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FINRA Facts and Trends: March 2024 - Bracewell

Welcome to the latest issue of Bracewell's FINRA Facts and Trends, a monthly newsletter devoted to condensing and digesting recent FINRA developments in the areas of enforcement, regulation and dispute resolution. This month, we report on FINRA's focus on uses of artificial intelligence as an emerging risk, oral argument in the Alpine Securities case that has broad implications for FINRA, a pair of enforcement matters that shed light on FINRA's concerns with off-channel communications, and much more.

FINRA Proposes Expanding Category of Persons Who May Receive Projections and Targeted Returns

In our December 2023 issue, we discussed a FINRA proposal that would amend Rule 2210 (Communications with the Public), which generally prohibits projections of performance or targeted returns in member communications, subject to certain exceptions. The amendment would allow member firms to provide projected performance or targeted returns in institutional communications and in communications to qualified purchasers.

FINRA has now filed Partial Amendment No. 1, which "marginally expand[s]" the category of persons who can receive projected performance or target returns to include "knowledgeable employees." As defined in Rule 3c-5 of the Investment Company Act, the term "knowledgeable employees" generally includes officers, directors, trustees, general partners and advisory board members, or persons serving in similar capacities of the fund or certain of its affiliates, as well as other employees that participate in the investment activities of the fund or certain of the fund's affiliates. As for why FINRA elected to include "knowledgeable employees," it noted that these employees typically have sufficient knowledge of the operations of the private funds with which they are associated. As a result, they are "less likely not to understand the risks and limitations of projections or targeted returns associated with such funds." Comments on the original amendment and Partial Amendment No. 1 are due by March 20, 2024. Anyone who wishes to file a rebuttal to a comment must do so by April 3, 2024.

FINRA Zeroes in on Vendor Use of Generative AI and Large Language Models

In its 2024 Annual Regulatory Oversight Report, which we reported on earlier, FINRA classified artificial intelligence as an "emerging risk," noting that deploying AI in the industry could affect virtually all aspects of a broker-dealer's operations. Now, in a recent episode of the FINRA podcast "FINRA Unscripted," three prominent executives at FINRA offered further insight into two particular risks: vendor use of generative AI and large language models. Generative AI, which gained popularity with the launch of ChatGPT in November 2022, refers to a category of artificial intelligence systems that are designed to generate new, original content rather than simply analyze existing data. While generative AI has the ability to create new content, including text images and even audio, based on patterns and information that it learns from extensive training data, large language models are specifically designed for tasks revolving around natural language generation and comprehension. Large language models have been trained on immense amounts of text data that allow them to learn patterns and relationships between words and phrases and generate natural

language and other types of content to perform a wide range of tasks.

Generative AI and large language models, while providing efficiencies that help member firms better serve customers, also present serious vendor management questions. From time to time, FINRA has made a point of cautioning firms and their registered representatives on the potential pitfalls when relying on these third-party vendors. During the COVID-19 pandemic, for example, FINRA observed that firms were increasingly leveraging vendors to perform risk management functions and to assist in supervising sales and trading activity and in customer communications. To address this concern, in 2021, FINRA published Regulatory Notice 21-29 on the topic of supervisory obligations related to outsourcing to third parties.

Now, however, vendor use of artificial intelligence presents another, albeit less predictable, layer of concern about accuracy, privacy, bias and intellectual property. According to Andrew McElduff, Vice President with Member Supervision's Risk Monitoring team, when it comes to supervising a vendor's use of these technologies, firms must do their diligence and ask the necessary questions to determine where their information is being stored and whether it is restricted only for the firm's use. When it comes to firms' use of vendors, Haimera Workie, Vice President and head of FINRA's Office of Financial Innovation, cautions firms and their registered representatives: "You can delegate a function, but you can't delegate ultimate responsibility." As a result, firms should make sure to have in place written compliance and operational policies and procedures concerning the supervision of artificial intelligence systems and ensure that all contracts with third-party vendors protect the information of the firm and its clients.

Oral Argument Held in Challenge to Constitutionality of FINRA Enforcement Powers

The landmark case brought by Alpine Securities Corporation against FINRA continues to make its way toward a decision in the DC Circuit Court of Appeals, with an oral argument held last month. As we have reported previously, the case has potentially monumental implications for FINRA's future.

Alpine, a firm that was expelled from FINRA membership following a 19-day hearing by an extended FINRA hearing panel, has sought to enjoin this so-called "corporate death penalty" by challenging the constitutionality of FINRA's enforcement powers based on an argument that FINRA wields those powers in violation of the Appointments Clause of the US Constitution. This argument was applied by the US Supreme Court, in Lucia v. Securities and Exchange Commission, decided in 2018, to hold that the SEC's Administrative Law Judges (ALJs) are subject to the Appointments Clause. In its briefs, FINRA has characterized the challenge to its own powers as an "existential threat."

