

# Q1 Enforcement Actions: A Preview for the Rest of 2023?

# Introduction

It's only been a few months since the start of 2023, and a lot has happened within and adjacent to the financial services industry. The [modernization of SEC 17a-4](#) is in full effect, both the SEC and FINRA emphasized their focus on [cybersecurity](#) and [digital communications](#), and [new technologies like ChatGPT](#) are creating plenty of compliance challenges.

In this regulatory update, we review major regulatory actions and fines against firms and individuals in the [first quarter of 2023](#). The goal of this report is to help firms and advisers understand the realities of regulatory enforcements and what they need to prioritize when planning, refining and executing their compliance strategy.

# Books and records tops enforcement issues

Overall, [Eversheds Sutherland's Annual Analysis of FINRA Disciplinary Actions](#) showed a decrease in sanctions and enforcement actions in 2022.

2021	2022	Percent change
\$103 million in fines	\$45 million in fines	Decreased by 56%
\$47 million in restitutions	\$21 million in restitutions	Decreased by 55%

While the number of overall cases reported by FINRA decreased in 2022, there was an increase in the number of “supersized fines” of \$1 million or more reported.

Books and records was the most enforced rule, as measured by fines. In 2022, FINRA reported 50 such cases and levied over \$14.8 million in fines.

Several of these cases included instances where firms and individuals failed to supervise and preserve business-related communications. In the largest case where books and records was the primary focus, FINRA fined a firm \$2.8 million, finding that the firm failed to correct inaccuracies in trade confirmations it sent to customers over multiple years and after three warnings.

# Firms disciplined

## Missed call (records) costs firm

FINRA fined a firm \$1.1 million for failing to timely and completely produce phone records in response to FINRA's requests for documents. The firm:

- Inaccurately produced certain phone records
- Failed to search a storage location containing older call detail records
- Failed to promptly advise FINRA of its production failures
- Did not identify all affected investigations where its responses were likely incomplete until more than a year after discovering the issue
- Failed to preserve certain responsive call detail records from an internal network drive
- Did not prevent responsive records from being deleted, resulting in missing call detail records ranging from several days to several weeks.

## Ineffective WSPs for email supervision

One firm was fined \$45,000 for failing to establish, maintain, and enforce reasonable supervisory systems, including written supervisory procedures (WSPs), to review electronic communications.

The firm's email review was unreasonable in practice, as it reviewed only 0.26% of the emails sent or received by registered representatives. The keywords used to flag emails for review were also inadequate, as they included the firm's own name, which appeared in virtually all emails.

In addition, the firm's WSPs did not specify any keywords or process for identifying keywords to flag emails for review or describe any parameters for conducting random sampling.

The firm's WSPs also lacked clarity on:

- The personnel responsible for email review
- Frequency and sample size of email review
- Keywords or process for identifying flagged emails
- Parameters for conducting random sampling, types of red flags requiring follow-up steps
- Steps for escalating issues identified during email review

## Customer complaints weren't archived

A firm was fined \$3 million for inadequate supervision in establishing and maintaining a supervisory system and WSPs to identify and respond to customer complaints.

The firm's supervisory system for identifying and responding to customer complaints was found to be poorly designed. There was insufficient allocation of staff and resources to handle the high volume of customer communications, including complaints.

Additionally, the firm failed to report written customer complaints to FINRA, including those involving theft or misappropriation. The use of a lexicon tool to identify potential customer complaints was deemed inadequate, and the firm's WSPs did not clarify that grievances related to customer questions, operational concerns, or service issues should be treated as customer complaints.

## Intentional use of 'auto-delete' messaging feature lands firm in hot water

The CFTC charged a firm for willfully evading Federal Law and operating an illegal digital asset derivatives exchange.

The firm was alleged to knowingly disregard applicable provisions of the Commodity and Exchange Act (CEA) while engaging in a calculated strategy of regulatory arbitrage to their commercial benefit. The complaint indicated that the firm acted as a designated contract market or swap execution facility based on its role in facilitating derivatives transactions without registering with the CFTC, as required.

The complaint charges the firm for conducting activities outside the US to avoid CFTC regulation requirements, including intentionally structuring entities and transactions to avoid registration and instructing customers on how to evade the firm's compliance controls.

