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Regulatory Practice Letter

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FINRA Requests Comment on a Concept Proposal to Develop the Comprehensive Automated Risk Data System

Executive Summary

The Financial Industry Regulatory Authority (FINRA) has issued a Regulatory Notice soliciting comment on a "concept proposal" to develop a new, rule-based program called the Comprehensive Automated Risk Data System (CARDS). FINRA states that CARDS would involve account reporting requirements that would allow it to collect account information on a standardized, automated, and regular basis. CARDS would also allow FINRA to collect account activity and security identification information that its member firms maintain as part of their books and records. FINRA also states that it would analyze CARDS data before examining firms on site, thereby identifying risks earlier and shifting work away from the on-site exam process.

The Regulatory Notice is intended to obtain the views of firms and others at the initial stage of determining how FINRA should obtain broader information to advance its supervision of firms and their associated persons.

Comments on the proposal were originally requested through February 21, 2014, but have been extended to March 21, 2014.

Background

Advances in technology have changed the way FINRA conducts examinations and oversees the securities markets by enabling it to collect, process, and analyze large quantities of information. FINRA states that increasing its access to this information will allow it to analyze data in innovative ways that will "better protect investors and ensure market integrity" and allow FINRA to take advantage of technological advancements in order to continue as an "efficient and effective regulator."

FINRA's current national examination program is a risk-based, on-site approach that requires information collection for each examination on a firm by firm basis. FINRA collects these data, such as purchase and sales blotters and customer account information, on an episodic basis. FINRA's data information requests may vary in content, scope, and time period, and may also overlap if FINRA issues more than one request to the same firm for different events (e.g., if the firm is undergoing simultaneous financial or market regulation examinations).

Because firms do not produce this information on a routine bases, FINRA does not currently have a data-driven method of assessing business conduct patterns and trends across the industry nor does it have the ability to efficiently review individual firm activities off-site prior to an examination. In addition, for individual examinations, firms need time to provide the requested information, which typically occurs while an examination is in progress. Such situations reduce FINRA's ability to assess the risk areas on which to focus their examination program.

FINRA states that its episodic information requests often require firms to produce information they maintain in multiple systems, requiring "significant effort" on the part of firms to comply with the requests. FINRA may also request that information be produced quickly if it is concerned about an investor protection threat, and FINRA believes that this time sensitivity may be contributing to increased firm production costs. Additionally, FINRA reports that firms have indicated they often must divert critical staff from their primary responsibilities, hire temporary staff, outsource the fulfillment effort to a third party, or request special support from clearing firms to respond to these information requests. Though currently necessary to fulfill FINRA's responsibilities, individual information requests "increase costs to firms, disrupt firms' business activities and slow FINRA examinations and inquiries."

In developing the CARDS concept, FINRA met with industry participants to begin identifying a cost effective approach for submitting the existing information currently collected in firms' books and records.

Proof of Concept

FINRA tested the feasibility of an automated data acquisition program on two major clearing firms and used the results to help inform the concept proposal.

One of these "proofs of concept," initiated in 2012, involved collecting information from individual firms in order to validate automated analytics designed to identify potentially problematic sales practice activities. The second proof of concept, initiated in 2013, involved collecting information from two clearing firms to test the feasibility of an automated data acquisition program.

FINRA applied analytics to individual firm data to identify potential red flags early in its examination preparation. By running these data through analytics for pattern detection, FINRA states that it was able to more accurately identify areas of risk, including:

- A firm that was selling a new, high-risk product in a recently formed business that was not disclosed in its financial reporting.
- A firm that was engaged in suspicious pump and dump activity from several years prior to a clearing firm conversion.[1]

Based on these two experiences, FINRA has determined that the "vast majority" of the information to be collected through CARDS is already being stored in an automated format at clearing and self-clearing firms and service bureaus. These

[1] Pump and dump schemes typically involve the touting of a company's stock through false and misleading statements to the marketplace by insiders and others who stand to gain by selling their shares after the stock price is "pumped" up by the buying frenzy they create. Once the insider shares are sold, or "dumped," the stock price typically falls, and outside investors lose their money.

proofs of concept helped FINRA develop the concept for an approach that used automated analytics and an ongoing data acquisition program whereby information is regularly submitted by firms. FINRA also notes that it was able to develop a standardized electronic data acquisition process that collected account, transactional, and position data from the two clearing firms on a recurring delivery schedule.

Description

FINRA is proposing a rule-based program that will allow it to collect, on a standardized, automated, and regular basis, investor account information, as well as account activity and security identification information that a firm maintains as part of its books and records. The particulars of the CARDS program proposal are outlined below.

Proposal for the Automated Submission of Account Information

As proposed, CARDS would be a broad ranging initiative supporting a comprehensive approach to FINRA's supervisory program. FINRA states that the system would enable it to more efficiently review firm and industry activity and better focus FINRA resources on key risks and exposures. Access to more comprehensive data would allow FINRA to better analyze customer dealing information on an individual firm basis, compare one firm's customer dealing activities against those of its peers, and understand industry-wide patterns and trends.

FINRA states that it intends to analyze CARDS information in advance of on-site examinations, potentially reducing the length of on-site visits and reducing intermittent information requests.