While there is always danger in attempting to read into a court's comments at oral argument, the three-judge panel of the DC Circuit expressed a fair degree of skepticism concerning the constitutional challenge brought by Alpine.

Counsel for Alpine argued that the "existential threat" runs both ways, and that the remedy Alpine seeks is the "ability to continue to run its business, while it pursues its claims, free from summary imposition of the corporate death penalty by an unaccountable enforcer of federal law."

But Judge Millett pushed back on the phrase "corporate death penalty," pointing out that FINRA cannot actually close Alpine's (or any firm's) business, but only expel Alpine from its private organization. Still, Judge Millett acknowledged that "the consequence of that, thanks to Congressional statute, may be that it's going to be very hard to stay in business." Chief Judge Srinivasan also provided some clarification as to whether FINRA is truly "unaccountable," asserting that any FINRA decision is immediately appealable to the SEC, which has the authority to issue a stay, such that the decision does not "irrevocably take effect immediately." Judge Millett, however,

leveled the harshest criticism of Alpine's position, stating: "I think it would be the first time . . . that a court would be declaring someone an officer of the United States when they are hired by, employed by, and paid by a private entity."

Counsel for FINRA took up this argument, telling the Court that: "No court in any jurisdiction has ever held that the Appointments Clause applies to employees of a private corporation. Alpine has not identified any reason for this Court to be the first to reach that unprecedented conclusion."

The judges had difficult questions for FINRA's counsel too. Chief Judge Srinivasan appeared concerned that FINRA's position was overly formalistic, and would allow the SEC to avoid the Appointments Clause problem identified in Lucia by doing nothing more than retaining a private contractor to perform the function of its ALJs. Judge Millett, however, argued that "historically, that was how the federal government did prosecutions . . . . It would contract out lawyers to prosecute cases. . . . Lincoln prosecuted cases for the federal government." Of the three-judge panel, Judge Walker appeared most troubled by the implications of FINRA's arguments, telling FINRA's counsel, "I think where we part ways is that you . . . disagree with this statement: significant executive power cannot be exercised by private citizens at all."

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

Notable Enforcement Matters and Disciplinary Actions

Off-Channel Communications. In its 2024 Annual Regulatory Oversight Report (which we highlighted in our January newsletter), FINRA emphasized its growing concern surrounding off-channel communications — those that occur on non-firm platforms or devices. FINRA has backed up its warning with a series of fines and suspensions stemming from brokers' engagement in such off-channel communications. In a recent enforcement action in February, FINRA imposed a $75,000 fine on a brokerage firm, alleging that it failed to adequately supervise employees' use of personal email for business-related communications. The firm also allegedly failed to retain these emails, contravening both Securities Exchange Act and FINRA rules. Despite being alerted to at least one representative regularly using personal email for business purposes, the firm took insufficient action and merely issued automated warnings with respect to some of the off-channel communications. As a result, correspondence between representatives' personal email addresses and customers remained unpreserved. In a separate enforcement action, a broker agreed to fines and a two-month suspension from the industry for allegedly exchanging hundreds of securities-related text messages with 14 firm customers via his personal cell phone. Since the device was not sanctioned by his firm, none of these messages were captured or maintained, as required by the Exchange Act and FINRA rules. These actions, and others, underscore FINRA's continuing commitment to enforce its rules concerning off-channel communications.

Municipal Securities. FINRA recently concluded what appears to be its first disciplinary case involving the close-out requirements outlined in the Municipal Securities Rulemaking Board (MSRB) rules. An investment bank was fined $1.6 million for its failure to promptly close out failed inter-dealer municipal securities transactions. According to FINRA, the bank had neglected to cancel or close out 239 failed inter-dealer municipal transactions — amounting to approximately $9 million — within the mandated 20-calendar-day period following the settlement date. In fact, some transactions remained unresolved for nearly three years. Moreover, the bank allegedly failed to take necessary steps to acquire timely possession or control over 247 short positions in municipal securities valued at approximately $9.4 million. It remains to be seen whether this enforcement action resulted from the severity of FINRA's allegations in this particular case, or whether it signifies a heightened focus on enforcement efforts within the municipal securities market.

Municipal Securities. In another municipal bonds case, FINRA expelled an underwriter and barred its principals from the industry for making fraudulent misrepresentations in the sale of municipal bonds. In a comprehensive 133-page decision, the OHO found that the underwriter made fraudulent misrepresentations concerning a $6 million municipal bond offering in Alabama, and negligent misrepresentations with respect to separate $2.2 million bond offering in Illinois. Both offerings failed shortly after closing, and the bondholders — many of whom were elderly — lost most of their investments. As a result of their misconduct, the underwriter and its principals (who had previously run afoul of FINRA rules) were barred indefinitely from the industry and were ordered to pay more than $4.7 million in restitution, plus interest and costs.

