PUBLICATION

FINRA Issues 2012 Priorities Letter

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Overview

On January 31, 2012, the Financial Industry Regulated Authority (FINRA) issued its 2012 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] FINRA's Priorities Letter encourages firms to assess their compliance and supervisory programs in the context of these key risk areas.

Regulatory Program Developments

The Priorities Letter explains that FINRA employs an ongoing process to discharge its regulatory responsibilities and utilizes a risk-based approach to enhance surveillance, examination and disciplinary initiatives focused on ensuring market integrity. As a part of this effort, FINRA will employ several enhancements to its regulatory programs in order to focus its attention and resources on the areas of greatest risk. These regulatory enhancements will include:

- A broader data collection effort and more comprehensive risk-assessment process which includes the capturing and leveraging of more granular operational and risk data so FINRA can better understand a firm's business model and the risk embedded within that model; and
- Deployment of a Risk Control Assessment (RCA) which is purported to be a dynamically generated survey that will assist FINRA in better understanding firms' business activities, product mix, customer base and underlying controls.

Examination Priorities

The Priorities Letter highlights issues that will be of heightened importance to FINRA in 2012. FINRA notes that its enforcement priorities are informed against the economic environment investors have faced since 2008, which includes conditions that foster an increased risk of aggressive yield chasing, inappropriate sales practices, unsuitable product offerings and misappropriation and fraud. FINRA's examination priorities represent risks that FINRA has identified both broadly across its membership and in the course of targeted reviews. The Priorities Letter cautions that with respect to any issues applicable to a firm, the firm should assess whether its internal controls, supervisory systems and risk management practices properly address FINRA's concerns. Firms would be well advised to pay attention to their sales practices, as well as their policies and procedures with respect to these areas, in order to ensure they are in compliance.

FINRA has found that the challenging economic environment has led individual retail investors to be susceptible to recommendations by their broker-dealers to chase yields without necessarily understanding the risk-versus-reward tradeoffs, especially as more complex products are included in retail portfolios. FINRA's primary concerns in this area include (i) the full disclosure of material risks, (ii) mispricing and overcharging issues and (iii) the suitability of products based on the underlying risks. FINRA notes its concerns are heightened where the products are more complex. Specifically, the Priorities Letter indicates FINRA is concerned with yield chasing, the lack of liquidity in the secondary trading markets, cash flow characteristics that are not in line with investor needs and the lack of transparent and accurate financial data being available to investors at the time an investment is made.

In order to address these concerns, the Priorities Letter notes that suitability reviews will continue to be important in 2012, and will be particularly important in light of the new Suitability Rule (FINRA Rule 2111) and the Know Your Customer Rule (FINRA Rule 2090), both of which become effective on July 9, 2012. It's worth noting that while FINRA's new suitability rule is generally modeled after NASD Rule 2310, it also contains new and modified provisions, including a broadening of the customer-specific factors that brokers must attempt to obtain and analyze when making recommendations. The new suitability rule also makes clear that suitability requirements apply to recommended investment strategies, including recommendations to hold securities.

The Priorities Letter specifically provides several products that illustrate areas where concerns relative to business conduct and suitability issues are especially heightened. While the list is not all-inclusive, it contains representative products that raise concerns when marketed and sold to retail investors. Several of the products included in the Priorities Letter are not surprising, as they have been a focus of regulatory concern in recent years, such as:

- Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities;
- Municipal Securities;
- Complex Exchange-Traded Products; and
- Structured Products.

However, some of the other products represent new FINRA priorities, such as:

- Variable Annuities. FINRA notes many variable annuity products have long holding periods and significant surrender fees, making them unsuitable for investors with high liquidity needs. In addition, variable annuity products may entail high fees, commissions and expenses, which could result in reduced performance in the underlying holdings. FINRA reminds members that FINRA Rule 2330 requires, among other things, that firms or associated persons have a reasonable basis to believe that a customer would benefit from certain features of a variable annuity, and a reasonable basis to believe that the customer has been informed, in general terms, of various features of variable annuities.
- Securities Offered through Private Placement. FINRA requires that firms conducting private placements under Regulation D or any other applicable exemption from registration must conduct a reasonable investigation into the issuer, based upon the facts and circumstances, with careful attention to any "red flags." Notably, firms should also be aware that the definition of accredited investor has changed.
- Unregistered Securities Acquired in Secondary Markets. The Priorities Letter states that as many high-profile companies have elected to remain private, secondary trading markets have emerged for their securities. FINRA notes that a significant risk to investors occurs because, despite their profile, many of these companies are difficult to value as public financial statements are not available. Investors may be particularly at risk where interests in such securities are acquired through a pooled investment or single security "fund," which introduces additional costs and risks.

