

PUBLICATION

FINRA Issues 2014 Regulatory and Examination Priorities Letter

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Overview:

On January 2, 2014, the Financial Industry Regulatory Authority (FINRA) issued its [2014 Annual Regulatory and Examination Priorities Letter \(Priorities Letter\)](#). This letter is issued annually to highlight new and existing issues of heightened importance to FINRA's Member Regulation, Market Regulation and Enforcement Departments, and the Office of Fraud Detection and Market Intelligence.¹ The priorities represent FINRA's current assessment of key investor protection and market integrity issues on which it will focus in the coming year. The Priorities Letter encourages firms to use the information in the letter to enhance their supervisory and compliance programs to mitigate risk and better protect investors.

The Priorities Letter sets out FINRA's concerns with respect to "risks" FINRA has identified in each of the following categories:

- Business Conduct Practices;
- Fraud Priorities;
- Financial and Operational Priorities; and
- Market Regulation Priorities.

This alert will provide an overview of several of the key risks FINRA has identified in each area. If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact any of the attorneys in Baker Donelson's Broker-Dealer/Registered Investment Adviser group.

Business Conduct and Sales Practice Priorities

The Priorities Letter highlights issues that will be of heightened importance to FINRA in 2014 and indicates that its business conduct topics of increased interest in 2014 are broadly consistent with themes identified in 2013. Some have been a focus of regulatory concern in recent years, such as:

- Complex Products (see our [June 27, 2012 Alert](#) on this issue);
- Municipal Securities;
- Securities Offered through Private Placements;
- Mortgage-Backed Securities; and
- Non-Traded REITs.

However, several of the other areas included in the Priorities Letter are identified specifically for the first time this year. Firms must pay particular attention to these areas, which include:

- Suitability – FINRA reiterated its concerns with respect to ensuring the suitability of recommendations to retail investors. Specifically, FINRA raised issues concerning the suitability of complex products whose risk-return profiles, including their sensitivity to interest rate changes, underlying product or

index volatility, fee structures or complexity may be challenging for investors to understand. FINRA noted that in some cases, the challenge of understanding products may be exacerbated by disclosure practices that are ineffective. FINRA also noted these concerns can be amplified where fee or compensation structures create a strong incentive for firms or reps to recommend such products. FINRA referred firms to [Regulatory Notice 13-31](#), which outlines practices that may enhance the effectiveness of suitability determinations. In light of these concerns, FINRA indicated that in 2014 it will focus on marketing, sale and suitability of the following products:

- Complex Structured Products;
 - Private Real Estate Investment Trusts (REITs);
 - Frontier Funds;
 - Interest Rate Sensitive Securities;
 - Mortgage-Backed Securities;
 - Long Duration Bond Funds;
 - Long Duration Bond ETFs;
 - Long Duration Corporates (Particularly Zero Coupon or Bullet Bonds);
 - Emerging Market Debt;
 - Municipal Securities; and
 - Baby Bonds.
- Recidivist Brokers – FINRA expressed concern regarding the small number of brokers who have a pattern of complaints or disclosures for sales practice abuses, which can harm investors as well as the reputation of the securities industry and financial markets. FINRA reminded firms of its High Risk Broker Initiative which aims to identify such individuals and expedite investigations. In examining firms in this area, FINRA indicated it will focus on reviewing the firm's due diligence conducted in the hiring process and the adequacy of the firm's supervision of higher risk brokers – including whether the brokers have been placed on heightened supervision – and will place particular focus on the brokers' clients' accounts in conducting reviews of sales practices.
 - Initial Public Offering Market – FINRA noted the increased market for Initial Public Offerings (IPOs) which it has seen recent months. FINRA recommended that firms entering the underwriting business, or significantly expanding their activities in the area, adopt practices and controls to comply with all relevant rules and regulations. FINRA will focus in particular on reviewing a firm's due diligence activities and the firm's filings regarding public underwritings with FINRA's Corporate Finance Department, and the firm's compliance with all rules concerning the sales and allocations of IPO securities, including whether firms are incentivizing reps to sell cold offerings to obtain client allocations of hot offerings.
 - Private Placements – FINRA identified several areas of concern with respect to the sale of private placement securities, including the general solicitation and advertising of private placements and the due diligence and suitability of private placements, as well as offerings of securities through private placements. Regarding its general solicitation and advertising concerns, resulting from amendments to Rule 506 of Regulation D which were prompted by the JOBS Act, FINRA indicated its focus was on ensuring that advertisements and other marketing materials are based on principals of fair dealing and good faith; are fair and balanced; and provide a sound basis to evaluate the facts about securities acquired in a private placement. FINRA further explained that it would focus on evaluating firms' private placement activity to ascertain whether firms are taking reasonable steps to validate that investors meet accredited investor standards and to ensure recommendations to purchase securities in a private placement are suitable. FINRA reminded firms of their reasonable inquiry responsibilities detailed in [Regulatory Notice 10-22](#).
 - Senior Investors – FINRA noted that there are a large number of American investors who are approaching retirement and who control a substantial portion of investable assets. FINRA indicated that it will focus on how firms engage with these senior investors, especially with respect to suitability

determinations, disclosures and communications, and firms' policies and procedures with respect to identifying and addressing situations of diminished capacity.

