

Comprehensive Automated Risk Data System

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

Comment Period Expires: February 21, 2014

Executive Summary

FINRA is requesting comment on a concept proposal to develop a new Comprehensive Automated Risk Data System (CARDS), a rule-based program that would allow FINRA to collect on a standardized, automated and regular basis, account information, as well as account activity and security identification information that a firm maintains as part of its books and records. This *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.

Questions concerning this *Notice* should be directed to:

- ▶ Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, at (202) 728-6911;
- ▶ Jonathan Sokobin, Sr. Vice President, Office of the Chief Economist, at (202) 728-8248; or
- ▶ Victoria L. Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104.

December 2013

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Risk
- ▶ Senior Management
- ▶ Technology

Key Topics

- ▶ Reporting Requirements

Referenced Rules & Notices

- ▶ FINRA Rule 2111
- ▶ FINRA Rule 8210
- ▶ NASD Rule 3150
- ▶ NTM 03-73

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 21, 2014.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Background and Discussion

Technology is changing the way that FINRA examines firms and oversees the markets, by enabling FINRA to collect, process and analyze large quantities of information. Access to this information allows FINRA to analyze data in new ways that better protect investors and ensure market integrity. FINRA must take advantage of technological advancements to continue as an efficient and effective regulator.

As discussed in more detail below, CARDS is a broad ranging initiative supporting a comprehensive approach to supervising firms. Initially, FINRA envisions using CARDS to collect specific retail customer information—*i.e.*, information 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 clearing firms can provide this information to FINRA in conjunction with other information the clearing firm provides. FINRA would use the information to run analytics that identify potential red flags of sales practice misconduct (*e.g.*, churning, excessive commissions, pump and dump schemes, markups, mutual fund switching), as well as help FINRA identify potential business conduct problems with member firms, branches and registered representatives.

In developing the CARDS concept, FINRA has begun to meet with industry participants and wishes to confer further with a broad cross-section of firms to identify a cost effective approach for submitting information from firm books and records. The information selected for submission to FINRA during the initial phase of CARDS would generally represent the same types of information FINRA currently collects on a firm-by-firm basis during the examination process. Based on experience with two major clearing firms with which FINRA tested the feasibility of an automated data acquisition program, FINRA believes that the vast majority of the information that CARDS would collect is already stored in an automated format at clearing and self-clearing firms and service bureaus. FINRA recognizes that the ability of firms to collect and submit the information efficiently in a standardized format may vary. As a result, 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.

A. Current Information Collection

FINRA's current risk-based national examination program is central to FINRA's efforts to protect investors. At its core, this examination program seeks to target potential business conduct abuses investors face. Currently, FINRA's examination program is a risk-based on-site approach that requires information collection for each examination on a firm-by-firm basis. FINRA collects firm data, such as purchase and sales blotters and customer account information, on an episodic basis.² These information requests necessarily vary in content, scope and time period, and may overlap if FINRA issues more than one request to the same firm for different events (such as a simultaneous financial and operational or market regulation examination). Because firms do not regularly produce the information FINRA collects for individual sales practice examinations, FINRA does not have a data-based method of assessing business conduct patterns and trends across the industry. In addition, for individual examinations, firms need time to provide the information requested while an examination is in progress. Such situations reduce FINRA's ability to assess the risk areas on which to focus its examination program, as well as FINRA's ability to efficiently review individual firm activities prior to an examination. CARDS would support the use of advanced technologies, defined data and targeted analytics that would permit FINRA to appropriately focus examinations on problematic areas.

Currently, FINRA information requests often require firms to produce information they maintain in multiple systems, requiring significant effort on the part of firms to comply. When FINRA is concerned about an investor protection threat, it may request information to be produced quickly, which increases the costs of the production. To respond to information requests, firms have indicated that 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. 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.

B. Proposal for Automated Submission of Account Information Requested by FINRA

Innovations in information technology now allow the collection, processing and analysis of large quantities of information. CARDS is designed to use this technology to support a more effective examination program.

CARDS' first phase is intended to increase FINRA's ability to use automated analytics on current and historical firm data to identify problematic sales practice activity. CARDS would enable FINRA to more efficiently review firm and industry activity and better focus its 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 its peers', and understand industry-wide patterns and trends.

In addition, CARDS is intended to reduce burdens on firms by eliminating intermittent information requests from FINRA for the information CARDS covers. FINRA would also analyze CARDS information before examining firms on-site, thereby potentially reducing the length of examiners' on-site visits to firms.

