laws violations caused by operational failures, each fine has been in the seven-figures range and each firm charged with a violation has been a major financial institution. Therefore, it appears that the impact of firm size on sanctions generally turns on who may be bringing the case. Larger firms could be subject to a FINRA or SEC action, whereas FINRA appears to be more focused on smaller firms.

Self-Reporting, Remedial Efforts and Cooperation

FINRA Rule 4530 requires a firm to, among other things, promptly report to FINRA any securities laws violations.[86] A number of the FINRA cases[87] included a cooperation credit for the firm's self-reporting of the violation as well as other cooperation efforts, such as providing FINRA with additional assistance and information above and beyond what is required by Rule 4530.[88] For example, when Citigroup upgraded its email archiving system, which resulted in a failure to retain millions of emails over a one-year and two-month period, FINRA credited Citigroup for self-reporting the issue and providing FINRA with the results of the firm's own internal investigation.[89] Another example involved Commonwealth Financial Network, which self-reported an email surveillance issue caused by a software violation and provided FINRA with information from its internal review, resulting in a cooperation credit towards its settlement.[90]

The SEC also publicly recognizes firms' remedial efforts and the cooperation afforded in settlement orders, including in five of the six 2015 SEC Actions.[91] The SEC previously has issued statements regarding cooperation, including the four measures considered when assessing cooperation by an entity: (1) self-policing prior to the discovery of the misconduct; (2) self-reporting of the misconduct when discovered; (3) remediation efforts; and (4) cooperation with law enforcement authorities, including providing the SEC with all relevant information related to the underlying violations and the company's remedial efforts.[92] While it is impossible to tell the extent that the remedial efforts and cooperation may have been factored into any given settlement, it is noteworthy that many settlement orders include such a statement and indicates that the SEC actively considers such cooperation.

As a separate but related point, experience shows that firms can help or hurt their prospects for avoiding an enforcement action, or mitigating penalties, by the way in which they handle operational concerns raised by regulatory examinations. By demonstrating to regulators that the firm is being proactive in addressing examination findings, firms can often turn around a hostile process. Helpful actions by the firm may include, where appropriate, acknowledging problems early, engaging outside counsel and consultants, providing complete information requested quickly, developing and adhering to detailed and credible remediation plans and involving appropriately senior levels of management.

Lessons Learned

The enforcement trends discussed in this article may be a useful guide to firms seeking to avoid operational errors that may violate the securities laws. As discussed in more detail below, firms should (1) "shore up" their compliance programs in times of change, (2) create thoughtful written supervisory procedures and controls and follow those closely, (3) conduct proper diligence and comprehensive testing in connection with software upgrades, (4) generally buttress their compliance programs to avoid human errors, (5) ensure third-party vendors are meeting regulatory obligations on behalf of the firms, and (6) facilitate ongoing surveillance to ensure compliance.

Mergers, Acquisitions and New Systems

A firm entering into a merger or acquisition should consider the technical impact on its systems as a result of the deal. In particular:

- *Operational due diligence*. As part of due diligence, the acquiring firm's IT department should be included in the operational due diligence process to ensure a proper understanding of the target's processes and whether those processes are appropriate for the acquiring firm's customer base and operational infrastructure. There may be a role for expert consultants in performing this type of due diligence in some cases.
- *Testing*. A firm should conduct robust testing to determine whether the newly merged systems are functioning properly and to identify potential issues before launching a potentially deficient system that could impact customers or the market place.
- *Updated policies and procedures*. A firm should consider if there is a need to update procedures relating to computer systems, operations systems, the detection and blocking of erroneous orders, and unusual transactions and reports.

Systems Upgrades

Software and hardware upgrades also will require robust testing and updated policies and procedures to ensure that appropriate controls are in place. Specifically, firms should consider:

- *Testing of internal controls*. A firm should test its internal control structure (*e.g.*, controls that should have the ability to detect and block potential issues caused by faulty technology) to ensure that no new or revised controls are necessary due to the upgrade.
- *Discipline in flipping the switch on new processes/changes*. A firm should be disciplined when taking a software upgrade live, ensuring that appropriate testing, reviews of policies and procedures, and examination of controls have been conducted beforehand.

