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Insights

FINRA FINES CETERA FIRMS TOTAL OF $1,000,000 FOR SECURITIES TRANSACTIONS

THE SECURITIES TRANSACTIONS WERE CONDUCTED THROUGH OUTSIDE REGISTERED INVESTMENT ADVISERS, WITHOUT PROVIDING CONTOURS OF REQUIRED SUITABILITY REVIEW AND SUPERVISORY OBLIGATIONS.

Jan 21, 2021

In a troubling recently-released Letter of Acceptance, Waiver and Consent ("AWC"), FINRA fined three Cetera Firms[1] a total of $1,000,000 for failing to conduct the appropriate suitability review and to otherwise satisfy their supervisory obligations for securities transactions conducted through a third-party (outside) registered investment advisers ("ORIAs").[2] Unfortunately, FINRA did not tell firms, with any degree of specificity, what level of review firms must do to satisfy these obligations, beyond simple baseline generalities of receiving and reviewing "transaction data" and "customer-specific account information" for these outside accounts. Instead, the reader is left to wonder the level of scrutiny firms must give to electronic transaction data feeds and each individual transaction, when the information is juxtaposed against customer account information. However, two conclusions that can be drawn from the Cetera Firms' AWC, for a firm that permits its representatives to conduct transactions through an outside RIA, are: (1) firms should perform some tangible, meaningful, documented review of transactional data feeds, giving consideration to each individual customer's unique suitability profile, and (2) a firm's written supervisory procedures ("WSPs") should provide some specific guidelines or procedures regarding how a such review should be conducted.

The background facts of the Cetera Firms' AWC are straightforward. During nearly the entire Relevant Period[3] for each Cetera Firm, their firms' supervisory systems and procedures did not require obtaining and reviewing customer-specific suitability information for customers of ORIAs. Moreover, two of the Cetera entities did not receive sufficient transactional data for all of the transactions conducted by ORIAs until June 2018 – nearly the end of the Relevant Period. Given that information gap, according to FINRA, the Firms could not properly supervise the transactions through the ORIAs. Finally, FINRA found that the Cetera Firms were on notice during the Relevant Period regarding their supervisory issues relating to ORIAs, given that the Securities and Exchange Commission ("SEC") in three separate instances made explicit findings on those issues.

What is particularly problematic about the AWC is that, while in several instances the AWC mentions that the particular Cetera Firm did not conduct "a suitability review," nowhere in the AWC does it give any guidance was to what that suitability review should like. Nowhere in the AWC does FINRA outline, simply by way of example, certain supervisory steps that may have satisfied the Cetera Firms' obligations. Instead, the several references to the Cetera Firm's failure to obtain "customer-specific account information" causes one to wonder if FINRA's expectation (if not an outright *de facto* requirement) is that the suitability review will resemble that required for a broker-dealer customer retail account. Most troubling is that FINRA found wanting one of the Cetera Firm's failure to obtain "the customer-specific information – such as net worth or income – necessary to review the transactions for suitability." This unelaborated language causes a reader to ponder: What level of net worth and income information? For what time period, three years, five years, or 10 years? What else besides "net worth or income" information is required?

FINRA last provided regulatory guidance on supervision of ORIAs over a quarter-century ago, when it issued NASD Notices to Members ("NTM") 94-44 and 96-33. In February 2018, it looked like much-needed clarity would arrive, when FINRA issued Regulatory Notice 18-08 (the "Notice"). The Notice sought comments on a proposed single FINRA Rule (Rule 3290) to replace the existing Outside Business Activities Rule (Rule 3270) and Private Securities Transactions Rule (Rule 3280). In particular, the Notice provided a degree of needed clarity and comfort for supervision of ORIAs, noting: "…prior notice by the registered person and risk assessment by the member [are core concepts of the proposed rule] because it is investment related and not excluded from the proposed rule, but the member is not required to supervise or keep records of the IA activities." Unfortunately, Rule 3290 never came to fruition, and at this point must be deemed essentially abandoned. Firms that allow outside RIAs must, therefore, continue to rely on the overbroad and outdated guidance contained in NTMs 94-44 and 96-33, and any limited guidance that can be gleaned from enforcement cases such as the recent Cetera AWC.

FINRA's failure to provide any particular specificity on the level of supervision required is at odds with FINRA's recent commitment to transparency on findings and sanctions. In that regard, FINRA's then-Head of Enforcement stated in February 2018: "We hold ourselves to the highest standards when it comes to legal reasoning, but that is only useful to you if we are transparent about our analysis. We want anyone to be able to look at a given case and immediately understand the basis for the charge. Without that transparency, we run the risk of creating confusion in the industry. We understand member firms will look at our actions to assess their own conduct." (Full remarks found at https://www.finra.org/media-center/speeches-testimony/remarks-sifma-aml.)

Although the Cetera AWC creates a host of unanswered questions, in light of the large fine and certification requirement imposed in the AWC, firms should (at a minimum) do the following:

1. First, they should ensure that they are obtaining all transactional data, from all custodians and other sources, to ensure they have the entirety of transactions conducted through ORIAs.

2. Second, firms should obtain customer-specific suitability data for each customer of the ORIAs – such data should include, at a minimum: income, net worth, investment objectives, risk tolerance, and time horizon.

3. Third, firms should ensure that they have specific guidelines in their WSPs regarding how suitability reviews should be conducted. Such guidelines should include, at a minimum: (1) person(s) responsible, (2) objective criteria to be considered, and (3) the timing in which such a review should occur.

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[1] - The Cetera entities named in the AWC are: Cetera Advisor Networks LLC, Cetera Advisors LLC, and Cetera Financial Specialists LLC.

[2] - Such transactions are, by definition, "private securities transactions" under FINRA Rule 3280.

[3] - The AWC defined the Relevant Period as January 2011-December 2018 for two Cetera Firms, and November 2012-January 2018 for the other.

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