To help inform this concept proposal, FINRA conducted two proofs of concept. One proof of concept collected information from individual firms to validate automated analytics designed to identify potentially problematic sales practice activities.³ The other proof of concept collected information from two clearing firms to test the feasibility of an automated data acquisition program.⁴

These proofs of concept helped FINRA develop a new approach using automated analytics and an ongoing data acquisition program where information is regularly submitted by firms. FINRA applied analytics to individual firm data to identify potential red flags early in its examination preparation. Importantly, FINRA also developed a standard electronic data acquisition process that collected account, transactional and position data from two clearing firms on a recurring delivery schedule. By running the firm data through analytics for pattern detection, FINRA was able to more accurately identify risk areas. For example, the analytics showed FINRA that a firm was selling a new, high-risk product—a business in which the firm was not historically engaged and its financial reporting did not disclose. FINRA used information from another firm to identify suspicious pump and dump activity from several years prior to a clearing firm conversion.⁵

While these proofs of concept have been informative, firm input is critical to further explore the opportunities and issues of collecting and analyzing customer dealing data on an ongoing basis. Thus, FINRA encourages comments generally on the concept proposal as well as in response to the specific questions set forth in the Request for Comments section below. 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.

C. Data Specifications

As currently envisioned, once CARDS is implemented, 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. Such information would include, at a minimum:⁶

- ▶ **Account Information:** This information identifies account types associated with account activity, firms and their branches and associated persons responsible for supervision and sales. This information would be used for sales practice reviews such as quantitative suitability, commissions and markup/down, and penny stock activities.
 - ▶ Account types and categories (*e.g.*, retirement, brokerage, cash, margin, options, discretionary, day trading)
 - ▶ Customer investment profile information (*e.g.*, investment objective, date of birth)
 - ▶ An identifier for beneficial owners or control persons⁷
 - ▶ Servicing registered persons and locations (*e.g.*, registered person CRD number and branch CRD number)
- ▶ **Account Activity Information:** In conjunction with account information, account activity information serves as the primary basis for risk identification related to suitability reviews, fraud detection, anti-money laundering and other sales practice-related reviews.
 - ▶ Details of account activity (*e.g.*, purchases and sales transactions, event dates)
 - ▶ Additions/withdrawals, securities and account transfers
 - ▶ Margin and balances
- ▶ **Security Identification Information:** Security identification information is required for FINRA to determine the characteristics of securities.
 - ▶ Description of securities (*e.g.*, CUSIP, symbol, description, name, ISIN, SEDOL)

Introducing firms would not be required to transmit the specified information directly to FINRA, but would provide their clearing firms with information in their possession that is necessary for the clearing firms to comply with CARDS' information submission requirements. Clearing firms would not be responsible for ensuring the accuracy or completeness of the information provided to them by their introducing firms for submission to FINRA in compliance with the program. The initial phase of CARDS would focus on information that is already required to be created and maintained by either the clearing firm or the introducing firm.

Any clearing or self-clearing firm submitting information would submit such information in a manner that would enable FINRA to distinguish between information pertaining to customer accounts of an introducing firm and information pertaining to customer accounts of any firm for which the introducing firm is acting as an intermediary in obtaining clearing services from a clearing or self-clearing firm.

FINRA envisions that firms would submit the required information to FINRA on a regular schedule (such as daily or weekly) in a standardized format that would permit FINRA to run analytics for a particular day during the period being reported. A firm submitting information would be permitted to enter into an agreement with a third party to fulfill the firm's reporting obligations. However, notwithstanding the existence of such an agreement, each firm would remain responsible for complying with the information reporting requirements.⁸

Given the value and sensitivity of the information to be collected via CARDS, it is essential that this information is protected from unauthorized disclosure or use. CARDS would incorporate current and effective information security methods to protect this information. FINRA welcomes comments regarding ways to further reduce security risks.

FINRA requests comment generally on the data specifications described in this *Notice*, as well as in response to the specific questions in the Request for Comments section below.

D. Phased Implementation Approach

As currently envisioned, the first phase of CARDS would focus on business conduct for retail accounts, but FINRA is considering ways to further structure such an approach. For example, FINRA is considering whether the initial phase of CARDS should begin with a select group of firms and the collection of a subset of information.

Based on information received in response to this *Notice*, FINRA would consider whether to include additional phases in implementing CARDS, and how to expand CARDS during any such later phases of its implementation.

E. Economic Impact

CARDS would require the submission to FINRA of account information, as well as account activity and security identification information by clearing firms (on behalf of introducing firms) and self-clearing firms. Introducing firms typically collect and retain information about the customer, including account information. Introducing firms may also have in their possession limited account activity and security identification information.

FINRA understands that, currently, clearing firms' systems may collect and retain information for new accounts of their introducing firms, and create and retain account activity and security identification information for such firms. Clearing firms' systems differ in how they collect and store this information and may or may not have unused or open fields in their systems. As a result, clearing firms have in their systems some but not all the information that would be required by CARDS.