Avoiding Human Errors

As noted above, many of the human errors identified by regulators as causing operational failures were due to a lack of training. In order to reduce the risk of operational failures caused by human error, a firm should ensure that employees are adequately trained on the relevant policies and procedures relating to the systems that they use and compliance departments should be cognizant of the need to update training as systems and processes change. Moreover, a thoughtful initial analysis of the human process and related controls with appropriate auditing may be in order in any case and appropriate testing of written supervisory procedures is essential. All supervisory procedures should be followed closely and periodically audited and tested.

Supervision of Vendors and Service Providers

To avoid liability for violations caused by vendors or service providers, a firm should ensure that third parties providing a compliance function or services that enable the firm to fulfill its regulatory obligations are supervised properly and are conforming to regulatory requirements. FINRA expects that members will have in place an appropriate supervisory system and written procedures regarding outsourcing to ensure compliance with applicable securities laws and FINRA rules. A firm may be proactive by requesting information regarding the vendor's ability to comply with the securities laws and the vendor's track record of compliance as part of its diligence during the hiring process and may request audit reports and third-party assessments of the potential vendor's compliance on an ongoing basis. In some cases, using consultants or independent third-party experts to vet service providers may be helpful.

Ongoing Surveillance of Processes

Compliance and supervisory procedures and controls should be periodically reviewed and revised to ensure that they reflect the current reality when new products, distribution methods or technologies are introduced. As part of their compliance programs, firms also must consider the appropriate frequency of audits and testing of existing processes to ensure that they are still running smoothly. Effective periodic testing may detect an operational failure in its early stages, allowing a firm to correct the issue and, if necessary, self-report prior to the situation escalating into a major operational failure that becomes the subject of a regulatory investigation.

Identification of a Compliance Issue

The firm must take immediate measures to stop the problem and prevent ongoing violations as soon as possible. And if employees at any level notice a problem, they need to continue raising the issue until it is addressed. Not only do these steps potentially prevent potential civil damages from compounding, but also failure to take prompt action will surely work against the firm in considering sanctions and raise the further risk of failure to supervise charges. In addition, the way in which a firm addresses items of an operational nature raised in an examination may help or hinder the firm's chances of limiting enforcement sanctions or avoiding enforcement altogether. A firm navigating a violation caused by an operational failure should coordinate with counsel to gather the information necessary to better understand the scope of the problem, the associated required reporting, potential cooperation with the regulators and anticipation of potential civil claims if customers or the market are affected.

Notes

1. While this article focuses on enforcement actions by the SEC, FINRA and other SROs, many broker-dealers are also regulated by other authorities, depending on their activities and affiliations. For example, many broker-dealers or their affiliates that engage in futures activities are also regulated by the Commodity Futures Trading Commission (CFTC), the National Futures Association and futures exchanges. Also, most larger broker-dealers are part of banking organizations, which are, in turn, subject to the regulatory and enforcement jurisdiction of the banking regulators, such as the Federal Reserve. In the past, these regulatory agencies have brought enforcement actions and used other regulatory powers, such as their examination authority to address operational failures. Firms whose activities are global in scope are also subject to enforcement by foreign regulators and SROs.

2. *See, e.g.*, 21 Gerard S. Citera, Broker-Dealer Supervision: A New Paradigm, Insights: The Corporate & Securities Law Advisor (July 2007).

3. Merrill Lynch, et al., Exchange Act Release No. 75083 (June 1, 2015); OZ Management LP, Exchange Act Release No. 75445 (July 14, 2015); Goldman Sachs & Co., Exchange Act Release No. 75331 (June 30, 2015); Citigroup Global Markets, Inc., Exchange Act Release No. 75729 (Aug. 19, 2015); Latour Trading LLC, Exchange Act Release No. 76029 (Sept. 30, 2015); and Credit Suisse Securities (USA) LLC, Exchange Act Release No. 75992 (Sept. 28, 2015). In its 2015 year-end press release announcing enforcement results, the SEC highlighted its cases against Merrill Lynch, Goldman Sachs and Latour Trading. *See* Press Release, Sec. Exch. Comm'n, SEC Announces Enforcement Results For FY 2015: Results Include Significant Number of High-Impact and First-of-their-Kind Actions (Oct. 22, 2015).

