Client Alert

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A Must Read: FINRA's 2014 Exam Priorities

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FINRA did not wait for any dust (or snow) to settle on the New Year before alerting the brokerage industry and the public about its regulatory and examination priorities for 2014. This year's letter, issued earlier than ever before, mixes many time-honored themes, such as conflicts of interest, complex products, suitability, AML, private placements, and algorithmic and high frequency trading, with significant new topical issues, including qualified plan rollovers, crowdfunding and recidivist brokers. Taken as a whole, the letter is an invaluable resource for broker-dealers, providing what FINRA Chairman and CEO Rick Ketchum describes as "a road map of issues that may be of risk to the investing public."

We summarize below some of the significant issues raised in the letter, along with our recommendations about how to prepare for a risk-based FINRA examination of these issues.

As with many FINRA initiatives, we anticipate that its 2014 examinations will focus as much on the quality of a broker-dealer's supervisory systems and procedures as on any underlying violations or customer harm. Indeed, Executive Vice President for Regulatory Operations, Susan Axelrod, who oversees the exam program, stated, "We encourage firms to use this guidance along with their own analysis to enhance their programs as we will be examining for strong controls and robust compliance efforts in these areas."

BUSINESS CONDUCT PRIORITIES

Suitability – If FINRA had a single over–riding concern over the last several years, it was the suitability of retail sales of complex products. As FINRA points out, these "may be challenging for investors to understand." This problem is magnified, according to the priorities letter, by incentive systems that create conflicts of interest (discussed more below), and by ineffective disclosure practices that do not include balanced discussions of risks and potentially negative scenarios that might result in customer losses. Examinations will focus on those issues as well as the training given to retail brokers to make sure that they understand the products they recommend.

As in previous years, FINRA highlights complex structured products and non–traded REITs as specific types of products that present heightened investor protection concerns. For the first time, however, FINRA lists Frontier Funds, which often invest in foreign or emerging markets and present the geopolitical risks of investing in politically unstable regions of the world. FINRA also groups together under the heading "Interest Rate Sensitive Securities," mortgage–backed securities, long duration bond funds and ETFs, emerging market debt and municipal securities, reasoning that increases in interest rates can cause such securities to lose a substantial portion of their value, sometimes in an amount disproportionate to the interest rate changes.

- **Recommendation** – Given FINRA's voluminous writing on this subject over the last five years (including Regulatory Notices and settled formal disciplinary proceedings), firms have had every opportunity to educate themselves about FINRA's concerns regarding various products and what types of products may be suitable

for sale to which customers. To prepare for a FINRA examination in which product sales and supervisory systems and procedures governing such sales will be reviewed, we recommend that a firm:

- First, conduct a review of the firm's current business, and assess the risks of each area of the business.
- Then, review FINRA's pertinent pronouncements related to each area, and ensure that the firm's procedures line up with FINRA's expectations.

Recidivist Brokers – In the wake of media and political attention to this problem over the past year, FINRA touts its High Risk Broker Initiative, launched in 2013 to identify brokers who have a pattern of complaints. It also reports its creation of an enforcement team to pursue those matters. FINRA states that it will be using its Broker Migration Model to profile brokers who formerly worked at disciplined firms and expects firms to be able to identify those brokers and to demonstrate that they are under heightened supervision, if appropriate.

- **Recommendation** – Ensure that your firm's procedures provide for due diligence of a new broker that goes beyond simply looking at the broker's CRD disclosures, and for heightened supervision of a broker who has a troubling pedigree.

Conflicts of Interest – FINRA will continue to focus on firms' procedures for managing conflicts of interest. This will include not only examining how a firm identifies and manages conflicts, but also confirming that senior management is aware of and involved in the process.

- **Recommendation** –
  - Carefully review the firm's procedures for identifying and mitigating potential conflicts presented by new products, and implement a procedure for post–launch review of performance.
  - Firms that offer wealth management services should test their procedures to ensure that the firm does not favor proprietary products or products where the firm gets a share of revenue.
  - Review compensation structures to ensure that they mitigate conflicts inherent in transaction–based and asset–based compensation schemes.

Cybersecurity – Pointing to recent publicized data breaches in the financial services industry, and the increasing frequency and sophistication of cybersecurity attacks, FINRA plans to focus on the integrity of a firm's policies, procedures and controls to protect sensitive customer information.

- **Recommendation** – Ensure that your firm's procedures and systems for protecting customer information are state of the art. If necessary, use consultants with expertise in cybersecurity issues. Review SEC and FINRA cases to identify where other firms have failed to adequately protect information, and plug the types of "holes" in the firm's data system that caused problems at those other firms.