1. *Anticipated Benefits of the Proposal*

As discussed in more detail above, CARDS would be expected to reduce present regulatory costs and burdens on firms by reducing the need for manual, partial, overlapping and one-time regulatory report generation for the information required to be reported to CARDS. It would result in a standard technology interface that would enable firms and FINRA to create and maintain one set of computer programs for firms to submit and FINRA to collect the information required by CARDS.

CARDS is intended to increase the effectiveness of the examination process by enabling FINRA to identify risks to efficiently target firm surveillance and examination programs. While FINRA has improved its approach over recent years to better gather firm information, standardized information collection and automated analytics would greatly strengthen that process.⁹ In addition, following FINRA's analyses of the information firms provide, FINRA could share its analyses, including performance benchmarks, with firms to help firms with their compliance and supervisory programs.

CARDS would not supplant the legal, compliance and supervisory programs firms administer. Rather, a firm's compliance and supervisory programs would continue to have the obligation to conduct oversight to prevent and detect problems based on the full information firms hold.

CARDS would also reduce FINRA's reliance upon, and eventually replace the use of, existing data systems and feeds, such as INSITE.¹⁰ FINRA is committed to a thorough analysis of existing as well as any future reporting requirements, such as those that may be required by the Consolidated Audit Trail (CAT), to eliminate duplication of reporting requirements as CARDS is implemented.

2. *Anticipated Costs of the Proposal*

Clearing firms would likely incur costs to build and maintain the infrastructure to submit the required information to FINRA. Clearing firms may also incur costs to monitor the information transmission. Introducing firms also would likely incur costs in providing additional information to their clearing firms to meet the new requirements. Introducing firms may face additional costs if they currently use open fields in the clearing firms' systems for their own business but are unable to do so going forward due to CARDS' information submission requirements. Both introducing and clearing firms may have to develop new procedures around information transmission and resolution.

Firms would incur costs if CARDS requires historical data to be collected for account information that was not previously received by the clearing firm. The burden of the costs would depend on whether the obligation to update the information was the responsibility of the introducing or clearing firm.

The potential costs may be affected by the frequency of the information transfers, whether the transfers are for complete datasets or only the changes between periods, and how the clearing or introducing firms create and maintain their information presently. As set forth in the Request for Comments section below, FINRA requests comment on the distinct costs that clearing and introducing firms would incur.

3. *Other Economic Impacts*

Once CARDS is implemented, FINRA intends to conduct a public retrospective review following an appropriate period to determine whether it is effectively achieving its intended purpose.

Request for Comments

FINRA seeks comments on the CARDS concept proposal, outlined above. In addition to general comments, FINRA specifically requests comments on the following questions. FINRA requests data and quantified comments where possible.

1. Are there alternative methods for FINRA to achieve its goals as articulated? If so, what are those alternatives and why might they be better suited? Are there other information collection methods FINRA should consider either as an alternative, or as a supplement, to CARDS?
2. What would be the primary sources of economic impact, including the potential costs and benefits, to clearing, self-clearing and introducing firms in developing, implementing and maintaining the systems that would be necessary to comply with the reporting requirements of CARDS? What systems would potentially have to be modified and what would be the anticipated costs? Would the primary sources of economic impact differ based on the size of the firm or differences in the business model?
3. In addition to systems modifications, what other potential changes to firms' infrastructure would be necessary? For example, would firms need to hire additional personnel either on a temporary or full-time basis to implement CARDS?
4. To what extent do firms believe that they would rely upon third parties to fulfill their reporting obligations? Should FINRA specify supervisory obligations for firms that enter into agreements with third parties to fulfill the firms' reporting requirements related to CARDS? How could FINRA use CARDS to reduce firm use of personnel or third parties to fulfill examination and reporting requirements?
5. To what extent do introducing firms currently maintain customer profile and suitability information with their clearing firms? If introducing firms maintain such information with the clearing firm, to what extent do introducing firms use the clearing firms' data fields in providing the information to the clearing firms? If the clearing firms' data fields are not used, how do introducing firms provide the information to their clearing firms? What would be the potential costs to introducing firms in providing the data elements required by CARDS to their clearing firms? If the data is not currently maintained in a standardized form, how much effort would be required to standardize the data to ensure comparability? Although CARDS contemplates the transmission of information from clearing firms to FINRA, would introducing firms find it more efficient and cost effective to transmit the specified information (or portions thereof) directly to FINRA?

