

# Client Alert

Business Litigation & Special Matters and Government Investigations Practice Groups

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## 2017 Financial Industry Regulatory Priorities *OCIE and FINRA Announce Examination Areas of Focus*

In early January, both the SEC's Office of Compliance Inspections and Examinations ("OCIE") and FINRA announced their examination priorities for 2017. As in previous years, both the SEC and FINRA share many examination priorities, a number of which are aimed at protecting retail investors, focusing on risks specific to senior investors, and managing market-wide risks. Although many of the identified priorities are carryovers from prior years, there also are some notable new themes and takeaways. During the past year, OCIE has announced that it will be shifting examination resources toward registered investment advisers and away from broker-dealers. As a result, OCIE's 2017 priorities include greater focus on its oversight of FINRA, which now has greater responsibility for conducting exams of registered broker-dealers. Both OCIE and FINRA emphasized their expanded capabilities to analyze data and the role that data analysis plays in their exam programs. Notably, in 2017 FINRA will initiate off-site, electronic reviews of a select group of firms not currently scheduled for a cycle examination in 2017. FINRA also announced that, starting this year, it will publish a summary report outlining key exam findings to alert firms to key regulatory issues and trends.

Both priority letters provide firms with a helpful guide as to what compliance programs and business operations should be evaluated in the coming year. As with most things, an ounce of prevention is worth a pound of cure, so these letters also provide a roadmap to areas that could be ripe for proactive assessment and remediation to prevent more costly exposure to enforcement actions down the road.

### Shared Priorities

In the coming year, both OCIE and FINRA share concerns about (1) high-risk and recidivist brokers, (2) senior investors, (3) operational risks such as cybersecurity and anti-money laundering, and (4) market integrity.

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## *Monitoring High-risk and Recidivist Brokers*

In 2017, OCIE will continue to use data analytics to identify and examine high risk and recidivist brokers and the investment advisers that employ them.<sup>1</sup>

Likewise, FINRA promises to “devote particular attention to firms’ hiring and monitoring of high-risk and recidivist brokers, including whether firms establish appropriate supervisory and compliance controls for such persons.”<sup>2</sup> FINRA intends to accomplish this goal by: (1) mobilizing a recently established examination unit that identifies and examines possible high risk brokers; (2) reviewing firms’ supervisory procedures for hiring or retaining recidivist brokers; and (3) evaluating firms’ branch office inspection programs and supervisory systems.

## *Senior Investors*

Both OCIE and FINRA noted particular concerns about senior investors and programs that affect them, and identified this area as an examination focus in 2017. OCIE noted that, “Americans are more reliant on returns from their investment portfolios to fund their retirement compared to previous generations”<sup>3</sup> and, therefore, it is devoting increased attention to these issues.

As part of its ReTIRE initiative, OCIE will conduct examinations of investment advisers that are likely to focus on the recommendations to investors, management and sales of variable insurance products and target date funds. OCIE also intends to assess controls surrounding fixed income securities.<sup>4</sup> Further OCIE promised to examine investment advisers to state pension plans, municipalities, and other government entities that hold a large amount of investors’ retirement assets. Examinations will include assessments of how those advisers manage conflicts of interest, gift and entertainment practices, and their fiduciary duties.<sup>5</sup>

Similarly, as part of its broader focus on sales practices, FINRA promises to assess firms’ controls to protect senior investors from fraud and improper advice. FINRA is particularly concerned about registered representatives offering senior investors (1) speculative or complex products that promise high yields and (2) microcap securities that are susceptible to fraud schemes.<sup>6</sup>

In response to these examination priorities, firms should assess their supervisory controls regarding communication with senior investors and products marketed to senior investors.

## *Operational Risks*

OCIE and FINRA shared similar concerns about specific operational risks, including firms’ cybersecurity and anti-money laundering programs.

