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FINRA Facts and Trends

Article By:

Joshua Klein

Keith Blackman

Russell W. Gallaro

Understand What's Happening in the Financial Industry Regulatory World With Commentary and Updates From Bracewell's Experienced FINRA Team

We are pleased to introduce the inaugural 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. We hope this will become a useful tool for practitioners, broker-dealers and their registered representatives who seek to keep abreast of rule changes and proposals, best practices, and the examination priorities of the nation's largest self-regulatory organization for securities firms.

Notable Enforcement Matters and Disciplinary Actions

- First Manhattan Co., a financial firm that offers investment advisory accounts for high-net-worth individuals and family offices, was fined $250,000 based on alleged violations related to customer transactions in microcap securities and alleged failures to maintain appropriate written supervisory procedures ("WSPs"). The Acceptance, Waiver & Consent ("AWC") detailing FINRA's findings—to which First Manhattan consented but neither admitted nor denied—is publicly available here.

  FINRA found that First Manhattan failed to implement WSPs that were reasonably designed to avoid becoming a participant in the unregistered distribution of securities, as required by Section 5 of the Securities Act of 1933. According to FINRA, First Manhattan's WSPs were deficient because they did not properly instruct representatives about how to conduct a searching inquiry to determine whether a transaction complied with the registration requirements of Section 5, and also did not provide direct representatives to use a pre-clearance form in connection with Section 5 reviews. FINRA also found that First Manhattan's anti-money laundering ("AML") program was insufficient to identify and address suspicious trading in microcap securities—i.e., securities of companies with very small (or "micro") capitalizations of less than approximately $300 million.

FINRA found that, as a result of these alleged failures, First Manhattan accepted certain deposits of microcap securities without conducting proper due diligence to ensure compliance with Section 5. Additionally, a small number of First Manhattan's customers engaged in transactions of microcap securities that should have been—but were not— flagged by First Manhattan for potential Bank Secrecy Act reporting and for suspicious activity for AML purposes.

Practice Tip: Firms should periodically review their WSPs and AML programs to ensure that they are effective, tailored to address all applicable securities laws and FINRA Rules.

Notable FINRA Regulatory Notices

- Regulatory Notice 22-11 – FINRA recently initiated enforcement actions against several member firms for failing to establish or maintain a reasonably designed supervisory system for recommendations of alternative mutual funds, often referred to as "alt funds" or "liquid funds." This Regulatory Notice provides summary findings from recent exams and communications reviews relating to Alt Funds and offers best practices that effectively address the unique risks of Alt Funds, including: maintaining documentation of the firm's reasonable diligence for Alt Funds, specifically limiting sales of Alt Funds to customers with accounts that were approved to trade options, and the implementation of new surveillance systems.

- Regulatory Notice 22-10 – FINRA issued a Regulatory Notice that seeks to clarify the potential liability of Chief Compliance Officers ("CCOs") under FINRA Rule 3110, which imposes specific supervisory obligations on member firms. FINRA explains that the ordinary CCO's role is advisory, not supervisory. Accordingly, except for situations in which the firm confers specific supervisory responsibilities on its CCO, FINRA generally focuses its attention on a member firm's senior business management and supervisors, rather than its CCO, for supervisory failures.

- Regulatory Notice 22-09 – FINRA is seeking comment on a proposal to modify its current program for expedited arbitration proceedings for senior or seriously ill parties, in order to further accelerate arbitration case processing for parties who are seriously ill or at least 75 years old. In doing so, FINRA has provided data showing that, under the current program, parties seeking expedited treatment went through the full arbitration process in thirteen months at the median, whereas parties who did not qualify for expedited treatment went through the full arbitration process in sixteen months at the median—a difference of only three months.

  Unlike the current program for expedited arbitration proceedings, the new proposal would provide for shortened, rule-based case processing deadlines for parties, and or provide guidance to arbitrators on how quickly the arbitration should be completed. Full details on the proposal and instructions on how to comment can be found here. The comment period remains open until May 16, 2022.

- Regulatory Notice 22-08 – Noting that retail investors are increasingly trading in complex investment products and options, FINRA reminds member firms of their regulatory obligations when making securities recommendations to retail customers— including, most particularly, the application of Regulation Best Interest. Additionally, FINRA is seeking comment on the appropriateness of the current regulatory framework, as well as soliciting suggestions for effective practices for recommendations relating to complex products and options.

Instructions on how to comment can be found here. The comment period remains open until May 9, 2022.

Notable FINRA Arbitration Awards

- Broker-dealers saw a string of negative decisions in customer-initiated arbitration proceedings relating to investments in real estate investment trusts (“REITs”) last month.

    - **18-01349** - Following a nine-day hearing in an arbitration brought against First Allied Securities relating to a variety of investments, including at least two REITs and several annuities, a three- arbitrator panel found First Allied liable for nearly $2 million in compensatory damages, in addition to $660,000 in attorneys’ fees under Arizona contract law.

    - **19-01916** – In an arbitration brought by a single Claimant alleging that Taylor Capital Management and one of its former representatives failed to adequately advise Claimant of the risks and commissions associated with an investment related to a REIT, a three-arbitrator panel found the Respondents liable for $150,000 in compensatory damages.

- UBS’s Yield Enhancement Strategy (“YES”), a managed options trading strategy launched by UBS Financial Services in 2015 and formerly offered to its customers, has continued to be the subject of FINRA arbitration proceedings. The outcome of these arbitration proceedings in the past month has been a mixed bag.

    - **20-02109** – A three-arbitrator panel denied all claims and awarded no damages in an arbitration brought in New York by a single Claimant, seeking between $500,000 and $1 million in damages in connection with investments in YES.

    - **20-04176** – Conversely, in an arbitration brought in Houston, Texas, a three-arbitrator panel found UBS liable for approximately $1.2 million in damages for alleged misrepresentations in connection with a recommendation to invest in YES.

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