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In April 2020, the Financial Industry Regulatory Authority and nearly all of the national securities exchanges announced they had formed a Cross-Market Regulation Working Group (CMRWG) to share information and reduce unnecessary duplication in the participants' regulatory efforts.

This development comes at a time when the exchanges are increasingly expanding their role in conducting enforcement investigations and prosecuting enforcement matters. Although FINRA and the exchanges currently coordinate and effectively centralize most enforcement investigations, recent changes indicate a move toward a more decentralized model and the possibility that exchanges may independently bring significant disciplinary cases against brokers.

On August 21, 2020 the SEC proposed a framework for FINRA's and the exchanges' access to cross-market trading data that could further impact whether the exchanges will conduct more independent investigations. This article describes how enforcement investigations among FINRA and the exchanges are currently coordinated, recent changes that indicate a move toward a more decentralized model, and potential ways to mitigate the duplication that can result.

As brokers steer their businesses through the challenges of the ongoing pandemic and economic crisis, taking advantage of the CMRWG may be a critical way for brokers to reduce the burdens of multiple investigations and enforcement actions.

Background

In any given year, a broker-dealer may be examined and investigated by a number of government regulators, including the SEC and the securities regulatory bodies in every state where the broker-dealer does business. Overlapping and duplicative exams and enforcement actions may pose any number of problems. At best, they can be inefficient and burdensome, especially as broker-dealer employees currently working from home offices struggle to provide regulators with information while they also juggle compliance challenges caused by a remote workforce and market volatility. At worst, overlapping regulatory regimes create the risk of inconsistent and unclear regulatory expectations. If different regulators interpret similar rules or regulations differently, broker-dealers cannot know how to comply with their obligations.

In addition to the regulatory duplication caused by the overlapping jurisdictions of government regulators, there is another layer of regulation for broker-dealers: self-regulation. Every self-regulatory organization (SRO)—which includes FINRA and each of the national securities exchanges—is also required to examine and enforce compliance by its member firms with the Exchange Act, the rules and regulations thereunder, and the SRO's own rules.

But broker-dealers do not typically find themselves facing overlapping examinations by FINRA and various exchanges. That's because FINRA has typically done this work on behalf of the exchanges, through a collection of contractual agreements and Exchange Act § 17(d) arrangements.

At times, these arrangements shift the exchanges' responsibility for examining and enforcing the rules to FINRA. For example, Rule 17d-1 relieves exchanges of their obligation to examine and enforce compliance with financial responsibility requirements (such as capital, margin, and protection of funds or securities) when another SRO, such as FINRA, is the member firm's designated examining authority (DEA). Similar arrangements have been established under Rule 17d-2 to centralize oversight responsibilities related to various regulations such as insider trading surveillance, compliance with Regulation NMS rules, and options-related matters. Pursuant to these arrangements, for joint FINRA/exchange members, only FINRA is obligated to examine firms' compliance with the relevant rules.

The exchanges remain obligated to investigate and enforce compliance with rules that are not allocated to FINRA. But the exchanges currently mitigate against possible regulatory duplication by hiring FINRA – which is already examining and investigating joint FINRA/exchange members – to conduct specific examination and enforcement activity on behalf of each exchange.

Therefore when a FINRA examiner requests information from a firm, she may be requesting that information on behalf of an exchange, pursuant to FINRA's contract to conduct exams on behalf of the exchange. Similarly, although the broker-dealer that is the subject of an enforcement investigation generally interacts with FINRA staff, the resulting enforcement matter may be a settlement with FINRA, with an exchange, or with both. If the enforcement matter involves an exchange, that exchange will decide whether any misconduct violates its rules, what sanction is appropriate, and what settlement language is acceptable.

Practically speaking, this model has resulted in a centralized examination and enforcement program across FINRA and the exchanges. FINRA plays a unique role in identifying overlapping concerns. For example, when it plans and conducts a consolidated examination on behalf of multiple SROs, FINRA minimizes the risk of duplicative exam requests and contradictory exam outcomes. And, although a broker-dealer's misconduct may impact more than a dozen exchanges, and each exchange has a regulatory obligation to investigate and enforce its rules, FINRA may conduct a single investigation on their behalf.