- *Cybersecurity*: Cybersecurity remains a significant risk for firms and both regulators will continue to examine firms’ cybersecurity risk mitigation programs.<sup>7</sup> FINRA noted two common cybersecurity weaknesses it has witnessed: (1) cybersecurity at branch and independent contractor offices and (2) failures to preserve certain records in accordance with Securities Exchange Act (“SEA”) Rule 17a-4.
- *Anti-Money Laundering (“AML”)*: As in previous years, OCIE continues to note money laundering and terrorist financing as high-risk areas and examination priorities. OCIE will examine broker-dealers with an eye toward whether firms have tailored their AML programs to their firm-specific risks, including compliance with Suspicious Activity Report requirements.<sup>8</sup> Correspondingly, in response to shortcomings FINRA has observed in automated AML surveillance systems, FINRA will focus on surveillance gaps

caused by data integrity problems, and surveillance parameters that are insufficient to capture potentially problematic conduct. Notably, while FINRA confirmed that firms may use the same trading surveillance for both AML and other supervisory purposes, it indicated that “surveillance must also include alerts tailored to the firm’s anti-money laundering red flags.”<sup>9</sup>

## ***Market Integrity***

As in previous years, both regulators shared concerns regarding market integrity on the whole. In order to assess market-wide risks in 2017, OCIE intends to focus examinations on money market funds, clearing agencies, Regulation Systems Compliance and Integrity (“Reg SCI”), and national securities exchanges. Specifically, the SEC adopted amendments to rules governing money market funds to address redemption risks that became effective in October 2016. Examinations will likely assess board oversight and compliance with these new amendments. Further, OCIE will continue to conduct annual examinations of clearing agencies and risk-based inspections of national securities exchanges. Importantly, because FINRA now will play a larger role in examining broker-dealers, OCIE intends to “enhance [its] oversight of FINRA, consistent with our aim to protect investors and the integrity of our markets” and will focus additional SEC resources to assess the quality of FINRA’s broker-dealer examinations.<sup>10</sup>

Both regulators stated that they will examine firms’ payment for order flow operations and controls. OCIE intends to examine select broker-dealers, specifically those that primarily serve retail customers, to assess compliance with best execution duties.<sup>11</sup> FINRA also reminded firms of the best execution obligations owed to customers with respect to the receipt, handling, and execution of client orders.<sup>12</sup> FINRA specifically urged firms to assess how technological advances in trading technology affect firms’ execution quality.

FINRA highlighted a number of market integrity concerns and programs including, but not limited to, market manipulation, best execution obligations, and a pilot trading examination program. FINRA emphasized that “[d]etecting and deterring manipulation remains a critical priority for FINRA, and it should be a priority for firms too.”<sup>13</sup> FINRA’s market manipulation concerns chiefly center on layering, spoofing, and trading practices surrounding the open or close (*e.g.*, aggressive trading on one side of the market to benefit a position on the other side of the market, at the open or close of a trading day). Again highlighting its capacity for independent data review, FINRA enhanced its layering and spoofing surveillance pattern to “look for even larger groups of market participants potentially engaging in manipulation,” amended its Order Audit Trail Systems (“OATS”) to capture more trading data from alternative trading systems (“ATS”), and, in 2017, intends to expand surveillance for cross-product manipulation.<sup>14</sup>

In order to further ensure market integrity, both OCIE and FINRA will assess whether examination programs should be broadened to include smaller firms and advisers. OCIE is expanding its “Never-Before Examined Adviser initiative to include focused, risk-based examinations of newly registered advisers” and advisers that have never been previously examined.<sup>15</sup> FINRA announced a pilot trading examination program that “will help [it] determine the value of conducting targeted examinations of smaller firms that have historically not been subject to trading examinations due to their relatively low trading volume.”<sup>16</sup>

## **OCIE-Specific Focus Areas**

Though OCIE and FINRA share many exam priorities for the coming year, due to the SEC’s broader jurisdiction, there are some areas of divergence and specific concerns which firms should be aware of.

## *SEC's Focus on Investment Advisers Serving Retail Investors*

In light of the widening array of financial products offered and the increasing complexity of the financial services industry, OCIE will engage in a number of examination initiatives aimed at registered investment advisers that will attempt to assess and mitigate potential risks for retail investors.

- *Electronic Investment Advice:* As investors are more able to obtain investment advice through automated digital platforms, such as “robo-advisors”, OCIE examinations will focus on “compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest.”<sup>17</sup>
- *Wrap Fee Programs:* OCIE will continue to examine investment advisers and broker-dealers that charge investors a bundled fee for advisory and brokerage services, with a specific focus on adherence to fiduciary duties and contractual obligations.
- *Exchange Traded Funds (“ETFs”):* OCIE will continue to review ETFs’ compliance with exemptive relief and unit creation and redemption processes, with a focus on sales practices and disclosures.
- *Multi-Branch Advisers:* OCIE believes that a branch office model may pose risks to investors, particularly with respect to implementation of a compliance and oversight program. As such, it will “continue to focus on registered investment advisers that provide advisory services from multiple locations.”<sup>18</sup>
- *Share Class Selection:* As in previous years, OCIE will focus examinations on conflicts of interest that may arise regarding investment recommendations in particular share classes of mutual funds.