In addition to the areas specifically discussed above, the Priorities Letter also addresses several practices which are of continuing concern to FINRA. Several of these practices include:

- **Cyber Security** – In the wake of cyber security issues reported across the financial services industry in recent years, FINRA continues to be concerned about the safety and integrity of customer data as well as the integrity of a firm's infrastructure.
- **Anti-Money Laundering (AML)** – FINRA continues to focus on AML compliance. In 2014, FINRA will focus on AML issues associated with institutional business. FINRA reminded firms that depending on the volume of shares, the specific securities liquidated, and the customer engaging in such activity, red flags for AML and Section 5 of the Securities Act of 1933 can be raised.
- **Crowdfunding Portals** – Because the JOBS Act allows retail investors to purchase unregistered securities offered through crowdfunding websites, FINRA and the SEC proposed rules on October 23, 2013 to ensure that the capital-raising objectives of the JOBS Act are advanced in a manner consistent with investor protection. FINRA advised firms to monitor the developments in this area, and noted that as the rules become effective, funding portals will become FINRA members and FINRA will implement a regulatory program designed to protect investors while recognizing the distinctions between funding portals and broker-dealers.

Fraud Priorities

FINRA indicated that its primary concerns in 2014 in this arena are microcap fraud and insider trading. Specifically, FINRA noted that speculative microcap and low-priced over-the-counter (OTC) securities are an area of significant ongoing concern for FINRA. FINRA advised firms to review their policies and procedures to ensure that their activities related to microcap and low-priced OTC securities are compliant with FINRA rules and federal securities laws. With respect to insider trading, FINRA noted that it continues to be a top regulatory concern for FINRA, the SEC, and federal criminal law enforcement. FINRA reminded firms to be vigilant in safeguarding material, non-public information, and to periodically assess information barriers and risk controls to ensure they are adequate.

Financial and Operational Priorities

FINRA identified several risk areas upon which it would focus in 2014 in this category, including funding and liquidity risk, risk control documentation and assessment, the accuracy of a firm's financial statements and net capital, and auditor independence.

Regarding funding and liquidity risk, FINRA indicated that it has found widely varying practices in the ways firms monitor and control their liquidity risk. FINRA provided that in 2014 it would undertake a more structured review of this area to compare strengths and weaknesses across firms and to identify effective practices. FINRA noted that larger firms will be asked to perform a liquidity stress test that incorporates factors FINRA believes are important to understanding the resiliency of a firm's business. FINRA also noted that it expects firms to maintain adequate liquid capital cushions to weather counterparty credit risk exposures, and will evaluate the rigor of firms' counterparty credit risk management programs.

With respect to risk control documentation and assessment, FINRA noted that the recent amendment to Rule 17a-3 of the Securities Exchange Act of 1934 will require firms that hold more than \$1 million in aggregate customer credits or \$20 million in capital, to document their credit, market and liquidity risk management controls. This is the first time larger broker-dealers will be required to document their risk controls. FINRA

indicated its focus in 2014 will be on examining whether such documentation is reflective of the controls in place, and whether they are reasonably designed to mitigate credit, market and liquidity risks.

Market Regulation Priorities

FINRA identified several risks in this area including algorithmic trading, high frequency trading, and trading systems. With respect to algorithmic trading, FINRA noted the risk that such trading can cause substantial market disruptions. Such malfunctions raise concern about a firm's ability to develop, implement and effectively supervise algorithmic trading systems. FINRA reminded firms that they will be vigorously tested in this area.

FINRA further indicated that the surveillance of abusive algorithmic trading systems remains a high priority for FINRA, and reminded firms to be vigilant when testing these strategies pre- and post-launch to ensure they do not result in abusive trading.

Finally, FINRA noted that it has introduced new surveillance patterns to monitor best execution in equities, options and fixed income securities. In 2014, FINRA will focus more closely on firms' practices to ensure compliance with their best execution obligations.

Conclusion

FINRA's Priorities Letter provides a blueprint of its regulatory and enforcement objectives going into 2014. In light of this guidance, firms should assess their compliance and supervisory programs in the context of these key risk areas. Firms must also evaluate their sales practices, as well as their policies and procedures with respect to these areas, in order to ensure they are in compliance with all applicable rules and securities laws.

If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact any of the attorneys in Baker Donelson's Broker-Dealer/Registered Investment Adviser group.

¹ In order to provide additional insight into the evolution of FINRA's regulatory and examination priorities, we have also prepared a detailed comparison of FINRA's priorities between 2007 and 2014, which is available [here](#).