Client Advisory

Katten
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Financial Services

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FINRA Provides Guidance on Broker-Dealer Funding and Liquidity Risk Management Practices

On November 1, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 10-57 (the Notice) encouraging broker-dealers to develop and implement sound funding and liquidity risk management programs. The Notice makes it clear that FINRA expects broker-dealers to regularly assess their funding and liquidity risk management practices to maximize the likelihood of continued operation under adverse conditions. FINRA also expects broker-dealers affiliated with holding companies to conduct this assessment and develop these programs at the broker-dealer level regardless of whether they also implement these programs at the holding company level. In order to provide guidance to its members, the Notice sets forth some suggested practices that broker-dealers may follow in developing and implementing their funding and liquidity risk management programs.

Risk Limits and Reporting

The governing board and senior management of a broker-dealer should participate in setting and periodically reevaluating the level of funding and liquidity risk the organization is willing to accept to meet its business goals. These determinations should be communicated by senior management throughout the organization so that management in the various business lines can set appropriate funding and liquidity risk limits and evaluate existing risks presented by various markets and counterparties.

Broker-dealers must maintain systems that timely capture their funding and liquidity exposure across all of their business lines. The scope and frequency of information analyzed will vary depending on the organization's size, complexity or the presence of a key measure of funding and liquidity. Some of the items identified by FINRA as key measures of funding and liquidity exposure include: (1) the amount of excess liquidity; (2) future cash-flow projections based on multiple scenarios; (3) the maturity profile of available funding sources; and (4) the liquidation and mark-down assumptions for inventory positions.

Independent Risk Oversight

Broker-dealers are encouraged to use independent personnel to monitor compliance with the funding and liquidity limits set by the governing board and senior management. Further, broker-dealers must periodically review the charters and mission statements of any funding or liquidity committees to ensure that these statements reflect prevailing market developments.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of **Katten's Financial Services Practice**.

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Maturity Profile of Funding Sources

Broker-dealers should consider the following steps in order to reduce their funding risk: (1) extend maturity terms beyond overnight for repurchase agreements or other short-term funding sources, and (2) establish irrevocable lines of credit or other supplementary sources of short-term funding.

Red Flags of Potential Funding and Liquidity Problems

Broker-dealers should have early warning programs in place to alert them to potential funding and liquidity problems. Some of the suggested triggering events set forth in the Notice include: (1) significant increases in funding costs; (2) unexpected increases in exposure to certain asset classes, markets and counterparties; (3) elevated costs of holding particular asset classes; and (4) significant increases in collateral disputes with counterparties.

Inventory Valuation

Broker-dealers should use controls to ensure that: (1) they value securities and derivative instruments daily based on current fair values; (2) they use consistent prices across business lines; (3) they reevaluate their valuation methodologies periodically and when realized results differ from expected results based on the firm's methodology; and (4) they verify prices using inputs and resources that are well-documented and independent from the person that makes trading decisions on their behalf.

Stress Testing

Broker-dealers should consider performing stress tests on a regular basis that contemplate firm-specific and market-wide events, for varying time horizons, and varying levels of liquidity duress. Some of the events that should be captured in these tests include: (1) significant increases in the cost of funding operations; (2) significant increases in the exposure to certain asset classes; (3) withdrawal of customer assets that the broker-dealer uses to finance operations; and (4) reduction in the value of assets held in an excess liquidity pool. Stress test results should be reviewed with senior management, and the Notice encourages senior management to formally sign off on any stress test results.

Contingency Funding Plan

Broker-dealers should consider maintaining and regularly updating contingency funding plans to: (1) clarify responsibilities and decision-making authority; (2) match sources of funds with contractual and potential obligations; (3) list contingency funding sources and identify when they should be employed; (4) identify business restrictions and reductions that may be employed to counteract a strain on liquidity; and (5) identify the various operational conditions that could affect access to backup credit lines. The Notice encourages senior management and governing boards to formally adopt these contingency funding plans.

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