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FINRA Facts and Trends: December 2023

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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 a significant proposed rule change that would permit firms to make performance projections when marketing to institutional investors, the latest on the challenge to FINRA's constitutionality in the DC Circuit, updates on FINRA's prosecution of Reg BI violations, and more.

FINRA Proposal Would Allow Investment Performance Projections in Marketing to Institutional Investors

On November 13, 2023, FINRA filed a proposed rule change that would amend FINRA Rule 2210 (Communications with the Public). Rule 2210 generally prohibits projections of performance or targeted returns in member communications, subject to certain specified exceptions. For the first time, the proposed amendment would allow member firms to provide projected performance or targeted returns in institutional communications and in communications distributed solely to qualified purchasers. The current prohibition against targeted projections is intended to protect those members of the investing public that may lack the sophistication to appreciate the risks of

projected performance in making investment decisions.

In promoting this proposal, FINRA notes that the proposed changes are consistent with the SEC's investment adviser marketing rule. The SEC rule also permits advisers to present hypothetical performance, including "targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to the securities offered" in an advertisement if the investment advisor meets specified conditions and does not violate the marketing rule's other requirements.

The 230-page proposal () would permit broker-dealers to offer projections on investments or investment strategies and use those in communicating with institutional investors with at least $25 million in assets under management. Broker-dealers would be permitted to do the same for qualified purchasers with at least $5 million in investments for private placements only. The proposal reflects FINRA's view that there is "no additional risk" in permitting broker-dealers to provide projected performance and targeted returns to customers that could already have access to that information through other sources, including investment advisors and capital acquisition brokers.

The proposal does include certain safeguards for investors, including requiring that member firms have: (1) appropriate policies and procedures; (2) a reasonable basis for the criteria and assumptions underlying the projected performance; and (3) disclosures to investors that meet the requirements of the proposal.

There will be a public comment period before the SEC decides on its approval. If the proposal is approved, it will dramatically change the marketing methods of private funds.

FINRA Fines Another Broker-Dealer for Reg BI-Related Violations

FINRA fined and censured a US subsidiary of a Vancouver-based financial firm

for violating Regulation Best Interest (Reg BI) requirements by recommending 134 sales totaling $11 million in private placements to US customers for more than nine years. According to the , the firm recommended sales of a certain type of Canadian private placement offering referred to as “non-brokered private placements (NBPPS)” without reasonable due diligence of the offerings or issuers. The firm conducted a superficial analysis of the offerings and “sought minimal information and relied mostly on the issuer with little to no independent verification,” according to FINRA. “Generally, the firm did not conduct any independent investigation, such as inquiring about past or pending litigation or disciplinary problems, reviewing the issuer’s key contracts, exploring the issuer’s business plan, or conducting a site visit.”

In a separate enforcement action, FINRA has decided to permanently bar a registered representative for allegedly churning and excessively trading in clients’ accounts for his own benefit between July 2020 and July 2021. Without admitting or denying the claims, the broker agreed to the sanction, which alleged that he violated Reg BI, lied to clients and provided false testimony to FINRA. According to the , the broker allegedly made an average of 102 trades per account or approximately thirteen times the average account value. The brokers’ actions affected customers whose primary investment objective was income or growth and whose risk tolerance was moderate. As a result of the excessive trading, his clients lost more than $2.3 million in value from their accounts and paid more than $715,000 in total trading costs and margin interest, including over $595,000 in commissions. In concluding that the broker had violated Reg BI, FINRA further noted that he generated fake account statements to hide the results of his trading and “repeatedly lied” to FINRA during its investigation.

Appellate Brief Is Filed in Challenge to Constitutionality of FINRA Enforcement Powers

As we have reported , an ongoing case brought in the DC Circuit by Alpine Securities Corporation has the potential to significantly curtail FINRA’s enforcement powers. Alpine, a firm that had been expelled from FINRA membership by an extended FINRA hearing panel following a 19-day hearing,

challenged the constitutionality of FINRA’s enforcement powers, and successfully obtained a preliminary injunction against its expulsion in the DC Circuit back in July.

More recently, in November, FINRA filed its own appellate brief in the DC Circuit, and Alpine filed its reply brief.

FINRA, in its brief, framed the constitutional challenge as an “existential threat” to FINRA and its regulatory framework. Alpine argued in its reply brief that FINRA in effect exercises governmental powers and “must be bound” by constitutional constraints on those powers.

Numerous amicus briefs have also been filed by concerned third parties. In addition to those filed in by an organization backed by former Attorney General William Barr (arguing against FINRA) and by the Municipal Securities Rulemaking Board (arguing for FINRA), several amicus briefs were filed this month in support of FINRA’s position. Notably, the Public Investor Advocate Bar Association (PIABA) submitted a brief warning that a ruling in favor of Alpine would “create market chaos and eviscerate meaningful protections for the investing public.” The US Department of Justice has intervened in the case too—as it did in the district court—offering its own brief arguing that FINRA’s self-regulatory framework passes constitutional muster.

Members of the industry are watching this case closely as they await a decision from the DC Circuit. While the DC Circuit’s decision may not be the final word—the parties may seek *en banc* review or petition for certiorari in the Supreme Court—it certainly has important implications for the future of FINRA.

Notably, the *Alpine* case is not the only present challenge to the authority of a financial industry regulator. In late November, the Supreme Court heard, in *SEC v. Jarkesy*, a case that tests the constitutionality of the SEC’s in-house enforcement proceedings. And the previous month, in October, the Supreme Court heard, in a separate case, *CFPB v. Consumer Financial Services Association of America*, a case that raises constitutionality questions about

the funding of the Consumer Financial Protection Bureau (CFPB). Together, these cases have the potential to reshape the future of regulation and enforcement in the financial industry.

FINRA Arbitration Panel Issues Ruling Following Complex 160-Day Hearing

On November 1, a panel of three FINRA arbitrators issued a in a complex, long-running arbitration matter, filed back in August 2018 by a group of more than 130 individual Claimants, seeking nearly $30 million in alleged damages from a FINRA broker-dealer. The panel's ruling followed a staggeringly long hearing held over 160 days, over a nearly three-year period beginning in October 2020 and ending in August 2023.

The case itself involved Claimants' investments in a series of distressed real estate projects in Florida, which were proprietary products of a non-SEC and non-FINRA registered, offshore broker-dealer, Biscayne Capital BVI, Ltd., a British Virgin Islands entity. The Claimants themselves were primarily individual citizens of the Republic of Ecuador and Ecuadorian business entities, and the investments were made through an Ecuadorian company called B.S. Corp. The Claimants alleged they were victims of a massive fraud perpetrated by B.S. Corp. and its brokers.

The claims against the FINRA broker-dealer were apparently premised on the fact that the investments, although not traded through the broker-dealer, were cleared and custodied in clearing accounts maintained by each of the Claimants with the broker-dealer.

In its lengthy, reasoned decision, the three-arbitrator panel ultimately denied the claims in their entirety, without awarding any damages. The panel expressly found that Claimants introduced no evidence that the investments were products of the FINRA broker-dealer, or that anyone at the broker-dealer had knowledge that the Ecuadorian company had made false representations to the Claimants.

Notable Enforcement Matters and Disciplinary Actions

FINRA Notices

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