## *Other Initiatives*

OCIE highlighted three additional exam priorities. First, it will continue to examine municipal advisers’ compliance with applicable regulations, including industry outreach and education initiatives. Second, it will “examine transfer agents that service microcap issuers, focusing on detecting issuers that may be engaging in unregistered, non-exempt offerings of securities.”<sup>19</sup> Third, it will continue to examine private fund advisers with a focus on conflicts of interest.

## **FINRA-Specific Focus Areas**

FINRA identified a wide area of focus areas that touch many (if not most) aspects of a broker-dealer’s business. FINRA urged compliance staff and senior business leaders to consider the various issues raised and suggested that firms engage in critical assessment of key compliance and internal control programs that manage registered representative oversight, sales practices, liquidity risk, and key operational risks.

FINRA’s examination priorities in 2017 are substantively similar to those in 2016, though in 2016 FINRA appeared to devote more focus to assessing firm culture, with a specific interest in how firm culture affected the way firms managed conflicts of interest and ethical issues.<sup>20</sup> Further, examinations of how firms manage conflicts of interest—including investigation of incentive structures, the use of research analysts in investment banking activity, and information leakage—was also a focus for FINRA in 2016 that was not highlighted in its 2017 priorities.<sup>21</sup> FINRA highlighted 2017 examination priorities surrounding firms’ sales practices, financial risk, and operational risk.

## *Sales Practices*

For 2017 FINRA noted four additional areas of concern related to sales practices:

- *Product Suitability and Concentration:* Similar to protection of senior investors, FINRA will “assess how firms conduct reasonable-basis and customer-specific suitability reviews.”<sup>22</sup> Assessments may include an examination of firms’ vetting processes for products and supervisory controls. FINRA suggests that firms focus on supervision and training when new products are introduced. Further, FINRA will increase its focus on the controls that firms use to monitor excess concentrations in customers’ accounts.
- *Short-term Trading of Long-term Products:* FINRA has observed instances where registered representatives recommend clients trade long-term products (e.g., mutual funds) on a short-term basis. FINRA is concerned with this practice because clients may experience diminished investment returns due to increased costs associated with these transactions. Similarly, FINRA has observed situations where registered representatives switch clients across products in an attempt to evade surveillance. As a result, “FINRA urges firms to evaluate whether their supervisory systems can detect activity intended to evade automated surveillance for excessive switching activity.”<sup>23</sup>
- *Outside Business Activities:* FINRA will continue to evaluate firms’ procedures for reviewing registered representatives’ written notifications of proposed outside business activities in light of the conflicts that may arise.
- *Social Media and Electronic Communications Retention:* FINRA said it will review firms’ compliance with record-retention obligations, particularly with respect to social media and other emerging electronic communication platforms, and noted that “firms must ensure the capture of business-related communications regardless of the devices or networks used.”<sup>24</sup>

## *Financial Risks*

In 2016, FINRA specifically identified liquidity risk management practices as an area of focus. This focus allowed FINRA to identify firms that were not adequately managing risk by maintaining liquidity risk management plans, conducting stress tests with sufficiently rigorous assumptions, and maintaining sufficient sources of funding. In light of FINRA’s 2016 findings, it will review firms’ funding and liquidity plans and assess whether firms adequately evaluate their liquidity needs given market-wide stresses and stresses specific to certain products. FINRA suggests that firms develop or revisit liquidity plans and conduct stress tests in order to manage liquidity risk and “urge[d] firms to consider the effective practices discussed in [Regulatory Notice 15-33](#)” when evaluating liquidity management plans.<sup>25</sup>

Further, FINRA intends to continue its discussions with firms to assess the most efficient ways firms are managing financial risk. In 2017, FINRA will ask certain firms to explain how they would react to a specific stress scenario that affects a firm’s market, credit, and liquidity risk and then will assess those firms’ financial risk management processes including: readiness; communication plans; triggers; and contingencies.

