WILLIAM A. DESPO

DESPO LAW GROUP

Suite One
36 Bingham Avenue
Rumson, New Jersey 07760

Alerts

FINRA Issues Regulatory and Examination Priorities for 2015

Related Attorneys
William Despo

01/15/2015

On January 6, 2015, FINRA set forth its regulatory and examination priorities (the "Priorities Letter") for 2015, providing insight into FINRA's concerns about the operation of the securities industry and markets.[1] The Priorities Letter presents an agenda of important regulatory matters that FINRA believes need to be addressed by the securities industry. Of utmost importance is the industry's relationship with the customer.

The Priorities Letter introduction is most telling in that it is vastly different from years past. In 2015, it identifies five recurring challenges facing FINRA and the industry. The challenges are:

- Placing the "best interests" of clients first, although there is no industry rule;
- Creating a culture within firms that values ethics and compliance;
- Developing and maintaining robust supervision and risk management systems and internal controls that act as critical safeguards to protect clients and encourage ethical conduct;
- Improving product development, sales training, and supervision. FINRA expects firms to establish reasonable basis and customer-specific suitability standards prior to offering a new product. Wealth Management divisions must act independently in order to safeguard their determination about the suitability of the product; and
- Developing and implementing programs to address enterprise conflicts of interest, which is a combination of ethics, cultural and organizational structure, policies, processes and incentives that in totality shape the firm's management of conflicts.[2]

Along with a focus on the customer relationship, sales practices, financial and operational activities, and market integrity remain FINRA's focal points for 2015.[3] In the sales practice area, FINRA highlighted eight new product types of concern, while restating two previous products. FINRA's concern with all products deals with the complexity of product features and sales practices. Appropriate product risk reviews need to concentrate on due diligence, suitability, disclosure, and supervision and training of sales personnel. Furthermore, changing circumstances, such as economic events, require firms to reevaluate products.

Sales Practices

Variable annuities have attracted FINRA's attention in regard to IRC Section 1035 exchanges and new purchases. FINRA intends to examine firms' compensation structures to determine if they may incentivize variable annuity sales and suitability recommendations, product feature disclosures, and training and testing of broker's and supervisor's product knowledge. It is suggested that a firm's product committee analysis, training programs and testing of brokers' knowledge will be paramount for satisfying a FINRA inquiry.[4]

The explosion in the marketplace of exchange traded products ("ETPs") has attracted FINRA's attention as well. Products that track indices such as equally weighted, fundamentally weighted and volatility weighed indices are viewed as complex products for the individual investor. Risks associated with ETPs remain questionable to FINRA, even when the ETP has been back tested.

Structured Retail Products ("SRPs") are complex products that may fall within a derivative classification. FINRA will focus its examinations on broker understanding of SRPs and investor knowledge. Retail communications related to the sale of SRP must be filed with FINRA within 10 days of first use.

Floating Rate Bank Loan Funds ("Funds") are typically marketed to institutional investors. However, FINRA has observed that retail investors have increased their exposure to these Funds. Although the Funds are said to be a hedge to interest rate fluctuations, these Funds carry significant credit and call risk. FINRA viewed these Funds as difficult to value, have longer terms than other investments, and to be relatively illiquid. The suitability of Funds will be a key focus of FINRA, along with determining the potential for a conflict of interest between the firm and the retail investor.

Securities-backed lines of credits ("SBLOC") are another product that concerns FINRA. SBLOCs are revolving loans that allow a customer to borrow from a lending institution using securities in their brokerage account as collateral. FINRA stressed that firms need to have proper controls in place regarding SBLOCs. Customers need to understand SBLOC program features and how market conditions may affect their brokerage account.

Noted in the 2014 Priority Letter, interest rate sensitive fixed income securities make a repeat appearance in 2015. The risks identified for this product last year remain applicable in 2015. Some of the risks include lack of liquidity, high fees and valuation difficulty. Valuation of these products remains a notable concern to FINRA.[5] As with other products identified in the Priority Letter, firms need to be vigilant and conduct on-going due diligence of these products. FINRA reminded firms that suggesting to a retiree that his/her only choice is to roll over retirement plan assets to a firm-sponsored IRA is false and misleading.