4. Merrill Lynch, et al., Exchange Act Release No. 75083 (June 1, 2015).

5. Citigroup Global Markets, Inc., Exchange Act Release No. 75729 (Aug. 19, 2015).

6. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Knight Capital with Violations of Market Access Rule (Oct. 16, 2013), *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539879795.*

7. *Id.*

8. Citadel Securities LLC, FINRA Acceptance, Waiver and Consent (AWC) No. 20100223345-05 (June 6, 2014).

9. NASD Rule 3010 (now FINRA Rule 3110 (Supervision)) requires firms to, among other things, establish, maintain and enforce a system of supervision that is reasonably designed to achieve compliance with applicable securities laws and regulations.

FINRA Rule 2010 requires firms to "observe high standards of commercial honor and just and equitable principles of trade when conducting business."

Exchange Act Rule 15c3-5 requires that financial risk management controls and supervisory procedures be reasonably designed to systemically limit the financial exposure of the broker-dealer that could arise as a result of market access. The rule further requires that regulatory risk management controls and supervisory procedures be reasonably designed to ensure compliance with all regulatory requirements that are applicable in connection with market access. 17 C.F.R. 240.15c3-5.

10. Merrill Lynch, NYSE Exchange Hearing Panel Decision, 05-87 (July 21, 2005).

11. The NYSE found that Merrill Lynch violated Section 5(b)(2) of the Securities Act by failing to deliver prospectuses in connection with sales of registered securities and Exchange Rules 401 and 476(a)(6) by failing to adhere to principles of good business practice and engaging in conduct that was inconsistent with just and equitable practices. Merrill Lynch, NYSE Exchange Hearing Panel Decision, 05-87 (July 21, 2005).

12. Citigroup Global Markets, FINRA AWC No. 20100218231 (Dec. 2, 2011).

13. MBSC Securities Corporation, FINRA AWC No. 20100213120-01 (Dec. 30, 2010).

14. E*Trade Securities LLC, FINRA AWC No. 20070094711-02 (May 10, 2010).

15. J.P. Morgan Securities LLC, FINRA AWC No. 20100220780-01 (May 15, 2012).

16. NASD Rule 3310 (now FINRA Rule 5210) prohibits publishing quotations or transactions not believed to be bona fide.

17. Goldman Sachs & Co., Exchange Act Release No. 75331 (June 30, 2015).

18. Citigroup Global Markets, Inc., FINRA AWC No. 2011026502901 (Dec. 11, 2014).

19. FINRA, Notice to Members, Guidance, Outsourcing: Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers, NASD NTM No. 05-48 (2005), *http://www.finra.org/sites/default/files/NoticeDocument/p014735.pdf.* If a vendor fails to comply with the securities law, the broker-dealer will have double liability, first for the substantive violation caused by the vendor and second for failure to comply with FINRA's outsourcing guidance.

20. PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 15, 2010).

21. Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012).

22. PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 15, 2010).

23. Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012).

24. Chase Investment Securities, FINRA AWC No. 20110262791 (Dec. 18, 2013).

25. Though outside the scope of this article, other market participants, such as exchanges, also have fallen victim to operational failures leading to enforcement actions. For example, on May 18, 2012, NASDAQ experienced technology problems in its handling of Facebook's IPO due to a system limitation, causing a delay in the start of Facebook trading and large-scale confusion as to the status of customer orders. The SEC brought an enforcement action against NASDAQ for violations of Section 19(g)(1) of the Exchange Act, Regulation SHO and Regulation NMS. *See* The NASDAQ Stock Market, LLC, Exchange Act Release No. 69655 (May 29, 2013).

26. Citadel Securities LLC, FINRA AWC No. 201022345-05 (June 2, 2014).

27. Matthew Goldstein, DealBook, *Goldman Sachs to Pay $7 Million Penalty Over Options Glitch*, N.Y. Times (June 30, 2015), *http://www.nytimes.com/2015/07/01/business/dealbook/goldman-sachs-to-pay-7-million-penalty-over-options-glitch.html.*

28. Knight Capital Americas LLC, Exchange Act Release No. 70694 (Oct. 16, 2013).

29. *Id*. Partly due to this trading event, Knight was left on the brink of insolvency and was ultimately acquired by Getco LLC.

30. *See, e.g.*, FINRA Rule 5310.

31. U.S. Sec. & Exch. Comm'n, Fast Answers: Best Execution (2011), *http://www.sec.gov/answers/bestex.htm.* Whether a broker-dealer exercised reasonable diligence to ascertain the best execution involves a "facts and circumstances" analysis. NASD Notice to Members 01-22.