6. The information provided to FINRA would include, at a minimum, account, account activity and security identification information. Is this information collected and maintained for all types of customers and products? To what extent is this information currently maintained in an automated format? To what extent is the information stored at clearing and self-clearing firms versus service bureaus?
7. FINRA expects that as applicable securities laws and FINRA rules evolve and are amended to include additional books and records requirements, it would revise CARDS' data specification elements to include that information. FINRA is contemplating assessing whether revisions to the data elements would be necessary on a 12- to 18-month cycle. What would be the feasibility of a 12- to 18-month cycle and what could impact that feasibility? What could be the potential economic impact of a 12- to 18-month revision cycle?
8. FINRA is considering submissions of the required information to FINRA on a regular schedule (such as weekly or daily) in a format that would permit FINRA to run analytics for a particular day during the period being reported. Should FINRA require a longer or shorter period of time for submission of the information to FINRA? Given the proposed purpose for collecting the information, what would be an appropriate schedule for submission of the information to FINRA? What would be the costs and benefits of a longer versus a shorter reporting schedule for submission of the information to FINRA? What would be the costs and benefits of requiring different submission schedules depending on the information to be provided to FINRA? For example, what would be the costs and benefits if FINRA were to require monthly submission of account information, but daily submission of account activity information?
9. FINRA is considering a phased approach to implementing CARDS. It envisions that the first phase of CARDS would focus on business conduct for retail accounts. What are the ways in which the first phase could be structured to best achieve the goal of focusing it on business conduct for retail accounts?
10. For purposes of the initial phase of CARDS, would firms be able to clearly distinguish between retail customers and others? What systems changes, if any, would be necessary to allow firms to limit the submission of information to retail account activity? What would be the economic impact on firms, including the costs and benefits of limiting the initial phase of CARDS to the submission of information relating to retail account activity only? Is it easier or harder to limit reporting to retail account activity? What other types of account activity should or should not be included in an initial phase of implementation? How should historical information versus new accounts be treated under a phased approach?
11. Following FINRA's analyses of the datasets firms provide, would it be beneficial for firms to receive the data with performance benchmarks? If so, should FINRA make that data available directly or through vendors or clearing firms?

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. FINRA information requests are triggered by expected events such as cycle examinations (approximately 1,700 to 2,400 per year depending on cyclical demands) and other non-routine events such as cause examinations, enforcement investigations and special sweeps that often cover similar periods.
3. The proof of concept focused on the use of the Risk Analytic Development Tool (RDAT), an electronic data submission format tool. FINRA used the RDAT for 12 examinations in 2012. The RDAT proof of concept validated that the automated analytics contained in RDAT were successful in identifying potentially problematic sales practice activity in many of the examinations. In addition, the analytics were successful in providing a better understanding of the firm's business model, operations and sales activity, and improving the quality of business conduct reviews through comprehensive, automated analysis of all brokerage activity. However, the data acquisition process was burdensome on FINRA staff and member firms due to a lack of standardization and automation. As a result, it was not feasible to move to a broader implementation. Nonetheless, through the proof of concept, FINRA reviewed much larger data sets than through current examination techniques.
4. FINRA engaged in the second proof of concept in early 2013. The goals of this proof of concept were to validate the operational and regulatory concerns with delivering the data; assess the data quality and availability of the desired data elements at the clearing firms; validate the interfaces of the analytics tools used in the program; and develop the internal business concept of operations around usage of the data.

To date, FINRA has successfully implemented an automated data acquisition program by collecting information for a total of 300 introducing firms from the participating clearing firms. In particular, FINRA identified the required data elements that these firms then extracted from their systems and transmitted to FINRA.
5. In August 2013, FINRA launched a pilot program that married RDAT with the information for the 300 introducing firms acquired from the clearing firms in the early 2013 proof of concept. The pilot includes 65 examinations, and involves examination teams from each FINRA district office. FINRA intends to continue collecting and analyzing information received as part of the pilot to better inform it about clearing firm information and capabilities and to assist it with articulating the data specifications for CARDS.
6. FINRA expects that as applicable securities laws and FINRA rules evolve and are amended to include additional books and records requirements, it would revise CARDS' data specification elements to include that information.
7. As FINRA develops CARDS, it intends to consider ways in which to gather account identifying information without disclosing account names or other personally identifiable information.

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8. FINRA notes that, in developing CARDS, it is not intending to amend FINRA's rules governing firm books and records requirements. *See, e.g.,* FINRA Rule 4511(b) (providing that member firms shall preserve for a period of at least six years those FINRA books and records for which there is no specified period under the FINRA rules or applicable Exchange Act rules).
9. For example, FINRA recently updated the FINRA Firm Gateway Records Request for cycle examinations and Information Request for other examinations (collectively "Records Requests") to facilitate the electronic request and fulfillment of electronic business documents. The Records Requests system includes a "Request Manager" that is a secure, encrypted channel for document requests and responses that also tracks the requested documents and allows firms to see the status of all requested documents on one screen.
10. INSITE, or "Integrated National Surveillance and Information Technology Enhancements," is an electronic information collection tool that gathers data pursuant to NASD Rule 3150 (Reporting Requirements for Clearing Firms) via technical specifications and requirements published on FINRA's website (*see* INSITE web page).