


## FINRA report expected to spur more extensive exams

In response to FINRA's self-critique of its handling of the **Bernie Madoff** and **R. Allen Stanford** cases, laid out in a report  FINRA released Oct. 2, the SRO is making sure its examiners are attuned to fraudulent activity. But don't hold your breath thinking this will result in examiners easing up elsewhere, industry pros cautioned.

"I think they're going to have to do both," said **Brian Rubin**, a partner in the Washington office of **Sutherland**. "[Examiners] can't get away from the nuts and bolts review that they currently do but at the same time, they will have to look at questionable activity that falls outside the boundaries of what they normally focus on, which could be fraud-related," he added.

A similar view was expressed by **Amy Lynch**, president of **FrontLine Compliance, LLC**, a regulatory compliance consulting firm based in Alexandria, Va. "I don't know if they're going to completely move away from the way they conduct exams now. The rules are still there for firms. They still have to maintain books and records, and those books and records will need to be reviewed, so I suspect they'll be adding more to the examination process as opposed to taking away," Lynch said.

Still, for FINRA to add a new fraud aspect to its exam regime will require greater resources, or

require FINRA to refine its risk-based approach to selecting firms for examination, Rubin predicted.

## Employee-employer arbitration

Another change deals with allegations that could surface in arbitration. These allegations can become grist for FINRA investigators to probe. The FINRA self-critique indicated that some of the allegations raised by a former Stanford employee in an arbitration case might have led to Stanford's alleged \$8 billion Ponzi scheme being detected much earlier if FINRA had checked out those allegations.

**Tip:** Consider interviewing a sampling of employees when they leave the firm so you can find out about firm-related problems you should know about, Rubin suggested. Some of these issues also might arise in employee-employer arbitration cases later.

Last March, FINRA implemented a policy to have its investigative staff - not just arbitrators - review all statements of claims made in employer-employee arbitration cases, according to testimony that FINRA Executive Vice President **Daniel Sibears** gave to the Senate Banking Committee in August (*BD Week*, Aug. 24, 2009).

## Use of NASD rule 2110 might increase

FINRA might increase its use of NASD rule 2110 (currently FINRA rule 2010), which cites the requirement for following "just and equitable principles of trade," even if no other FINRA rules are cited, as long as it relates to actions by a registered rep or by the broker-dealer, Rubin said.

The report indicated that FINRA could have invoked this rule to examine the CDs that Stanford's BD was selling even though there was some question among FINRA staff about whether the CDs were securities.

The report stated that FINRA has authority to use FINRA rule 2010 to sanction member firms and

*(FINRA report, continued on page 2)*

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**FINRA report** *(cont. from pg. 1)*

associated persons for a broad range of unlawful or unethical activities, including those not involving ‘securities.’ “For example, the SEC has approved FINRA disciplinary actions involving conduct related to insurance applications and premiums, tax shelters, the general entrepreneurial activity of member firms, and even to a member firm employee’s improper use of a co-worker’s credit card,” the report said.

Also noted in the report is that FINRA has the authority to get information about securities transactions “executed as part of an investment advisory business that is conducted within the legal entity registered as the broker-dealer. FINRA, however, has not utilized the full extent of its jurisdiction.”

“I think we will see [use of FINRA rule 2010] more in the future, and it may be an attempt by FINRA to assert its power and to establish itself to be in a position to formally regulate RIAs, if and when that happens,” Rubin said.

**Third-party verification**

A recommendation made in the report was the need for FINRA staff to check firm-provided information with third-parties. Given that SEC examiners are contacting some firms’ customers, “most likely FINRA will also start doing that during routine examinations,” Lynch said.

“There’s going to be push-back initially,” Lynch said. “But if it does truly become routine, the industry will eventually get used to it. They will find a way to communicate to their customers that this is

happening during these routine examinations, and that there’s nothing to worry about – most likely, of course.”

Among the reports other findings and recommendations:

✓ FINRA waited three years to investigate a 2005 tip from the SEC’s Fort Worth, Texas office that stated that Stanford’s CD program was “too good to be true”;

✓ In 2005 and possibly even today, FINRA’s exam staff are unsure of the full scope of FINRA’s investigative authority;

✓ FINRA’s routine cycle exams lack a means to uncover complex frauds; and

✓ **Bernerd Young**, who headed FINRA’s Dallas office from 1999 to 2003 became the compliance manager for the Stanford firm from June 2006 through 2009. No evidence was found suggesting that Young’s presence at Stanford compromised FINRA’s subsequent exams of the firm.

Changes FINRA has made include beefing up the exam program to better detect fraud, creating an Office of the Whistleblower, and planning technology improvements to better share information within FINRA. ■

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