FINRA will examine a firm's procedures and controls for preventing excessive trading and product concentration issues.

Due diligence and suitability analysis concerning private placements is another supervisory area discussed by FINRA in the Priority Letter. Some issues associated with contingent offerings and escrow provisions relating to private offerings noted by FINRA include[6] amending offering terms without a proper rescission offer being made to investors, and failure by a firm to establish escrow procedures.

Supervision

FINRA's new supervision rules (3110, 3120, 3150 and 3170) became effective on December 1, 2014. The new rules modified requirements pertaining to the supervision of offices of supervisory jurisdiction, inspections of non-branch offices, conflicts of interests, performing risk-based reviews of correspondence and investment banking activities, monitoring of inside trading, conducting internal investigations, reporting of selected information to FINRA, and testing and verifying supervisory control procedures.

Instances of customers not receiving volume discounts (breakpoints) and sales charge waivers to which they were entitled when purchasing products like REITS, Unit Investment Trusts, and mutual funds were observed by FINRA. As such, it is imperative that firms focus on their internal controls regarding the handling of wealth events such as IRA rollovers in order to assure their customers receive sales charge discounts and waivers when appropriate.

In 2014, increases in microcap activity and foreign currency conversions in delivery versus payment/receipt versus payment (DVP/RVP) accounts occurred. Some firms were not monitoring activity in these accounts due to improper procedures and controls, and may have failed to report suspicious activity pursuant to the Anti-Money Laundering rule. For purposes of compliance with the Anti-Money Laundering rules, FINRA will examine cash management accounts and DVP/RVP accounts.

Financial and Operational Priorities

Valuation of securities remains a priority for FINRA. A firm's program for monitoring its funding and liquidity risks will be examined by FINRA. Mark-to-market processes and supervisory controls, especially with non-high grade, illiquid assets, are key areas of concern to FINRA.

A firm's cybersecurity system is of critical importance to risk management as a cybersecurity issue could ultimately impact the accuracy of a firm's books and records. Accordingly, FINRA will review a firm's approach to compliance with SEC Rule 17a-4(f) in the event of cyber attack. This rule, in part, permits a firm to store its records electronically, in a non-rewriteable, non-erasable format.

Market Integrity

One of FINRA's goals is to maintain fair and orderly markets. In this regard, a broker-dealer must have supervisory controls and proper governance. A firm's trading technology is critical in the satisfaction of its obligation to supervise trading activities. Algorithms used in trading continue to raise FINRA's interest. Trading activities implicate the firm's risk management and financial operational control, and may adversely affect a firm's net capital. Moreover, abusive algorithms pose a significant risk to market integrity. Cross-market and cross-product manipulation continue to be an issue for FINRA. It intends to enhance both its equities and options cross-market surveillance activities.

Firms should also examine their best execution procedures in routing customer option orders. An active best execution committee is a necessity in order for a firm to meet its regulatory obligation.

Summary

FINRA's Priority Letter lays out FINRA's view of issues challenging the securities industry. However, one issue impacts all of their concerns - firm ethics. Putting the interest of the client over that of the broker is a key priority for FINRA, which appears to be moving ahead of the SEC in addressing a fiduciary standard for brokers. Brokers need to examine, and continue to reexamine, their conflict of interest policies and procedures. In part, the firm's culture for ethical practices and compliance must originate from its highest levels in order to filter down within the organization. Sales practices, supervision and market integrity will all benefit positively.

---

[1] See, http://www.finra.org

[2] See FINRA press release, *FINRA Fines 10 Fines a Total of $43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection with Toys "R" Us IPO* Dec. 11, 2014.

[3] But FINRA raised an unrelated problem that it is experiencing where firms fail to respond in a timely matter to information request in connection with examinations and investigations.

[4] The sale of "L" share annuities is of particular concern to FINRA.

[5] See FINRA Notice to Members 15-02

[6] Pursuant to FINRA Rules 5122 or 5123 firms are to file offering documents with FINRA.

E-MAIL: Bill@WDespoLaw.com
Cell: 732-977-4659

Direct: 732-945-5178
Fax: 732-945-4000