Of note, on December 15, 2016 the first phase of new amendments to [FINRA Rule 4210](#), requiring firms to establish margin requirements for certain agency transactions, became effective. To ensure compliance, FINRA believes that firms should tailor their risk policies and limits accordingly. In 2017 FINRA will be reviewing how firms’ ensure compliance with the new rule requirements.

## *Operational Risks*

FINRA identified a number of operational risks that have long been a focus, including but not limited to:

- *Supervisory Controls Testing:* FINRA reiterated that it will be testing firms' internal supervisory controls. "Regular testing is critical to enabling firms to identify and mitigate gaps or inadequate controls (e.g., poorly set parameters in automated compliance systems) that, left undetected, may lead to significant, systemic control breakdowns."<sup>26</sup> Highlighting the concern, FINRA noted that it observed situations where inaccurate data has prevented automated alerts from identifying client activity for further compliance review.
- *Segregation of Client Assets:* In 2017 FINRA promised to evaluate firms' compliance with SEA Rule 15c3-3. This will include assessments of whether firms "properly include customer securities positions and money balances on multiple platforms in the reserve formula and in the possession or control calculations" among other assessments.<sup>27</sup> FINRA will test and review whether (1) Special Reserve Account agreements contain appropriate no-lien language, (2) whether money movements in these accounts are timely, and (3) whether a firm's possession and control processes are sufficient. FINRA also expressed concern that some firms may be engaging in transactions primarily designed to reduce their segregation requirements. FINRA will review suspect transactions as well as the mechanisms that firms use to disapprove such transactions.
- *Regulation SHO:* FINRA will focus on compliance with Regulation SHO's locate requirement in connection with a firm's acceptance of short sale orders. In particular, while noting that it has observed fails-to-deliver securities by settlement date where locates were granted without a reasonable grounds to believe the security could be borrowed, FINRA will review the process used to prepare "easy-to-borrow" lists and automated locate models.<sup>28</sup>

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The annual examination priority letters from OCIE and FINRA provide firms with a useful guide for assessing overall risk management protocols. Firms should evaluate and adjust their compliance activities and risk management procedures as a proactive step in tackling the priorities that OCIE and FINRA announced.

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*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."*

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<sup>1</sup> See Examination Priorities for 2017, SEC OCIE (January 12, 2017), at 2 ("SEC OCIE Letter"), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf>; see also OCIE Risk Alert, "Examinations of Supervision Practices at Registered Investment Advisers," SEC OCIE (Sept. 12, 2016), available at <https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf>

<sup>2</sup> FINRA 2017 Regulatory and Examination Priorities Letter," FINRA (January 4, 2017), at 2 ("FINRA Letter"), available at <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>

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<sup>3</sup> SEC OCIE Letter at 3.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> FINRA Letter at 3.

<sup>7</sup> *Id.* at 4.

<sup>8</sup> *Id.* at 5.

<sup>9</sup> FINRA Letter at 8.

<sup>10</sup> SEC OCIE Letter at 4.

<sup>11</sup> *Id.*

<sup>12</sup> See Regulatory Notice 15-46.

<sup>13</sup> FINRA Letter at 9.

<sup>14</sup> *Id.*

<sup>15</sup> SEC OCIE Letter at 2; *see also* OCIE's Letter to Never-Before Examined Investment Advisers, SEC OCIE (February 20, 2014) available at <http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf>

<sup>16</sup> FINRA Letter at 10.

<sup>17</sup> SEC OCIE Letter at 2.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 5.

<sup>20</sup> See FINRA's 2016 Regulatory and Examination Priorities Letter (January 5, 2016) at 1-2, available at <http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf>

<sup>21</sup> *Id.* at 2-3.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 4.

<sup>24</sup> *Id.* at 5.

<sup>25</sup> *Id.* at 6. Reg. Notice 15-33 provides firms with guidance regarding liquidity risk management, which FINRA suggests must include rigorous stress testing and critical assessment of liquidity funding sources.

<sup>26</sup> *Id.* at 7. See also FINRA Rules [3120](#) and [3130](#).

<sup>27</sup> *Id.* SEA Rule 15c3-3, more commonly known as the "customer protection rule," prescribes the minimum amounts of funds that must be protected in segregated accounts for broker-dealers who handle customer funds.

<sup>28</sup> *Id.* at 8.