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Critics question Finra as watchdog's caseload plunges

Enforcement actions hit an all-time low last year while fines plummeted to half of 2016 haul, raising doubts about its effectiveness.

June 28, 2024 *By Bloomberg News*

Two days after Christmas, a prominent Wall Street regulator updated a database with news of interest to the industry: A $1.4 trillion brokerage had been slapped with one of the year's biggest fines for allegedly losing track of almost a million trades.

But there was no press release when ***the Financial Industry Regulatory Authority hit LPL Financial Holdings Inc. with the $6 million penalty***. Nor did Finra seek attention for its multimillion-dollar sanctions of Goldman Sachs Group Inc. and Barclays Plc months earlier.

The quiet end to those probes capped a year in which the number of enforcement actions brought by the brokerage industry's self-funded regulator slid to the lowest level in its history. Total fines picked up last year but are down by about half since a peak in 2016. Meanwhile, Finra's headcount and budget have expanded.

The declines are raising concerns that the watchdog isn't policing firms with the same aggressive posture it adopted after the 2008 financial crisis and multibillion-dollar Ponzi scams by brokerage operators Bernie Madoff and Allen Stanford, both of which went undetected for years.

Finra rejects the idea that it has pulled back on enforcement. But some are raising the question: Will the regulator catch the industry's next big fraud?

"Right now, there's no big crisis going on," said Brad Bennett, Finra's enforcement director from 2011 to 2017. "The tide is in, but as sure as the sun rises in the east, the tide will go out. And people will be wondering: Where the hell was Finra?"

The changes at Finra have frustrated some enforcement staff, who have pushed the regulator to more aggressively pursue and promote cases, according to people familiar with the matter. In multiple instances in recent years, employees drafted press releases to promote cases, only for managers to spike their publication, the people said.

Last year, the regulator issued press releases on just 10 of 426 enforcement actions, compared with 63 in 2015. Finding details on cases like LPL's can require digging into a cumbersome Finra database.

Finra says it hasn't strayed from its mission.

"There is an important reason why there are fewer enforcement actions: Finra has reduced the number of bad actor firms and individuals over time," Ray Pellecchia, a spokesperson for the regulator, wrote in a reply to Bloomberg's questions. "Any suggestion that we have let up on our regulatory focus is just dead wrong."

Finra said it has improved rules that keep bad actors from being brokers, leading many to operate in industries that it doesn't regulate — like insurance. It prioritizes cases that involve repeat offenders and customer harm. And the regulator said it tries to address multiple matters in one enforcement action when appropriate, which tends to decrease the total number of actions.

On press releases, Pellecchia said issuing too many of them would dilute the impact of enforcement actions it wants to emphasize. Finra also publishes them in a monthly newsletter and two databases, he said.

A spokesperson for the SEC, which oversees Finra, declined to comment. The SEC's enforcement numbers stayed relatively steady even as Finra's fell.

Gary Carleton, a former senior counsel at Finra, said he has no reason to believe that there has been decline in financial crime, including in areas that Finra regulates. "To the contrary, with the growth of so many more financial platforms, ***the use of social media*** and direct messaging, there is far more opportunity for abuse that is harder to detect," he said in an interview.

When asked about the drop-off in enforcement, Senator Elizabeth Warren said she planned to investigate.

"Finra's job is to protect investors and hold big financial services firms like Goldman and Barclays publicly accountable when they don't follow the rules – but they can't do that if they take the cop off the brokerage beat," Warren, a Massachusetts Democrat, said in an emailed statement to Bloomberg.

Finra was created in 2007 through a merger of self-regulatory organizations. It serves as a beat cop for brokerages and exchanges, helping to track stock and option trades in US markets. Each year, it feeds reams of tips on suspicious trades to the SEC.

The watchdog emerged as an influential force in the US effort to toughen regulation after the 2008 financial crisis. In addition to regularly ***fining major banks for misconduct***, it played roles in probes of Wall Street spoofing and aided in the SEC investigation into hedge fund titan Steve Cohen.

But Finra's hands-on, in-person and dogged examinations exasperated many brokers, according to two former board members.

"I felt that examiners came in with the idea that they were going to find violations, and it was just a question of how many," Mark Cresap, a money manager in the Philadelphia area, said in an interview. His firm, Cresap Inc., manages about $1 billion in assets.

Examiners would spend months at a time at his firm, Cresap said. Finra, he said, was devoting too much time scrutinizing small, well-intentioned companies and not enough time looking at firms trying to skirt the rules.

Broker Joe Romano, president of Romano Brothers & Co., said Finra's oversight often fixated on minor violations rather than major fraud.

Perceived overregulation has even driven one firm to challenge the constitutionality of parts of Finra. That case is making its way through the appeals process.

New Chief

In 2016, Robert Cook, a former white-collar law partner and SEC official, ***took the helm of Finra***. The year before, Finra had a record high of 1,147 enforcement actions, based on the number of settlements and complaints filed by the regulator. Finra's internal statistics on disciplinary actions show a higher count, though a similar decline over the years.

In one of his first major actions, Cook launched Finra360, described as a "comprehensive self-evaluation and organizational improvement initiative." Finra needed to modernize, streamline and engage more with brokers, he said.

One of Romano's messages — echoed by other brokers — was that Finra had to cut down on the number of enforcement cases and increase their quality. That feedback quickly made its way into Finra policy.

At an industry conference in New York in February 2018, Susan Schroeder, Cook's then-head of enforcement, announced her priorities. She said they were driven by Finra360.

"Enforcement action, while a powerful tool in Finra's toolbox, is not the right tool in all cases," Schroeder said in ***her speech***. "In fact, we must be thoughtful and intentional in order to use our finite enforcement resources in the matters where they are most needed."

In 2018, Finra brought 557 enforcement actions, nearly half the 2015 mark. Company expulsions and broker suspensions decreased. Finra combined two enforcement divisions into one, explaining that it would lead to a "more effective and efficient" unit.

'Precipitous Drop'

The changes in approach led to a "precipitous" drop in enforcement, said Justin Chretien, a senior official in Finra's enforcement division from 2011 to 2021. The department was streamlined, and there was more transparency for brokers under investigation, he said, but productivity declined.

Schroeder said in an email that she gave the speech to explain Finra's approach to enforcement. For enforcement to be effective, "it has to be predictable, transparent and risk-based," she said.

Finra360 didn't lead to a reduction in the number of enforcement actions, Finra's Pellecchia said. Rather, it focused on making enforcement more efficient and consistent, he said.

Tim Scheve, a Finra board member and former CEO of Janney Montgomery Scott, said it didn't feel like there was less enforcement. "Finra continues to be an aggressive regulator," he said.

LPL Settlement

In LPL's case, the lack of a press release was notable not only because of the fine's amount but also due to the size of the company, which includes affiliated brokers that don't usually do business under the firm's banner.

The alleged lapses were also extensive. ***According to Finra***, LPL failed to track hundreds of thousands trades its brokers made on behalf of clients – and neglected to check whether those investments were appropriate for them. For 2 million other transactions, LPL didn't collect required data on investors, like their ages and investment needs, Finra said.

LPL's $6.1 million payment to settle the probe amounted to about two days of the firm's profit in 2023. An LPL representative didn't respond to emailed requests for comment. The company didn't admit to or deny the allegations. Neither did Goldman Sachs nor Barclays.

There's value in shining a light on such cases, said US Representative Katie Porter, a California Democrat and law professor. When you don't, "you are losing the deterrent effect," she said.
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