FINRA's 2017 Regulatory and Examination Priorities

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At the start of each year, the Financial Industry Regulatory Authority (FINRA) issues guidance concerning its regulatory priorities for the coming year. FINRA issued its 2017 Annual Regulatory and Examination Priorities Letter on January 4. FINRA's 2017 letter sets out five broad areas of focus for the coming year:

- High-risk and Recidivist Brokers;
- Sales Practices;
- Financial Risks;
- Operational Risks; and
- Market Integrity.

The 2017 Priorities Letter addresses many of FINRA's traditional focus areas and also incorporates several new focuses based on recent observations. This article contains summaries of several of the critical issues identified as focus areas for FINRA in the coming year.

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 2017. The comparison of FINRA's priorities is available HERE.

High-risk and Recidivist Brokers

FINRA plans to strengthen its approach to high-risk and recidivist brokers in three areas. First, FINRA has recently established a separate examination unit to identify and examine brokers who may pose a high-risk to investors based on prior misconduct and/or the broker's regulatory disclosures. This group is tasked with conducting a "rigorously review" of these brokers' interactions with customers, their compliance with rules regarding suitability, outside business activities and private securities transactions, and the commissions and fees they charge.

Second, FINRA will review firms' supervisory procedures and due diligence for hiring or retaining these brokers, which will include determining whether a firm or third-party service provider conducts a national search of reasonably available public records to verify the accuracy of the information in an applicant's Form U4. FINRA will also assess firms' development and implementation of supervisory plans that should be "reasonably tailored to detect and prevent future misconduct by a particular broker based on prior misconduct and regulatory disclosures."

Third, FINRA will evaluate firms' branch office inspection programs as well as their supervisory systems for branch and non-branch office locations, including independent contractor branches. Among the specific areas of review identified by FINRA are: the potential use of unapproved email addresses for business, communications with customers through social media, seminars, radio shows or podcasts, outside business activities, the use of consolidated account statements and operational activities such as distribution of funds and changes of address or investment objectives.

Sales Practices, Including Senior Investors, Excessive Short-Term Trading of Long-Term Products and the Use of Social Media

FINRA's efforts to protect senior investors will remain a top priority in 2017. As a part of these efforts, FINRA will assess firms' controls to protect senior investors from fraud, abuse and improper advice. In fact, in October 2016, FINRA submitted to the SEC Proposed Rules to amend Rule 4512 (Customer Account Information) and adopt Rule 2165 (Financial Exploitation of Specified Adults) to address the growing concerns of financial exploitation of seniors and other vulnerable adults.

Additionally, FINRA's reviews will focus on issues including: product suitability and concentration, outside business activities, private security transactions, reasonable-basis and customer-specific suitability reviews, excessive concentration, and excessive and short-term trading of long-term products. FINRA also indicated it will assess the use, retention and supervision of social media and electronic communications. In fact, FINRA specifically cautioned that it will review firms' compliance with their supervisory and record-retention obligations in light of the increasingly important role that social media plays in the securities business.

Financial Risks

Firms' management of liquidity is a continuing area of concern for FINRA and in 2017 FINRA will review the adequacy of firms' contingency funding plans and risk management governance in light of their business models. In furtherance of these policies, FINRA will assess firms' practices to understand whether their approaches appear "reasonable in light of the risks to the firm's business" though purportedly, "not with an expectation of a 'right way' or 'wrong way' to deal with a scenario."

Operational Risks, Including Cybersecurity and Municipal Advisor Registration

A particularly important and constantly evolving priority for FINRA is its focus on firms' supervision and risk management related to cybersecurity, technology management and data quality and governance. FINRA has indicated these areas are particularly significant because cybersecurity threats are one of the most substantial risks that firms face. Accordingly, FINRA indicated it may review firms' methods for preventing data loss, including understanding their data (e.g., the degree of sensitivity and where the data is stored) and its flow through the firm and possibly to vendors. FINRA also listed two areas in which it has observed shortcomings in firms' controls: (1) weaker cybersecurity at branch offices, particularly independent contractor branch offices; and (2) firms' failures to fulfill one or more of their obligations under the Securities Exchange Act (SEA) Rule 17a-4(f), which require firms to, among other things, preserve certain records in a non-rewritable, non-erasable format, commonly known as "write one read many" (WORM) format.

In addition to cybersecurity, FINRA identified several other operational risks upon which it will focus in 2017, including supervisory controls testing, customer protection/segregation of client assets, regulation SHO, AML and suspicious activity monitoring, and municipal advisor registration (noting that the Series 50 Municipal Advisor Representative Qualification Examination became available September 12, 2016, and individuals currently engaging in municipal advisor activities have one year to pass the exam).

Market Integrity

Finally, FINRA will focus on market integrity, including market manipulation, best execution, audit trail integrity, market access, trading examinations and fixed income surveillance. In 2017, FINRA will expand surveillance for cross-product manipulation to trading in exchange-traded products and related securities, continue its use of the Cross Market Equity Supervision Report Cards, continue enforcement of the data collection obligations under the Tick Size Pilot and introduce a new pilot trading examination program. FINRA also discussed its intent to develop a data integrity program to monitor the accuracy of submitted data (in light of TRACE requirements for transactions in U.S. Treasury securities which are scheduled to become effective in July 2017) and customer protection surveillance patterns focusing on compliance with rules applicable to U.S. Treasury securities, as well as patterns looking for abusive algorithms.

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.