This centralized model has enabled FINRA to identify widespread misconduct that threatens multiple markets. FINRA receives market data from each exchange in order to perform regulatory work on its behalf. The agency combines that data to conduct cross-market surveillance to identify potential misconduct affecting multiple SROs.

If FINRA identifies conduct that affects multiple exchanges, it may consolidate the investigations on behalf of multiple SROs into a single, centralized matter. As a result, although a matter involves multiple Exchanges, member firms deal only with FINRA staff and a unified or coordinated set of information requests, on-the-record interviews, legal discussions, and settlement negotiations. FINRA, the only SRO with contractual arrangements to receive data from each exchange, has been uniquely positioned to play this role.

Recent Developments

But FINRA's role at the center of this regulatory framework has begun to change. In recent years, some exchanges have begun to conduct enforcement activities they previously delegated to FINRA. The New York Stock Exchange resumed conducting its own surveillance and enforcement for activity on its own markets in January 2016, stating that it was focused on "the early detection and prompt disposition of potentially violative conduct" on its exchanges. Last year, the Securities and Exchange Commission approved Nasdaq's similar proposal to resume operational responsibility for certain investigation and enforcement functions previously performed by FINRA. Nasdaq stated that the change would "ensure that contested cases are handled promptly" and "enable the Exchange to take timely action when appropriate…"

To be clear, the change has not yet been dramatic. Today, FINRA continues to conduct examinations on behalf of the SROs, significantly reducing the risk of duplicative exams (setting aside those pesky SEC and state examinations). It is in the enforcement context where there are some signs of de-centralization, as NYSE and Nasdaq have begun to bring enforcement matters concerning misconduct limited to their own markets. But along with all the other SROs, NYSE and Nasdaq continue to rely on FINRA to identify and investigate misconduct that affects multiple markets. In general, enforcement actions concerning widespread misconduct remain largely centralized.

However, that model based on contractual arrangements between the SROs may change. In particular, the industry's transition to the Consolidated Audit Trail (CAT), a central repository to which SROs and broker-dealers report detailed audit trail information about quotes and orders in NMS securities, could affect the ways the SROs work together. Today the exchanges rely on FINRA to conduct cross-market surveillance using the trading data it receives from each exchange. FINRA then investigates and prosecutes resulting enforcement actions on behalf of itself and all affected exchanges. When CAT is fully implemented, the exchanges may directly access cross-market trading data for surveillance and regulatory-related analysis.

In a letter to SEC Chairman Jay Clayton, SIFMA argued that the CAT plan should restrict exchanges from accessing trading activity on other markets, questioning why exchanges would need broader data capabilities given FINRA's current role in cross-market surveillance. But Rule 613 requires the SROs to update their surveillance and oversight activities to make use of data available from CAT, and the SEC has not proposed revising the rule to restrict CAT data access.

Rather, on Aug. 21, 2020, the SEC released a proposal that would allow FINRA and each exchange to analyze CAT data using a secure workspace provided by FINRA, or a separate analytical environment approved by the SEC. According to the Commission, this framework could facilitate commercial opportunities for FINRA and the exchanges to offer regulatory services or licensed technology to each other. If the SEC's proposal is approved, the SROs will choose how to meet their regulatory obligations going forward. Rather than relying on FINRA's surveillance, it is possible some exchanges will choose to conduct cross-market surveillance and independently pursue any resulting enforcement actions.

A review of NYSE Enforcement actions filed directly by NYSE Regulation, rather than by FINRA on NYSE's behalf, reveals that NYSE has imposed a variety of substantial penalties and obligations, including six- and seven-figure penalties and significant undertakings requiring broker-dealers to hire outside auditors or additional senior staff, among more traditional undertakings such as revising supervisory procedures. NYSE matters spanning multiple NYSE exchanges indicate that its enforcement investigations are broad in scope and focused on potentially widespread issues and systemic misconduct.