32. Citigroup Global Markets, Inc., FINRA AWC No. 20090187389-01 (Aug. 26, 2014).

33. *See* News Release, FINRA, FINRA Fines Citigroup Global Markets, Inc. $1.85 Million and Orders Restitution of $638,000 for Best Execution and Supervisory Violations in Non-Convertible Preferred Securities Transactions (Aug. 26, 2014), *https://www.finra.org/newsroom/2014/finra-fines-citigroup-global-markets-inc-185-million-and-orders-restitution-638000.*

34. *See, e.g.,* Citigroup Global Markets, Inc. FINRA AWC No. 2011026502901 (Dec. 11, 2014); Chase Investment Securities, FINRA AWC No. 20110262791 (Dec. 18, 2013); PFS Investments, Inc., FINRA AWC No. 2011025791201 (Aug. 30, 2012).

35. FINRA has stated: "The policy underlying the recordkeeping provisions is to ensure that regulators have access to certain basic information about securities transactions to allow it to adequately police the securities markets. Access to transaction records such as order tickets therefore serve as an essential component of the surveillance of broker-dealers by self-regulatory bodies." *FINRA v. Barclays,* NYSE Arca Proceeding No. 20110275670-02 (June 20, 2014).

36. Citigroup Global Markets, FINRA AWC No. 20100218231 (Dec. 2, 2011).

37. Frost Brokerage Services, Inc., FINRA AWC No. 2008014620601 (Aug. 5, 2011).

38. *FINRA v. Barclays,* NYSE Arca Proceeding No. 20110275670-02 (June 20, 2014).

39. Commonwealth Financial Network, FINRA AWC No. 2012032025201 (Mar. 19, 2014).

40. *See* Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA AWC No. 2013037904801 (June 4, 2014); Barclays Capital Inc., FINRA AWC No. 2013036917401 (June 4, 2014); Goldman, Sachs & Co., FINRA AWC No. 2013037230001 (June 4, 2014).

41. FINRA also found that the firms did not have in place adequate audit systems to provide for accountability of their blue sheet submissions and required each firm to certify that it had conducted a comprehensive review of its systems.

42. Exchange Act Rule 17a-25 requires broker-dealers to submit electronically securities transaction information upon request by SEC staff. Exchange Act Rule 17a-4(j) requires broker-dealers to furnish promptly true, complete and current copies of records upon request by the SEC staff. Exchange Act Rule 17a-4(f)(3)(v) requires broker-dealers to have an audit system in place that provides for accountability regarding the inputting of records required to be maintained and preserved.

43. Scottrade, Inc., Exchange Act Release No. 71435 (Jan. 29, 2014).

44. Press Release, U.S. Sec. & Exch. Comm'n, OZ Management LP Admits Providing Inaccurate Data, Impacting Brokers' Record and "Blue Sheets," (July 14, 2015), *http://www.sec.gov/news/pressrelease/2015-145.html.* In its press release, the SEC emphasized that it "relies on the accuracy of the books and records of financial institutions and blue sheet data. OZ Management's inaccurate data had a substantial ripple effect that the SEC staff discovered through diligent investigative work." *Id.*

45. Credit Suisse Securities (USA) LLC, Exchange Act Release No. 75992 (Sept. 28, 2015).

46. Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA AWC No. 20090203563 (Sept. 21, 2012).

47. *Id*.

48. Of the 56 cases reviewed for this survey, approximately 18 percent of the cases reviewed were brought by the SEC and 82 percent by FINRA.

49. Knight Capital Americas LLC, Exchange Act Release No. 70694 (Oct. 16, 2013). During the time of the SEC's enforcement action, there had been wide press coverage of the circumstances surrounding the SEC's enforcement action against Knight.

50. *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Keynote Address at the Evolving Structure of the U.S. Treasury Market Conference, Federal Reserve Bank of New York: "Taking Stock of Treasury Market Regulation" (Oct. 20, 2015); Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference (June 5, 2014); Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Economic Club of New York (June 20, 2014); and Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting on Regulation SCI (Nov. 19, 2014).

51. *See, e.g.,* Regulation Systems Compliance and Integrity, 79 Fed. Reg. 72252 (Dec. 5, 2014).

