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FINRA's 2016 Focus

Proactive Compliance in Innovative Markets

On January 5, 2016 FINRA released its annual Regulatory and Examination Priorities Letter identifying its 2016 areas of focus, as well as areas of historical focus. FINRA identified three priority focus areas for 2016: (1) culture, conflicts of interest and ethics, (2) supervision, risk management and controls, and (3) liquidity. While these broad areas of focus have received attention in previous years, in light of market innovation – including improved technology, new trading techniques, and diverse compensation structures – FINRA encourages member firms to proactively manage their compliance and risk procedures.

Firm Culture

FINRA defines "firm culture" as "the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm's business."[1] FINRA's 2016 assessments will focus on how firm culture affects compliance efforts and risk management programs. FINRA identified five key indicators of firm culture:

1. Whether control functions are valued within an organization;
2. Whether policy or control breaches are tolerated;
3. Whether an organization is proactive in its efforts to identify risk and compliance events;
4. Whether supervisors are role models of firm culture, and
5. Whether sub-cultures, either within departments or at branch offices, that may not conform to overall corporate culture are identified and addressed.[2]

These key indicia provide a roadmap for the type of compliance culture that FINRA's oversight seeks to engender.

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Supervision, Risk Management and Controls

Firm culture, as the overarching driver of proactive compliance, is inextricably intertwined with FINRA's second focus area: supervision, risk management and control. Member firms are obligated to maintain systems to supervise associated persons and ensure compliance with securities laws, regulations and FINRA rules. FINRA noted four areas of risk management concern for 2016 related to business conduct and market integrity:

- *Conflicts of Interest*: Conflict of interest management is a historical and overarching concern for regulators. In 2016 FINRA "will complete the targeted examination [it] launched in late 2015 regarding incentive structures and conflicts of interest in connection with firms' retail brokerage business."[3] FINRA encourages firms to review compensation plans with an eye toward mitigating conflicts of interest, specifically regarding the sale of proprietary, affiliated, or revenue-sharing products. Further, FINRA reiterated that "[f]irms may not use research analysts or the promise of offering favorable research to win investment banking business."[4] Ten firms have already been fined for such activity. FINRA also guided firms to proactively consider additional risk management procedures to minimize information leakage, both within a firm and to those outside a firm.

- *Technology*: FINRA will continue to focus on risk management practices firms employ in relation to hardware, software and information technology employees. Technological failures can have damaging effects on a firm, its customers, and the broader market. FINRA recommends that member firms focus on cybersecurity, data quality, and technology risks.[5] In particular, based on deficiencies observed in 2015, FINRA noted that it will examine member firms' technology governance and change management practices related to algorithm maintenance (including order-routing algorithms), back office and vendor system changes, lifecycle development and new system implementation. Based on FINRA's guidance, member firms should consider proactively reviewing their written supervisory procedures and controls in these areas.

- *Outsourcing*: Due to the increased use of outsourcing to reduce costs, FINRA will focus on the supervision of outsourced services. FINRA reminded members that broker-dealers are ultimately responsible for compliance with rules and regulations and must supervise the completion of all outsourced tasks.[6] FINRA also noted that firms must conduct adequate initial and ongoing due diligence on all outsource service providers. Additionally, FINRA suggested that members "avoid outsourcing functions that are required to be performed by qualified registered persons."[7]

- *Anti-money laundering*: FINRA will maintain its focus on "the adequacy of firms' monitoring for suspicious activity, including surveillance of both money movements and trading activity."[8] FINRA noted that systems should be tested and data should be verified, particularly for high-risk accounts. In 2016, FINRA will continue to focus on high-risk activity involving microcap securities. Per FINRA, conducting due diligence on microcap securities is key to ensuring compliance.[9]

Liquidity

FINRA will focus on identifying individual firm failures to manage liquidity. While liquidity risk has always been a focus for FINRA, its 2016 guidance suggests that member firms evaluate their liquidity needs as they relate to market-wide stresses or stresses of the particular industry in which a firm operates. To manage liquidity risk, FINRA recommends that firms develop contingency plans to ensure sufficient liquidity and conduct stress tests to evaluate the effectiveness of such plans. FINRA notes that firms engaging in high-frequency trading should specifically manage risk associated with execution rates and market events.[10]

Other 2016 Focus Areas

FINRA identified a number of additional narrow areas of concern, including, but not limited to:

- *Sales practices*: FINRA previewed their focus on sales practices involving seniors and vulnerable investors, volume discounts or sales charge waivers, 529 college savings plans, private placements, public offerings and the 2015 SEC Regulation A+ amendments, non-traded REITs and direct participation programs, and customer charges in new bond sales;

- *Financial and Operational Controls*: FINRA will focus on financial controls involving: market-maker net capital exemptions, exchange-traded funds, fixed-income brokerage, internal audits, client onboarding, and customer funds transmittal; and

- *Market Integrity*: FINRA noted concerns related to compliance with the Vendor Display Rule (SEC Rule 603(c)), market access and manipulative trading practices (*e.g.*, layering and spoofing), fixed income order handling, compliance with SEC Regulation SHO, cross market manipulation, and audit trail integrity.

The list of FINRA's focus areas is anything but short. FINRA stressed that member firms should strive to create a firm culture of proactive compliance with the applicable regulatory framework and take the opportunity to review risk management priorities and procedures in connection with firm activities. Such a culture will enable a rapid response to issues facing our consistently innovative financial markets. FINRA's 2016 letter provides firms with a useful guide for assessing overall risk management protocols.

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[1] "FINRA 2016 Regulator and Examination Priorities Letter," FINRA (January 5, 2016), at 1, *available at* http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf.
[2] *Id.*
[3] *Id.* at 2.
[4] *Id.*
[5] *Id*. at 3-4.
[6] *Id*. at 4.
[7] *Id.*
[8] *Id.*
[9] *Id*. at 5 ("FINRA reminds firms to review deposits of microcap securities to determine compliance with or exemptions from registration requirements. This includes physical deposits as well as electronic deposits through Deposit/Withdraw at Custodian (DWAC) transfers, Depository Trust & Clearing Corporation (DTCC) transactions, and transfers into Delivery Versus Payment/Receive Versus Payment (DVP/RVP) accounts.").
[10] *Id*.