Initially, FINRA envisions using CARDS to collect specific retail customer information already contained in required books and records from clearing and self-clearing firms on a regular schedule. Introducing firms would be required to provide their clearing firms with specified information they control, so that the clearing firms can provide this information to FINRA in conjunction with other information provided by the clearing firms. FINRA states that it would intend to use this information to run analytics that identify potential red flags of sales practice misconduct, including:

- Excessive commissions, primarily through the use of:
  - Churning. This occurs when a broker engages in excessive trading of securities in a customer's account, or trading that is not consistent with the financial goals and risk tolerance of a customer, for the purposes of generating broker commissions.
  - Excessive markups. A markup is the difference between the current market price of a security and the price charged to a customer by the broker-dealer for executing the security transaction.[2]
  - Prohibited mutual fund switching. Although the selling of holdings of one mutual fund to buy shares of one or more different funds may be appropriate under certain conditions, some transfers between funds may constitute unsuitable switching, particularly if the broker recommends switching funds only to earn a commission from the transaction or if the broker recommends

[2] Although the fairness of a particular markup is subject to interpretation depending on the individual circumstances, the Securities and Exchange Commission has taken the position that markups over 5 percent are questionable and FINRA has also adopted the 5 percent markup guideline for its members.

a fund purchase for a quantity just beneath the point where the customer could save significant commission charges by purchasing a few more shares.

- Market manipulations, primarily through pump and dump activity.

FINRA states that the collection of this information will also help it to identify potential business conduct problems with member firms, branches, and registered representatives.

Data Specifications

Once implemented, FINRA envisions that clearing firms (on behalf of introducing firms) and self-clearing firms would submit, in an automated, standardized format, specific information relating to their customers' accounts and the customer accounts of each firm for which they clear. This information would include, at a minimum:

- Account information that identifies account types associated with account activity, firms and their branches, and associated persons responsible for supervision and sales, which FINRA intends to use for its sales practice reviews, including:
  - Account types and categories (e.g., retirement, brokerage, cash, margin, options, discretionary, or day trading);
  - Customer investment profile information (e.g., investment objective and date of birth);
  - An identifier for beneficial owners or control persons, although FINRA notes that it intends to consider ways that it can gather this type of information without disclosing account names or other personally identifiable information; and
  - Servicing registered persons and locations (e.g., registered person Central Registration Depository (CRD) number and branch CRD number).
- Account activity information, which FINRA states will be used in conjunction with account information data as the primary basis for risk identification related to suitability reviews, fraud detection, anti-money laundering, and other sales practice related reviews, including:
  - Details of account activity (e.g., purchases and sales transactions, and event dates);
  - Additions and withdrawals, securities, and account transfers; and
  - Margin and balances.
- Security identification information, in order for FINRA to determine the characteristics of securities, including:
  - Description of securities (e.g., CUSIP, symbol, description, name, ISIN, and SEDOL).

FINRA envisions that firms will submit the required information to FINRA on a "regular schedule (such as daily or weekly)."

Next Steps

FINRA has determined that the information selected for submission during the initial phase of CARDS would generally represent the same types of information FINRA is currently collecting on a firm-by-firm basis during its examination process. FINRA recognizes, however, that the ability of firms to collect and submit the information efficiently in a standardized format may vary. To address this, FINRA envisions implementing CARDS through a phased approach over a "reasonable period of time" and is seeking comment regarding the structure of a phased approach.

While FINRA states that the proofs of concept it conducted have been informative, firm input will be "critical" to further explore the opportunities and issues of collecting and analyzing customer data on an ongoing basis. FINRA is requesting comments on the general merits of the concept proposal as well as answers to a series of specific questions set forth in the proposal. These questions encompass requests for possible alternatives methods that will still achieve FINRA goals, the impact on firms' existing infrastructures and necessary system modifications, and the extent to which firms believe they will need to rely on third parties to fulfill their reporting requirements, among other concerns. In particular, FINRA requests comment on the economic impact of CARDS, including the costs and benefits of the proposal, and requests submission of data and quantified comments, where possible.

Commentary

The lack of standardized data at a sufficiently granular level to conduct research is a primary concern among regulators seeking to harness these data in order to better detect vulnerabilities and risks to the financial system. The CARDS proposal could potentially provide a more efficient way of collecting account information than FINRA's current process of gathering data on a firm by firm basis. However, due to the high profile nature and media coverage of recent data breaches, the building of a broad-based customer data collection system such as CARDS comes at a delicate time for the financial services industry. Given the value and sensitivity of the data to be collected through CARDS, protecting this information from unauthorized disclosure or use will be essential.

In addition to these heightened security concerns, FINRA must contend with the following as it seeks to further regulate the securities industry through increased technology, defined data, and targeted analytics:

- *Increased compliance costs:* Clearing firms will likely incur costs to build and maintain the infrastructure needed to submit the required information to FINRA, while introducing firms will also likely incur costs associated with providing additional information to their clearing firms to meet the new requirements. It is not clear that these firms will have the ability to absorb these costs without directly or indirectly passing the increased costs to investors.
- *Lack of automation and standardization:* Because account information may be maintained in different ways by individual brokerages and clearing firms, these firms will likely have to incur costs to both automate their processes and standardize their data collection efforts around a consistent taxonomy.
- *Increased data warehousing and transmission requirements:* Both introducing and clearing firms will have to control reams of new account information that will have to be stored, collated, and managed. These firms may also have to develop new data transmission procedures and may incur costs associated with monitoring their transmission protocols.

The potential increased costs may be affected by the frequency of the information transfers, whether the transfers are for complete datasets or only for changes between periods, and how the clearing or introducing firms are currently creating and maintaining their information. Firms could also incur costs if CARDS requires historical data to be collected for account information that was not previously received by the clearing firms. The burden of these costs will likely depend on whether the obligation to update the information is the responsibility of the introducing or clearing firm.

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