

PUBLICATION

FINRA Issues 2013 Regulatory and Examination Priorities Letter

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Overview:

On January 11, 2013, the Financial Industry Regulated Authority (FINRA) issued its [2013 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.

Business Conduct and Sales Practice Priorities:

The Priorities Letter highlights issues that will be of heightened importance to FINRA in 2013. The Priorities Letter explains that given the current slow growth, low-interest-rate environment, retail investors are particularly vulnerable. Particularly, while efforts to lower balance sheet risk and to shift assets to safer investments have contributed to an unprecedented compression of credit risk premiums and yields in the U.S., investor appetite for yield, among other factors, has bid up market prices on investment-grade and high-yield debt, putting pressure on upside growth potential and creating significant downside risk. Therefore, in this environment, FINRA is particularly concerned about sales practice abuses, yield-chasing behaviors and the potential impact of any market correction, external stress event or market dislocation on market prices.

The Priorities Letter provides that FINRA will focus its examination efforts on several areas. Some of the areas included in the Priorities Letter have been a focus of regulatory concern in recent years, such as:

- High-Yield Debt Instruments;
- Structured Products;
- Exchange-Traded Funds and Notes;
- Non-Traded REITS;
- Municipal Securities and
- Variable Annuities.

However, several of the other areas included in the Priorities Letter are new areas to which firms must pay attention, such as:

- **Complex Products** – These products have been a regulatory focus of FINRA for some time. However, the 2013 Priorities Letter marks the first time Complex Products have been specifically identified by FINRA as a target area of concern. FINRA is particularly concerned with firms' and registered representatives' full understanding of complex or high-yield products. Specifically, FINRA is concerned about the market risk exposure, credit risk exposure and liquidity risk exposure that can be associated with complex products. Baker Donelson previously issued an Alert on [Complex Products](#).

- **Business Development Companies (BDCs)** – BDCs are typically closed-end investment companies, some of which primarily invest in corporate and equity of private companies. Often BDCs offer attractive yields generated through high credit risk exposures amplified through leveraging strategies. In addition, there have been increasing issuances of non-traded BDC funds, which, due to the illiquid nature of non-traded BDCs, limit investors' existing opportunities.
- **Leveraged Loan Products** – Leveraged loans are adjustable-rate loans extended by financial institutions to companies of low credit quality that have a high amount of debt relative to equity. Such products can be relatively illiquid and difficult to value. Moreover, while these products are often marketed as less vulnerable to interest rate fluctuations, the underlying loans held in the fund can be subject to significant credit, valuation and liquidity risks.
- **Commercial Mortgage-Backed Securities (CMBS)** – FINRA heightened concerns regarding the sale and marketing of CMBS to retail investors. The CMBS space, in particular, saw a significant compression in risk premium in 2012 as investors bid up prices and drove down yields while default rates remained high as compared to historical norms. FINRA's concerns specifically relate to full disclosure, in a transparent manner, the considerable risks of CMBS, given today's low-interest-rate, low-yield environment.

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

- **Cyber Security and Data Integrity** – FINRA continues to be concerned about the safety and integrity of customer data as the frequency and intensity of threats – such as denial of service attacks – and the number of data security breaches, continues to rise. FINRA expects firms to implement policies, procedures and controls to protect sensitive customer data.
- **Private Placement Securities** – FINRA continues to be concerned about the sale and marketing of private placement securities. In particular, FINRA is concerned that inadequate due diligence regarding private placements could expose customers to harm and result in insufficient disclosures. Firms must conduct due diligence on all private placement offerings, paying particular attention to policies and procedures, valuation processes, the integrity and independence of third-party valuation services and the timely disclosure of material risks. In addition, firms must comply with new FINRA Rule 5123, which requires member firms that sell an issuer's securities in a private placement to individuals to file a copy of the offering document with FINRA.
- **Anti-Money Laundering (AML)** – FINRA continues to focus on AML compliance, particularly at firms with higher-risk business models due to their clients, products and service mix, or location in which they operate. FINRA has raised concerns regarding the level of due diligence performed by firms and about inadequate reviews for potential suspicious activity. Money laundering risks are continually changing, requiring firms to be vigilant in reviewing for suspicious activity and adapting their AML programs accordingly.
- **Automated Investment Advice** – While the use of software solutions to dispense automated investment advice to retail clients has grown in recent years and may be helpful to investors, FINRA has concerns that in some instances, the platforms may not adequately gather the necessary attributes of the investor to determine an investment profile.
- **Branch Office Supervision** – FINRA continues to review branch office supervision practices and requires that firms ensure that they have a robust supervisory structure and that their branch office inspection programs are reasonable and appropriate to the scale and scope of activities and risks at the branch. Baker Donelson previously issued an Alert on the [branch examination process](#).
- **Insider Trading** – Insider trading continues to be a top regulatory priority for FINRA, the SEC and federal criminal law enforcement. FINRA requires firms to be vigilant in safeguarding material, non-public information, and firms should periodically assess information barriers and risk controls to ensure they are adequate.

Financial and Operational Priorities:

Given the current market environment, FINRA has concerns regarding firms' abilities to adequately fund their operations under various stress conditions. The Priorities Letter states that FINRA will focus significant efforts on net capital issues, the protection of customer assets and the accuracy and integrity of firms' books and records. In particular, FINRA will review, among other things, the implementation of Generally Accepted Accounting Principles (GAAP) and the accurate recording and reporting of required liabilities, securities valuation issues and the concentration of market, credit and liquidity risk concentrations on the balance sheet. For example, FINRA will examine:

- **Guarantees and Contingencies** – GAAP requires that firms determine the dollar amount of losses that could result from guarantees or contingencies, and accrue such losses in computing their net worth when their occurrence is probable and the amount can be reasonably estimated. FINRA is particularly focused on whether firms are identifying all contingencies and guarantees and have documented the basis for any associated liability accrual or lack thereof.
- **Margin Lending Practices** – The valuation and marketability of certain securities that collateralize margin receivables raise concerns when margin loans are collateralized by thinly traded equities, municipal bonds and highly structured collateralized mortgage obligations. Firms should have a governance process to judiciously determine whether extensions of credit are appropriate on various asset classes and to determine the amount of margin that should be extended on less-liquid positions. Firms must also determine whether clearing house margins are adequate or whether additional house margins should be collected. Baker Donelson previously issued an Alert on [Rule 5123](#).

Market Regulation Priorities:

The Priorities Letter provides that, because of the increasing complexity of the financial services architecture, it is vulnerable to disruption. Therefore, FINRA will focus significant resources on maintaining market integrity. Some of the practices FINRA will specifically focus on are:

- **Algorithmic Trading** – In light of the several high-profile algorithmic trading failures that caused significant market disruption in 2012, FINRA continues to be concerned about how firms are supervising the development of algorithms and trading systems, and specifically whether firms have adequate testing and controls related to such trading strategies.
- **High-Frequency Trading (HFT)** – Because many high-frequency trading strategies can be used for manipulative purposes, the surveillance of HFT strategies is a high priority for FINRA. Therefore, FINRA will assess whether firms using HFT strategies adequately test these strategies pre- and post-launch to ensure they do not result in abusive trading.
- **Fixed Income Sales** – FINRA remains focused on trading issues such as best execution, inter-positioning and fair pricing in the fixed-income market. FINRA is particularly focused on fair pricing in products such as collateralized mortgage obligations (CMOs) and mortgage-backed securities (MBS), as retail activity in these products has increased.

Conclusion:

FINRA's Priorities Letter provides a blueprint of its regulatory and enforcement objectives going into 2013. 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 your Baker Donelson attorney.