And in at least one case, NYSE Enforcement filed charges that FINRA, not NYSE, was responsible for enforcing when NYSE charged Wedbush Securities with violations of the exchange's margin rules. In re Wedbush Securities, Inc., No. 2016-07-01264 (Jan. 8, 2019). These characteristics of NYSE's maturing enforcement program seem to point to more and bigger cases coming from the SRO, and cross-market data like CAT data may be useful for identifying widespread potential misconduct that gives rise to significant enforcement actions.

Looking Ahead

As the exchanges are able to access more data and further develop their own enforcement programs, the industry should be concerned about duplicative investigations and inconsistent enforcement outcomes that could create inefficiency and confusion. Looking ahead, both the SROs and their members will play important roles in helping to address these developing challenges. For example, the SROs have taken steps toward "eliminat[ing] duplication in their surveillance, examination, investigation" efforts with respect to CAT by filing a Rule 17d-2 plan that calls for allocating these regulatory responsibilities for compliance with CAT to a designated SRO.

Further to that end, on April 8, 2020, FINRA and the exchanges announced the formation of the CMRWG. It is a voluntary working group of the U.S. Subgroup of the Intermarket Surveillance Group to focus on ways to reduce unnecessary regulatory duplication. The group serves as a forum for FINRA and the participating exchanges to share information and collaborate in connection with their ongoing surveillance, investigation and enforcement efforts in an effort to avoid unnecessary duplication.

The group has specifically said that its members have discussed "regulatory arrangements among the SROs for conducting surveillance, investigations, examinations and enforcement functions related to their members' compliance with CAT reporting rules," but the CMRWG has not yet indicated how it intends to coordinate on market surveillance based on CAT data and any resulting investigations. SEC officials acknowledge that questions are still open regarding regulatory coordination in this space, and that regulatory coordination may evolve over time.

To the extent multiple SROs encounter and seek to investigate the same cross-market activity of a member, the CMRWG participants have expressed interest in hearing from their broker-dealer members who may be subject to duplicative disciplinary action. Acknowledging that "it is possible that an individual or firm may receive similar or overlapping requests for information from regulatory employees of more than one participant," the CMRWG provides contact information for each SRO (or SRO family) and asks firms to direct concerns or questions about regulatory duplication to those addresses so that the concerns or questions may be addressed.

A broker-dealer that finds itself the subject of such "overlapping" regulatory activity will bear both increased costs resulting from duplicative investigations and the risk of confusing and even conflicting outcomes. Firms should therefore seek to identify overlapping requests from different SROs and to flag concerns, using the mechanism provided by the CMRWG, as early as possible.

Taking advantage of the forum provided by the CMRWG will give SROs the opportunity to coordinate and/or streamline duplicative matters. In some cases, for example, it may be reasonable for SROs with similar interests to designate one SRO to take the lead in an enforcement investigation to minimize the burden of multiple requests for information. There is precedent for SROs taking the lead with respect to certain joint members' conduct on a rotating basis, which could be used as an approach to non-duplicative cross-market surveillance.

The CMRWG may also be an important avenue for escalating more substantive policy concerns and resolving conflicting applications of the law in the enforcement context. For example, suppose SROs take conflicting positions on the application of federal law to a specific set of facts. In that case, the CMRWG may provide a forum for discussion and negotiation or a path to escalation to the SEC.

Each SRO has a regulatory responsibility to enforce its own rules and the federal securities laws. Recent developments—including the availability of CAT data—create new opportunities for the SROs to do that effectively. But in a landscape already crowded with federal and state regulators, more investigations and increased enforcement activity by SROs may significantly increase the costs of compliance for broker-dealers and could cause confusion if different regulators take contradictory positions about what compliance requires.

The SROs' creation of the CMRWG is timely as SROs continue to develop and expand their enforcement programs. Despite the challenges of managing through a pandemic, broker-dealers face ongoing demands by multiple regulators on a daily basis. Broker-dealers should be considering when to invoke intervention by the CMRWG, and how to best use this new tool more broadly to reduce duplication and enhance regulatory clarity.