Securities Lending. In separate actions, four broker-dealer firms agreed to pay a combined $2.6 million in fines and restitution to settle claims that they failed to properly supervise fully paid securities lending programs. The Letters of Acceptance, Waiver, and Consent (AWCs) detailing FINRA's findings in these matters are available here, here, here and here. Fully paid securities lending programs permit investors to lend out securities they already own to clearing firms, which in turn lend the securities to third parties for a fee. The fee is generally shared among the various participants: the customer, the broker-dealer and the clearing firm. When the investor chooses to sell the borrowed securities, the clearing firm is responsible for recalling them from the borrower. In each of the four cases, FINRA alleges that the broker-dealers automatically enrolled new customers in fully paid securities lending programs upon account opening, irrespective of suitability, and then pocketed the revenue they received from the clearing firms, in violation of written disclosures. Additionally, some customers who received cash payments in lieu of dividends allegedly suffered adverse tax consequences, for which the companies agreed to pay more than $1 million in restitution.

FINRA Notices and Rule Filings

Regulatory Notice 24-02 – FINRA has adopted new FINRA Rules 3110.19 (Residential Supervisory Location) and 3110.18 (Remote Inspections Pilot Program). FINRA also announced the end of the pandemic-era relief issued under Regulatory Notice 20-08. Rule 3110.19, which will become effective on June 1, 2024, establishes a new framework for inspections of private residences at which an associated person engages in specified supervisory activities. These private residences will be treated as non-branch locations — defined as "residential supervisory locations (or RSLs)" — and will be subject to inspections at least every three years, instead of the annual inspections currently required for a supervisory branch office. Firms must meet specified conditions to qualify for an RSL designation, including conducting and documenting a risk assessment. Rule 3110.18, which will become effective on July 1, 2024, establishes a voluntary, three-year remote inspections pilot program, which will allow member firms to fulfill their inspection obligations for qualified branch offices remotely (without an on-site visit). Firms must meet certain specified terms to participate, and must opt in to the pilot program no later than June 26, 2024. Finally, FINRA ended the relief provided under Regulatory Notice 20-08. A measure extended during the COVID-19 pandemic, Regulatory Notice 20-08 temporarily suspended the requirements for member firms to maintain updated U4 information with respect to the employment address for certain employees who temporarily relocated during the pandemic. The Notice also suspended the requirement to report newly opened temporary office locations or space-sharing arrangements. FINRA announced that these relief measures will expire on May 31, 2024.

Regulatory Notice 24-03 – FINRA has amended its Code of Arbitration Procedure to reflect changes to the arbitrator list selection process. The changes include:

- Randomly generated lists of arbitrators for each proceeding will now incorporate a manual review for conflicts of interest that are not identified in the list selection algorithm, with the Director

empowered to exclude arbitrators from lists based on its review of current conflicts of interest;
- The Director is now required to provide a written explanation with respect to any decision to grant or deny a party's request to remove an arbitrator; and
- The time for a party to request removal of an arbitrator for conflict of interest or bias (or for the Director to remove an arbitrator on its own initiative) will be from when arbitrator ranking lists are generated, to no later than the date on which the first hearing session begins.

FINRA also amended its Codes of Arbitration Procedure to make numerous clarifying and technical changes to the requirements for holding prehearing conferences and hearing sessions, initiating and responding to claims, motion practice, claim and case dismissals, and providing a hearing record.

Regulatory Notice 24-04 – FINRA has adopted amendments to its rules pertaining to securities settlement including by shortening the timeframes for delivery or settlement, consistent with the SEC's recent adoption of final rules that changes the settlement cycle for most U.S. securities transactions from T+2 to T+1. The Regulatory Notice also amends 17 related FINRA rules with respect to transaction reporting, trade report processing, dates of delivery, and other similar matters.
Regulatory Notice 24-05 – FINRA announced the adoption of new Rule 6151 (Disclosure of Order Routing Information to NMS Securities). The new rule will go into effect on June 30, 2024, and will require member firms to submit to FINRA order routing reports for NMS securities, as required under SEC Rule 606(a). The reports will be required on a quarterly basis and will be publicly reported on a free website for at least three years.

Regulatory Notice 24-06 – In consultation with the Department of the Treasury, FINRA announced that, on March 25, 2024, it will begin disseminating an end-of-day file that includes information on individual transactions in US Treasury securities that are "on-the-run nominal coupons." FINRA will also provide a new Historic TRACE data set for Treasury securities, which will contain transaction information on a six-month delayed basis. These reports will be publicly available and free of charge on FINRA's website for non-professionals' personal, non-commercial purposes, on a next-day basis.

SR-FINRA-2024-004 – FINRA has proposed a rule change that would amend FINRA Rule 6730 to reduce the 15-minute TRACE reporting timeframe to one minute, with exceptions for member firms with de minimis reporting activity and for manual trades.

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