Qualified Plan Rollovers – Echoing its Regulatory Notice issued earlier in the week (as discussed in this Client Alert), FINRA notes that the decision of employees who retire or change jobs regarding their 401(k) plan is "a moment of

heightened importance and vulnerability." FINRA warns that investors may be misled about the benefits of rolling over assets from a 401(k) plan to an IRA, in particular by claims by brokers about the costs associated with IRAs. FINRA will be examining firms' marketing materials and supervision in this area.

- **Recommendation** – Review the firm's marketing materials and supervisory procedures and practices with a focus on the issues highlighted by MoFo's Client Alert and FINRA's Regulatory Notice.

Initial Public Offerings – FINRA notes the recent increase in the market for IPOs, and directs firms to Rule 5131 (adopted in 2011), which addresses abuses in this market, including *quid pro quo* allocations and "spinning," that is, allocating shares of hot IPOs to officers or directors of companies in exchange for investment banking business. The priorities letter states FINRA's plans to review broker–dealers' due diligence activities, their filings made with FINRA's Corporate Finance Department, and compliance with other relevant rules.

- **Recommendation** – Firms should review FINRA's rules relevant to IPOs as well as FINRA's guidance and FAQs related to those rules, and ensure that its systems and procedures are adequate to address each of these issues.

Anti–Money Laundering – FINRA singles out DVP/RVP (Delivery versus Payment/Receipt versus Payment) customers' use of executing brokers to liquidate large volumes of low–priced securities. These transactions raise red flags and enhance the need for the executing broker to make a reasonable inquiry about the source of the securities to detect potential money laundering or Section 5 registration issues. FINRA also affirmed that customer identification program requirements apply to DVP/RVP customers, and the executing broker is responsible for them, absent a formal undertaking that the prime broker is responsible.

- **Recommendation** – Determine if your firm engages in DVP/RVP business and, if so, review the firm's AML procedures to ensure that they address FINRA's concerns.

Private Placements – FINRA highlights recent amendments to Rule 506 of Regulation D that will, for the first time, permit general solicitation in private offerings provided that all purchasers are accredited investors. These amendments increase the importance of due diligence conducted in connection with private placements, since firms must ensure that all investors meet accredited investor standards. In addition, the letter points out that the Regulation D amendments do not change a firm's responsibility to conduct a reasonable basis suitability review.

FINRA also reminds firms participating in private offerings to individual investors that they are required to file a copy of private placement memoranda and other offering documents with FINRA. FINRA notes that some of the filings to date raise concerns that broker–dealers may not be performing reasonable inquiries into the specifics of a particular private placement.

- **Recommendations** –
    - Ensure that your firm's advertising and marketing procedures have been updated to reflect the ability to engage in general solicitations. The procedures should reflect the firm's overall obligation to ensure that marketing materials – including those related to a general solicitation for a private offering

– are fair and balanced, provide a sound basis to evaluate the securities on offer and are based on principles of fair dealing and good faith.

- Review the Rule 506 adopting release and ensure that your firm's due diligence procedures are adequate to make the determination that investors in private placements are "accredited investors."
- Review Regulatory Notice 10–22 and ensure that your firm's procedures adequately reflect the responsibility to conduct a reasonable basis suitability review about private placements.

Municipal Advisers – Final rules regarding municipal advisers become effective on January 13, 2014, and FINRA anticipates that municipal advisory activity will be an area of focus in 2014 sales practice examinations.

- **Recommendation –** Firms should ensure that their written supervisory procedures and their compliance procedures are appropriately updated to reflect the new rules.

Crowdfunding Portals – FINRA and the SEC proposed new rules in October 2013 related to the implementation of crowdfunding as required by the JOBS Act. If enacted in their current form, crowdfunding will occur through an intermediary that is either a registered broker–dealer or a "funding portal" registered with FINRA. FINRA's proposed crowdfunding rules, among other things, streamline the registration process for a funding portal in light of the relatively limited scope of permitted activities in which it can engage.

- **Recommendations** – It is anticipated that many funding portals will launch soon after the rules become final. Firms planning to launch a funding portal should consult with experienced regulatory counsel to ensure that they have designed and implemented compliance and supervisory procedures that adequately protect investors in the context of the capital raising objectives of the JOBS Act. In view of the attention given to the crowdfunding proposals over the last year, there is no question that FINRA will closely review activities in this area by member firms.

Senior Investors – FINRA continues to be concerned about how firms engage with investors approaching retirement and those experiencing diminished mental capacity. FINRA intends to continue its 2013 assessment of firms' written supervisory procedures to determine whether firms have in place adequate controls to identify potential financial abuse of senior investors. FINRA may issue a report of firms' practices upon completion of the review.

- **Recommendations –** FINRA identifies several practices that firms may want to consider implementing, including:
  - Requiring registered representatives to ascertain a client's retirement status, prospects for future employment and healthcare needs; and
  - Product–specific guidelines designed to determine suitability of a particular investment for a client.