Practices of Concern

In addition to the specifically mentioned products discussed above, the Priorities Letter also addresses several practices which are of increasing concern to FINRA. These practices include:

- Failing to establish and enforce adequate supervisory systems and internal controls that are specifically tailored to the firm's business model, the products and services it sells and the types of clients or counterparties with which it does business.
- Charging retail investors hidden, mislabeled or excessive fees. FINRA requires that firms charge only reasonable fees and that those fees be disclosed up front. In 2011, FINRA brought cases against several broker-dealers engaging in "fee schemes." Such schemes have included charging excessive postage and handling charges unrelated to actual costs.
- Failing to engage in robust, tailored and well-designed branch office inspections testing as to whether compliance policies and supervisory procedures are being followed at the branch level. Baker Donelson previously issued an Alert on the branch examination process.
- Failing to properly monitor, supervise and approve communications via social media sites and electronic communications, and failing to keep proper records of such communications. Baker Donelson previously issued an Alert on the use of social media.
- Engaging in the inappropriate use of off-balance sheet instruments, and improper netting of assets and liabilities for financial statement purposes. FINRA is also concerned with the additional risks that are involved in the use of increased leverage, including market credit and liquidity risks. FINRA will focus on the review of funding and liquidity risk management practices, and particularly on potential adverse circumstances that can result from broker-dealer-specific events or systematic credit events.
- Failing to maintain adequate internal controls and risk management systems geared toward detecting and preventing rogue trading, i.e., unauthorized trading.
- Failing to have processes in place to obtain robust, independent and reliable valuations for illiquid and hard-to-value securities, such as private-label mortgage-backed securities and various structured products.
- Where firms are engaged in margin-lending practices, failing to determine whether the collateral supporting receivables is readily marketable, appropriately valued, unencumbered and readily available to finance credit extended to clients. FINRA notes that in 2011 it investigated several instances in which firms extended credit through margin lending or reverse repo transactions on complex structured products that were difficult to value, as well as on thinly traded securities. FINRA requires that firms assess the sufficiency, the valuation and the liquidity of this collateral as well as the concentration of collateral in a specific security or class of securities, in a single customer account and across all customer accounts.
- Failing to maintain accurate books and records, financial statements and computations of net capital.
- Failing to maintain a supervisory system and internal control procedures reasonably designed to safeguard and restrict the use of customer assets by a broker-dealer in its business activities, particularly in the wake of the MF Global bankruptcy.
- Failing to have risk management controls and supervisory procedures that are reasonably designed to manage the financial, regulatory and other risks associated with market access, as required by the new Market Access Rule (SEA Rule 15c3-5) which became fully effective in November 2011.
- Engaging in High Frequency Trading (HFT) without being vigilant in testing HFT strategies and other trading algorithms – both pre- and post-launch – to ensure that the strategies do not result in abusive trading and/or unintended consequences.
- Engaging in transactions that result in conflicts of interest in the sale and marketing of complex investments. FINRA notes that during 2011, there were several high profile civil suits against systematically important financial institutions based on conflicts related to the sales and marketing of complex financial instruments – cases which directly challenged the notion of fair and transparent markets and had the potential to harm both institutional and retail market participants.

Conclusion

FINRA's Priorities Letter provides significant insight into its regulatory and enforcement objectives going into 2012. 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 following Baker Donelson attorneys:

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[1] In order to provide additional insight into the evolution of FINRA's regulatory and examination priorities, we have also prepared a chart showing a detailed comparison of FINRA's priorities between 2007 and 2012, which is available here.