**“Evidence suggests that [the firm’s CEO] and [former CCO] were aware that [the firm’s] activities in the United States were subject to registration and regulatory requirements under US law and that they deliberately disregarded these requirements. While [the firm’s] compliance program was ineffective in complying with the law, evidence suggests that it was quite effective at directing US customers on how best to evade [the firm’s] access controls.”**

**- Kristin Johnson, CFTC Commissioner**

The charges state the [firm] used different messaging applications (e.g., Telegram, WeChat, Signal) to conduct business and would enable auto-delete features to cover their tracks after communicating about inculpatory matters.

## Individuals disciplined

### Hasty social media marketing results in fine and suspension

FINRA fined a registered representative \$5,000 and issued a 10-business-day suspension for social media posts on a public Facebook page. The posts included:

- Performance
- Investment returns
- Industry standing
- Purported successes of the investment club and a separate hedge fund
- Options-related posts that don’t explain investment risks or warnings that options may not be suitable to all investors

Additionally, the representative failed to obtain approvals for the social media posts through FINRA’s Advertising Regulations Department at least ten days prior to the use of the posts.

### CCO on hook for supervisory failures

FINRA fined a CCO \$5,000 and suspended her for 40 business days for failure to reasonably supervise the sales practices of two registered representatives. The CCO approved a representative’s recommendation of new variable exchanges to 11 customers. The CCO also failed to investigate red flags indicating that another representative was conducting securities business through an unapproved email account.

Despite being assigned supervisory responsibilities, she did not review or ensure retention of business-related emails despite being advised by FINRA that the representative and office staff were continuing to use the outside email account to conduct securities business.

## **Firm reportedly fining employees for tarnishing firm reputation**

A firm fined \$200 million in the SEC's ongoing off-channel communications sweep exam is reportedly punishing employees responsible for the violations. Ranging from a few thousand dollars to more than \$1 million per individual, the penalties are for the misuse of WhatsApp and other messaging applications to conduct off-channel communications for business.

These fines were reported to affect either the employee's future pay or clawbacks on bonuses already received.

## **Celebrity sponsorships come with a price**

The quarter held several instances of celebrities fined for touting crypto assets on social media without disclosing that they were paid to do so. Penalties and disgorgements range anywhere from \$4,000 to \$1.5 million.

The SEC has stated that failing to disclose compensation violated Section 17(b) of the Securities Act, which makes it unlawful for any person to promote a security without fully disclosing the receipt and amount of such compensation from an issuer.

## **Emojis need to be captured and archived**

A judge from the United States District Court of the Southern District of New York ruled that certain emojis would be considered financial advice or indicate a return on investment. The court stated that the use of the "rocket ship" emoji (🚀), "stock chart" emoji (📈), and "money bags" emoji (💰) violated security law by misleading the public to expect a financial return on investments in Tweets about NFTs.

# What do Q1 enforcement actions tell us?

Regulatory actions in Q1 give the financial services a taste of what's to come: firms and individuals will need to shore up their compliance strategy to meet the heavily enforced books and records requirements.

More specifically, enforcement actions are strongly trending towards an emphasis on discovering and reasonably supervising for off-channel communications. This is a challenging reality as more firms, employees and customers are gravitating towards newer (and often encrypted) communication tools.

Failure to meet regulatory requirements can result in fines and disciplinary action. Firms must establish a reasonable supervisory system for business communications and ensure that the policies are properly enforced and followed through reasonable supervision.

## Based on the above, firms should consider the following elements:

1. Reassess your established WSPs to review electronic communications to meet current communications pitfalls
2. Make sure you can retain and supervise all business-related communications including text messages and mobile messaging applications
3. Review your supervisory system and written supervisory procedures to assess if you can properly identify and respond to customer complaints
4. Reassess if you have adequate allocation of staff and resources to meet your compliance obligations, particularly in light in the increase in communications firms are experiencing
5. Work with proven archiving vendors to enable business communications



While an effective WSP is the first step to defining your firm's compliance strategy, it can't simply be a prohibition policy. It won't save firms from fines if their brokers are communicating with clients over those prohibited channels. And as we've consistently seen, the number of off-channel communications will continue to grow.

To learn how your firm can expand permissible channels to meet communication requirements, get our free guide, [Compliance Made Easy for RIAs and Broker-Dealers](#).

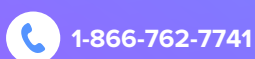


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