

FINRA 2013 Examination Priorities for Broker-Dealers

04.04.13 01.07.26

Garvey Schubert Barer Legal Update, April 4, 2013.

FINRA has announced a list of priorities for its 2013 field examinations of member firms. The published release (the "Release") describes areas in which FINRA staff personnel will concentrate their efforts as they proceed with this year's cycle examination program. Not surprisingly, many of the concerns appear to be prompted by the current environment of low-interest rates and slow economic recovery which, in FINRA's view, may make brokerage firm clients - particularly retail customers - more prone to abuses associated with higher-risk or inadequately understood investment products.

Business Conduct and Sales Practice Concerns – Complex Products

The Release reminds member firms of their expanded obligations under FINRA's updated suitability rule (Rule 2111). Particularly where high-yield and complex products are involved, examiners will be looking at whether the firm and its registered representatives fully understand, and are conveying to their customers, important information on market, credit and liquidity risks relating to customer needs. Examples cited in the Release for these types of products include:

Business Development Companies (BDCs), which are generally closed-end investment companies holding corporate debt and equity of private companies and offering attractive yields generated through high credit risk exposure and leverage.

Leveraged Loan Products, consisting of investments in financial companies or funds holding debt of low-credit quality issuers, which may not trade on any organized market, may be difficult to value, and may have liquidity and other risks not clearly disclosed to investors.

Commercial Mortgage-Backed Securities (MBS or CMOs). The Release notes that "FINRA has heightened concerns about the sale and marketing of commercial mortgage-backed securities to retail investors", particularly about whether firms are clearly disclosing "the considerable risks" represented by CMOs in "today's low-interest-rate, low-yield environment".

High-Yield Bond Funds, which have now attracted a large inflow of investor cash resulting in increased prices, an upsurge in high-yield underwriting, compression of risk premiums, and greater market and credit risk exposure to customers.

Structured Products, often marketed to retail customers and promising attractive initial yields and some principal protection, and which are almost always complex, generally lack a secondary market, and usually have characteristics and risk-adjusted rates of return that are difficult to estimate.

ETF Products, or exchange-traded funds and notes, have proliferated, raising concerns that retail investors are not being given sufficient guidance on the differences among types of index products, the risks associated with these investments, and the importance of information on valuation and performance track records.

Closed-End Funds, which often offer high distribution rates attractive to retail customers, but which may include, in such distributions, returns of capital not sufficiently understood by retail investors.

Specialized Municipal Securities. The Release points out that, unlike municipal securities rated as general obligation bonds, specialized forms of governmental or quasi-governmental debt instruments are not backed by general tax revenues and usually depend on the specific profit-making or non-profit activity conducted by a separate entity. Since these can have higher default rates and greater other risks, examiners will be checking to see if appropriate customer disclosures are being made.

Variable Annuities, which can offer predictable income streams, tax deferrals and flexible investment choices, also involve long holding periods, significant surrender charges, and high fees, making them less suitable for investors with near-term liquidity needs. In addition, changes in insurance company issuers may create incentives for brokers to persuade clients to switch products, resulting in additional fees.

When encountering significant levels of complex products in customer accounts, examiners will review information on suitability, on the extent of product-specific knowledge and on due diligence performed by the firm.

Other Business Conduct Concerns

Cyber-Security and Data Integrity. Especially given recent publicity on cyber-security breaches in the financial services industry, the Release signals that FINRA will undertake increased scrutiny of procedures and mechanisms intended to protect customer and other sensitive information.

Microcap Fraud. The SEC has become increasingly active in combating pump-and-dump and other schemes for the distribution of speculative microcap OTC securities which are generally promoted through spam emails and telemarketing campaigns, and, in a number of well-publicized cases, has worked with federal law enforcement authorities to prosecute offenders. The Release urges firms to review their policies and procedures and to emphasize such protections as: (i) heightened supervision of employees involved in trading microcap securities or who have business activities associated with microcap companies; (ii) ensuring that microcap recommendations are balanced and suitable for the relevant customers and that any firm research is accurate and contains appropriate risk disclosures; (iii) monitoring of customer accounts liquidating microcap securities to ensure the firm is not unwittingly facilitating an

unregistered distribution; and (iv) monitoring solicitations to trade microcap securities. Firms need also to be aware of AML implications, especially where repeat fund transfers related to microcap transactions are taking place with overseas accounts.

Private Placements. The Release reminds member firms of Rule 5123 requirements (effective December 3, 2012) to file copies of offering documents used in selling private placements, subject to applicable exemptions. FINRA is signaling its concern over the sale and marketing of private placements, particularly where firms do not have access to independent financial information on the issuing company and do not undertake reasonable due diligence on the issuer. FINRA states that its examiners "will focus on due diligence policies and procedures, valuation processes, placing special emphasis on the integrity and independence of third-party valuation services, and the timely disclosure of material risks".