FRAUD PRIORITIES

Microcap Fraud – FINRA presents concrete recommendations (discussed immediately below) for addressing this perennial concern, and links the issue to a firm's AML responsibilities to monitor for suspicious activity and the suitability and disclosure obligations of a broker selling low–priced securities.

- **Recommendation** – Review and implement FINRA's recommendations:
    - Review the firm's policies and procedures related to microcap and low–priced OTC securities.
    - Perform heightened supervision of employees who have outside business activities associated with microcap securities, traders who trade such securities, and firm activities where a firm affiliate is the transfer agent for such securities.
    - Ensure that the firm's research for microcap and low–priced OTC securities is accurate and balanced.
    - Monitor the accounts of customers liquidating microcap and low–priced OTC securities to ensure that the firm is not participating in an unregistered distribution.

Insider Trading – Referring to the increased level of law enforcement activity in this area, FINRA reminds firms to be vigilant in safeguarding material non–public information, and to periodically ensure that its information barriers are adequate.

- **Recommendation** – Firms should assess their risk controls along the lines discussed by FINRA:
    - Review emails of business units – such as investment banking and research departments — that possess material non–public information;
    - Maintain information–barrier policies and procedures, limiting the flow of material non–public information on a "need–to–know" basis; and
    - Monitor employee trading activity to look for suspicious activity and look for trading in securities on the firm's watch or restricted lists.

FINANCIAL AND OPERATIONAL PRIORITIES

Funding and Liquidity Risk – Over the last several years, FINRA has consistently reviewed funding and liquidity risk in individual firm evaluations. Beginning in 2014, FINRA intends to conduct a more structured review and to compare strengths and weaknesses in this area across the industry. FINRA also intends to ask large firms to conduct liquidity stress tests.

- **Recommendations** – Large firms should take the initiative to consider the four areas identified in the priorities letter and implement their own stress testing before FINRA asks them to do so.

Risk Control Documentation and Assessment – Subsequent to recent amendments to Rule 17a–3, large broker–dealers are required to document controls designed to mitigate credit, market and liquidity risks. FINRA said it will be testing whether firms have documented procedures in place to address these rule changes.

- **Recommendation –** Review the release adopting changes to Rule 17a–3 and ensure that your firm's risk controls have been updated appropriately.

Accuracy of Financial Statements and Net Capital – FINRA took the opportunity to remind firms that they must comply with their net capital obligations at all times and they must be in a position to prepare accurate financial

statements throughout the year.

- **Recommendation –** Ensure that your firm has the requisite expertise on staff – or at your service provider – to ensure that financial statements are prepared according to GAAP and that net capital is maintained appropriately given your specific business model. The Notice includes a summary of several areas where FINRA continues to have concerns, which should be reviewed carefully.

MARKET REGULATION PRIORITIES

Algorithmic Trading and Trading Systems, and High Frequency Trading Abuses – FINRA referred to algorithmic trading system malfunctions in recent years that caused substantial market disruptions, and stated that it will continue to assess – possibly through targeted investigations – whether firms' testing and controls related to high–frequency trading and other algorithmic trading strategies are adequate.

FINRA reminds firms to be vigilant when testing high frequency trading strategies to ensure that they will not be used for manipulation or other abusive trading strategies. The priorities letter lists various problematic strategies to which FINRA will be particularly alert.

- **Recommendation** – Firms should test their algorithms and trading systems – ideally, before implementation – and actively monitor those algorithms and systems and any changes made to them. For FINRA examinations, firms should be prepared to address those tests, and document the results. Importantly, firms should show their procedures for responding to "catastrophic system malfunctions."

Audit Trail Integrity – FINRA reports "significant, prolonged and wide–scale" deficiencies in some firms' Large Options Positions Reporting (LOPR), as well as in marking the capacity of their options orders. FINRA promises to pursue cases involving these deficiencies.

- **Recommendation** – Firms should review their systems to ensure that they are filing accurate and complete LOPR reports and using accurate capacity codes.

Best Execution – FINRA reports the use of new "surveillance patterns" to monitor best execution in equities and fixed income securities. FINRA also will review situations where a customer is disadvantaged when a firm places an options trade on a market that does not provide the most favorable available price.

- **Recommendation** – Firms should regularly review their execution practices to ensure that they are designed to ensure that customers receive the most favorable prices.

CONCLUSION

A firm's best protection against adverse examination findings or enforcement action is to proactively review and strengthen its compliance and supervisory program in light of FINRA's stated priorities. Although it doesn't preclude an individual broker from engaging in troubling or problematic behavior, a strong and well–documented risk–based compliance program will provide firms with a good story to tell FINRA if it uncovers that behavior in an exam.

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