52. FINRA Rule 2010 (2014).

53. *See, e.g.,* LPL Financial Corporation, FINRA AWC No. 2009016570001 (Jan. 20, 2011); Frost Brokerage Services, Inc. No. 20080146206 (Aug. 1, 2011); Citigroup Global Markets Inc., FINRA AWC No. 20100218231 (Dec. 2, 2011); Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012); J.P. Morgan Securities LLC, FINRA AWC No. 20100220780-01 (May 15, 2012); VCAP Securities, LLC, FINRA AWC No. 2010021119401 (May 31, 2012); PFS Investments, Inc., FINRA AWC No. 2011025791201 (Aug. 30, 2012); Interactive Brokers LLC, FINRA AWC No. 20100234784-01 (Apr. 5, 2013); First Asset Financial, Inc., FINRA AWC No. 2012030785501 (May 2, 2013); MBSC Securities Corp., FINRA AWC No. 20120329950-01 (Dec. 16, 2013); Commonwealth Financial Network, FINRA AWC No. 2012032025201 (Mar. 19, 2014); Citadel Securities, FINRA AWC No. 20100223345-05 (June 12, 2014); TD Ameritrade Clearing, Inc., FINRA AWC No. 2011030752701 (July 2, 2014); SunTrust Investment Services, Inc., FINRA AWC No. 2011029668001 (Sept. 2, 2014); Jefferies LLC, FINRA AWC No. 2012030420201 (Sept. 3, 2014); Betterment Securities, FINRA AWC No. 20120304068-01 (Sept. 25, 2014); RBS Securities, Inc., FINRA AWC No. 2012030528601 (Jan. 30, 2015); Merrill Lynch, Pierce, Fenner & Smith, Inc., FINRA AWC No. 2011028644501 (Feb. 5, 2015); Ladder Capital Securities LLC, FINRA AWC No. 2014041526501 (Apr. 28, 2015).

54. *See, e.g.,* MBSC Securities Corp., FINRA AWC No. 20120329950-01 (Dec. 16, 2013); MBSC Securities Corporation, FINRA AWC No. 20100213120-01 (Dec. 30, 2010); Citigroup Global Markets, Inc., FINRA AWC No. 20100218231(Dec. 2, 2011); Order Accepting Offers of Settlement, *Dep't of Enf't v. McManus & Miles Inc.,* No. 2009016343701 (FINRA Dec. 18, 2011); VCAP Securities LLC, FINRA AWC No. 2010021119401 (May 31, 2012); PFS Investments, Inc., FINRA AWC No. 2011025791201 (Aug. 30, 2012); TD Ameritrade Clearing, Inc., FINRA AWC No. 2011030752701 (July 2, 2014); SecondMarket, FINRA AWC No. 2011029759901 (Dec. 23, 2014).

55. *See e.g.,* LPL Financial Corporation, FINRA AWC No. 2009016570001 (Jan. 20, 2011); Frost Brokerage Services, Inc., FINRA AWC No. 20080146206 (Aug. 1, 2011).

56. *See* Citigroup Global Markets Inc., FINRA AWC No. 20100218231 (Dec. 2, 2011); Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012); VCAP Securities, LLC, FINRA AWC No. 2010021119401 (May 31, 2012); PFS Investments, Inc., FINRA AWC No. 2011025791201 (Aug. 30, 2012).

57. Barclays Capital, Inc., FINRA AWC No. 20120337256-01 (July 14, 2015).

58. RBS Securities Inc., FINRA AWC No. 2012030528601 (Jan. 30, 2015).

59. The SEC also alleged and settled with Latour Trading for Regulation NMS violations.

60. *See* OZ Management LP, Exchange Act Release No. 75445 (July 14, 2015); Credit Suisse Securities (USA) LLC, Exchange Act Release No. 75992 (Sept. 28, 2015).

61. *See* Robert L. D. Colby, Federal Securities Exchange Act of 1934, Chapter 2 Regulation of Securities Markets (2015) for a discussion of the development of FINRA's just and equitable trade requirement.

62. *See* Exchange Act Section 21(f) (limiting the grant of authority contained in Sections 21(d)(1) and (e)(1)). By contrast, FINRA has the authority to enforce both the Exchange Act and FINRA's own rules. *See* Exchange Act Sections 15A(b)(2) and 19(g)(1).