Anti-Money Laundering. The Release notes a well-publicized case against HSBC involving serious AML violations through the bank's foreign affiliates. FINRA cites a specific new evasive tactic in which foreign financial institutions purchase U.S. denominated foreign bonds with local currency, move the bonds to the U.S. for sale, and then transfer proceeds offshore to unknown recipients. Look for more guidance in FINRA AML releases as the sophistication of AML-avoidance schemes changes.

Automated Investment Advice. Recognizing increased use of software programs to analyze customer data and to dispense automated investment advice to retail clients, the Release serves notice that examiners will seek to confirm whether such programs are being regularly assessed, updated and tested to adequately serve investor needs.

Branch Office Supervision. FINRA will continue to look for a "robust supervisory structure" in checking on firms' oversight of their branch offices, and will insist on branch inspection programs that are related to the scope of branch office activity, especially in branches in which resident brokers have disciplinary histories.

Financial and Operational Concerns

In the context of today's economic uncertainties, FINRA has reiterated its concerns over adequate maintenance and reporting of net capital, and is reminding firms of the following:

Guarantees and Contingencies. In accordance with GAAP, a firm is required to calculate and record amounts for which it may be liable because of guarantees of third-party financial obligations. In addition, examiners will be looking for appropriate accounting treatment for adverse awards entered in arbitrations or other litigation, material penalties incurred in an SRO or other regulatory proceeding affecting net capital, and any pledge of allowable assets as collateral to secure third-party obligations.

Margin Lending Practices. Examiners will be looking at the valuations placed on marketable securities used to collateralize margin receivables. When those securities consist of thinly traded equities or less liquid municipals or CDOs, the carrying value of the collateral may be far from its liquidation value if the customer fails to meet a margin call, in which case the accounting treatment for the margin indebtedness and the

firm's net capital will need to be adjusted.

Balance Sheet Liquidity. For firms which have complex balance sheets, carry assets with uncertain valuations (such as reverse repurchase agreements) or rely on parent funding for liquidity, examiners may be looking at the possible need to extend liability maturity dates order to bring liquid assets and current liabilities into proper balance, and to ensure that the firm can continue to operate in adverse circumstances.

Market Regulation Priorities

Bearing in mind recent major problems with algorithmic and high-frequency trading practices at market-makers, the Release emphasizes that FINRA is prepared "to focus significant resources" on:

Algorithmic Trading. Examiners will assess whether firms have adequate testing and controls related to high-frequency trading (HFT) and other algorithmic trading strategies and trading systems, including (i) whether firms conduct independent and "robust" pre-implementation testing of algorithms and trading systems; (ii) whether a firm's staff and vendors are adequately performing their roles in the design and development of the systems; (iii) whether such systems are adequately monitored for functionality and potential trading abuses once they are operational; (iv) how subsequent system changes are controlled; and (v) whether firms have adequate "kill" switches and other procedures for responding to widespread malfunctions.

High-Frequency Trading Abuses. Recognizing legitimate uses for HFT strategies, FINRA is concerned about evidence of manipulative abuses, and is making HFT surveillance a high priority. Areas which will be looked at include entering and layering non-bona fide orders and using "momentum-ignition strategies," wash sales, high volume trading at the open or close of trading, suspicious trading activity emanating from firm-sponsored participants outside the U.S., and comparable strategies intended to distort normal market functioning.

Alternative Trading Systems (ATS). Along with the SEC, FINRA has noted an increased volume of ATS-executed transactions, and is accordingly conducting a series of examinations of ATS firms and their affiliates. This targeted exam program will look into: (i) how such firms route, represent, interact or otherwise handle subscribers' order flow; (ii) the capacities in which they may participate in the ATS (agent and/or principal) and the disclosures as to order types; (iii) how they are compensated for their services; (iv) how they handle errors and indications of interest; (v) how they protect confidential customer order information; (vi) what interactions occur between the ATS and its affiliates; and (viii) and how ATS firms apply the fair access requirements of Regulation ATS.

Insider Trading

Along with substantially increased SEC and federal criminal law enforcement activity against insider trading, FINRA will emphasize these areas in field examinations: (i) the types and frequency of review of

electronic communications of personnel in business units with access to material, non-public information, such as investment banking and research departments; (ii) the adequacy of information-barrier procedures designed to limit the flow of material, non-public information within the firm; (iii) the monitoring of employee trading activity both inside and outside the firm to identify suspicious activity; (iv) the conduct of regular reviews of proprietary and customer trading in securities that are placed on a watch/restricted list; (v) the extent of employee training on the use and handling of material, non-public information; and (vi) the process for identifying suspicious customer trading in securities of their employer or corporate affiliates.

The Release is intended as general guidance for firms preparing for this year's field examination cycle, and there is no assurance that all firms will be examined on all of the items mentioned or that FINRA examiners will not seek to review areas not covered in the Release. For the full text of the Release, which covers topics in addition to those mentioned above, please go to:

<http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P122861>

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