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Morrison & Foerster discusses FINRA Analysis of Broker-Dealers' Failure to Adequately Supervise Alternative Investment Sales

By Daniel Nathan and Ana-Maria Ignat April 9, 2014

In March 2014, the Financial Industry Regulatory Authority (FINRA) fined a broker-dealer $950,000 for supervisory deficiencies related to its failure to adequately supervise the sale of "alternative investments." These investments include a laundry list of products that have been at the forefront of FINRA's priorities in recent years: nontraded real estate investment trusts (REITs), oil and gas partnerships, business development companies (BDCs), hedge funds, managed futures, and other illiquid pass-through investments.

FINRA's findings provide a useful "case study" as to the types of issues that a firm should consider in evaluating its own processes for sales of complex products.

Specifically, FINRA found that between January 2008 and July 2012, the broker-dealer did not:

- have a reasonable supervisory system to determine whether the purchases of alternative investments caused a customer's account to be unsuitably concentrated in those investments;
- implement a computer system or written materials that consistently identified alternative investment transactions that fell outside of the broker-dealer's internal suitability guidelines, prospectus, or state suitability standards;
- adequately train its supervisory staff to analyze state suitability standards as part of alternative investment suitability reviews; and
- have compliance or written supervisory procedures reasonably designed to achieve compliance with NASD and state suitability requirements. Existing procedures did not delineate the supervisory steps to be taken in connection with alternative investment product reviews, and did not offer any guidance to registered representatives or reviewing principals regarding analyzing state suitability standards for alternative investments such as REITs, BDCs, and managed futures.

FINRA addressed the broker-dealer's supervisory shortcomings using a high level of detail. FINRA's findings, which are instructive for firms evaluating the adequacy of their supervisory policies and procedures, include the following:

- The firm's Alternative Investment Form ("AI-1 Form") did not differentiate between retirement accounts of customers below or above 59 and ½ years of age;
- There was no indication from a review of the AI-1 Form that fees, taxes, or penalties associated with early withdrawal of retirement accounts were deducted from the liquid net worth calculation;
- The AI-1 Form contained confusing information which did not conform to the firm's written supervisory procedures, because the Form suggested that concentration percentage limits were to be applied to each product type, rather than the entirety of a customer's alternative investment holdings;
- The firm did not require supervisors to check for fluctuations in a customer's liquid net worth or net worth on the AI-1 Form, or by comparing it to the customer's previous AI-1 forms;
- The firm did not require managers to verify a customer's financial information, such as liquid net worth, net worth, and income, on the AI-1 Form, to ensure that the customer was not overly concentrated in each alternative investment, and that the investment was consistent with the firm's suitability standards;
- The firm did not look to the prospectus pertaining to the respective alternative investment for state suitability standards, and instead relied either on the subscription agreement (which often contained different information about state concentration limits than the prospectus) or email alerts from the alternative investment product sponsor regarding state suitability requirements (which were not consistently provided in a timely manner);

- The firm lacked controls to ensure that the subscription agreement used by the financial advisor was the most recent and corresponded to the most recent prospectus issued by the sponsor of the respective alternative investment. As a result, the firm's supervisory personnel used incomplete or obsolete information regarding state concentration limits in performing the suitability review;
- The firm did not compare or analyze its liquid net worth definition against the definitions provided by the states in which its customers resided, and did not train its managers to differentiate between the liquid net worth definitions in the various states where it sold alternative investments;
- To track suitability standard compliance, the firm used outdated and inaccurate information regarding state suitability requirements, and misstated the suitability standards for various states;
- The firm lacked formal training for its supervisory staff regarding appropriate methods for analyzing and applying state suitability standards to certain alternative investment transactions, including the terminology used in state suitability requirements or the differences between the applicable state standards; and
- The firm's written supervisory procedures offered no guidance for complying with certain state concentration limits and/or understanding and applying the states' suitability standards.

These deficiencies had real-world results that attracted FINRA's attention. A significant number of customers were determined to have alternative investment holdings that exceeded the firm's concentration guidelines. For example, FINRA identified 25 instances of REIT transactions that were approved in contravention of state suitability standards or prospectus suitability standards. FINRA also identified a specific registered representative that had executed a significant number of transactions that exceeded the firm's concentration guidelines, many of which were unsuitable for the relevant customers; this representative was able to enter false customer information and to effect these transactions without detection due to the firm's insufficient supervision.

The full and original memo was published by Morrison & Foerster LLP on March 27, 2014 and is available here.

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