63. *See, e.g.,* PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 15, 2010); E*Trade Securities LLC, FINRA AWC No. 20070094711-02 (May 10, 2010); Edward D. Jones & Co., FINRA AWC No. 2007010537701 (June 2, 2010); MBSC Securities Corporation, FINRA AWC No. 20100213120-01 (Dec. 30, 2010); LPL Financial Corporation, FINRA AWC No. 2009016570001 (Jan. 20, 2011); Citigroup, FINRA AWC No. 20100218231 (Dec. 2, 2011); Order Accepting Offers of Settlement, *Dep't of Enf't v. McManus & Miles Inc.,* No. 2009016343701 (FINRA Dec. 19, 2011); Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012); VCAP Securities LLC, FINRA AWC No. 2010021119401 (May 31, 2012); PFS Investments, Inc., FINRA AWC No. 2011025791201 (Aug. 30, 2012); Scottrade, Inc. FINRA AWC No 20090199136-01 (Jan. 15, 2013); Interactive Brokers LLC, FINRA AWC No. 20100234784-01 (Apr. 5. 2013); SEI Investments Distribution Co., FINRA AWC No. 2012030611301 (Apr. 12, 2013); First Asset Financial, Inc., FINRA AWC No. 2012030785501 (May 2, 2013); Citadel Securities LLC, FINRA AWC No. 20100223345-05 (June 12, 2014); Alternet Securities Inc., FINRA AWC No. 2011030810101 (Aug. 28, 2013); National Financial Services LLC, FINRA AWC No. 2012031282301 (Nov. 13, 2013); Merrill Lynch, Pierce, Fenner & Smith, Inc., FINRA AWC No. 2009016999-01 (Nov. 18, 2013); Lazard Capital Markets LLC, FINRA AWC No. 20130356817-01 (Dec. 3, 2013); MBSC Securities Corp., FINRA AWC No. 20120329950-01 (Dec. 16, 2013); Chase Investment Services Corp., FINRA AWC No. 20110262791 (Dec. 18, 2013); Commonwealth Financial Network, FINRA AWC No. 20120330969-01 (Apr. 8, 2014); CovergEx Execution Solutions LLC, FINRA AWC No. 20120330969-01 (Apr. 8, 2014); TD Ameritrade Clearing, FINRA AWC No. 2011030752701 (July 2, 2014); SunTrust Investment Services, Inc., FINRA AWC No. 2011029668001 (Sept. 2, 2014); Forethought Distributors, LLC, FINRA AWC No. 2013038584601 (Dec. 26, 2014); SecondMarket, FINRA AWC No. 2011029759901 (Dec. 23, 2014); Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA AWC No. 2011028644501 (Feb. 5, 2015); WealthForge, FINRA AWC No. 2014041526501 (Apr. 28, 2015); Ladder Capital Securities LLC, FINRA AWC No. 2014041526501 (Apr. 28, 2015).

64. *See, e.g.,* Citigroup Global Markets, FINRA AWC No. 20100218231 (Dec. 2, 2011); LPL Financial, FINRA AWC No. 2012032218001 (May 21, 2013).

65. *See, e.g.,* Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA AWC No. 20090203563 (Sept. 21, 2012); Chase Investment Services Corp., FINRA AWC No. 20110262791 (Dec. 18, 2013).

66. *See, e.g.,* Barclays Capital Inc., FINRA AWC No. 20120337256-01 (July 14, 2015); Knight Capital Americas LLC, Exchange Act Release No. 70694 (Oct. 16, 2013); Citigroup Global Markets, FINRA AWC No. 2011026502901 (Dec. 11, 2014); Citadel Securities LLC, FINRA AWC No. 20100223345-05 (June 12, 2014).

67. Most of the cases surveyed that involved third-party vendors drew fines that were $100,000 or below. *See, e.g.,* PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 15, 2010); Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012); SEI Investment Distribution, FINRA AWC No. 2012030611301 (Apr. 12, 2013); First Asset Financial, Inc., FINRA AWC No. 2012030785501 (May 2, 2013); National Financial Services LLC, FINRA AWC No. 2012031282301 (Nov. 13, 2013); Betterment Securities, FINRA AWC No. 20120304068-01 (Sept. 25, 2014); Ladder Capital Corporation, FINRA AWC No. 2014041526501 (Apr. 28, 2015).

68. Chase Investment Securities, FINRA AWC No. 20110262791 (Dec. 18, 2013).

69. *See* FINRA Sanction Guidelines 50 (2015).

70. *Id.* at 29.

71. Citigroup Global Markets, Inc., Exchange Act Release No. 75729 (Aug. 19, 2015).

72. Credit Suisse Securities (USA) LLC, Exchange Act Release No. 75992 (Sept. 28, 2015).

73. *See* Evan Weinberger, SEC Guidelines on Sanctions Unlikely to Ease Tension, Law360 (June 2, 2010), available at *http://www.law360.com/articles/170411/sec-guidelines-on-sanctions-unlikely-to-ease-tension.*

74. Chase Investment Services Corp., FINRA AWC No. 20110262791 (Dec. 18, 2013).

75. Citigroup Global Markets Inc., FINRA AWC No. 2011026502901 (Dec. 11, 2014).

76. In 2007, Citigroup had been sanctioned for failure to deliver disclosures documents relating to ETFs. NYSE Hearing Board Decision 07-143.

77. OZ Management LP, Exchange Act Release No. 75445 (July 14, 2015).

78. Credit Suisse Securities (USA) LLC, Exchange Act Release No. 75992 (Sept. 28, 2015).

79. *See, e.g.,* Deutsche Bank AG, CFTC No. 15-40, 2015 WL 5783049 (Sept. 30, 2015).

80. *See* FINRA Sanction Guidelines at 2.

81. *Id.*

82. *Id.* ("Adjudicators may consider a firm's small size in connection with the imposition of sanctions with respect to rule violations involving negligence. With respect to violations involving fraudulent, willful or reckless misconduct, Adjudicators should consider whether, given the totality of the circumstances involved, it is appropriate to consider a firm's small size and may determine that, given the egregious nature of the fraudulent activity, firm size will not be considered in connection with sanctions.").

83. *See, e.g.,* PlanMember Securities Corporation, FINRA AWC No. 2009016589701 (Apr. 15, 2010); Order Accepting Offers of Settlement, *Dep't of Enf't v. McManus & Miles Inc.,* No. 2009016343701 (FINRA Dec. 19, 2011); Van Clemens & Co. Inc., FINRA AWC No. 2011025499401 (Mar. 21, 2012); VCAP Securities LLC, FINRA AWC No. 2010021119401 (May 31, 2012); First Asset Financial, Inc., FINRA AWC No. 2012030785501 (May 2, 2013); Alternet Securities Inc., FINRA AWC No. 2011030810101 (Aug. 28, 2013); Forethought Distributors, LLC, FINRA AWC No. 2013038584601 (Dec. 26, 2014).

84. Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA AWC No. 20080123505-01 (May 9, 2012).

85. J.P. Morgan Securities LLC, FINRA AWC No. 20100220780-01 (May 15, 2012).

86. FINRA Rule 4530(b). However, FINRA expects a member to report "only conduct that has widespread or potential widespread impact to the member, its customers or the markets, or conduct that arises from a material failure of the member's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts." FINRA Rule 4530 Supp. Material .01. It should be noted that a firm could have double liability if it did not make the appropriate reports—first, for violating the securities laws and second, for a failure to report.

87. Citigroup Global Markets, FINRA AWC No. 20100218231 (Dec. 2, 2011); Commonwealth Financial Network, FINRA AWC No. 2012032025201 (Mar. 19, 2014); National Financial Services LLC, FINRA AWC No. 2012031282301 (Nov. 13, 2013); MBSC Securities Corporation, FINRA AWC No. 20100213120-01 (Dec. 30, 2010).

88. FINRA Rule 4530 FAQ 1.7 states that: "For credit for self-reporting, [the firm] would, at a minimum, have to include a detailed account of the discovered conduct and an offer to explain in complete detail all aspects of the conduct and provide relevant documents and witnesses. Furthermore, additional factors to be considered in evaluating credit for cooperation include, but are not limited to: (1) extraordinary steps to correct deficient procedures and systems; (2) extraordinary remediation to customers; and (3) other substantial assistance to FINRA investigations." *http://www.finra.org/industry/faq-rule-4530-frequently-asked-questions#1-7.*

89. Citigroup Global Markets Inc., FINRA AWC No. 20100218231 (Dec. 2, 2011).

90. Commonwealth Financial Network, FINRA AWC No. 2012032025201 (Mar. 19, 2014).

91. The SEC did not include a remediation section in its settlement order with Merrill Lynch. Merrill Lynch, et al., Exchange Act Release No. 75083 (June 1, 2015).

92. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, Exchange Act Release No. 61340 (Jan. 19, 2010).

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