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Client Alert

Current Issues Relevant to Our Clients

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FINRA 2015 Regulatory and Examinations Priorities

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued its Regulatory and Examinations Priorities Letter. A copy of the letter is available here. While not an exhaustive list, FINRA's 2015 priorities letter focuses on:

- *key areas FINRA has observed contributing to member firm compliance and supervisory deficiencies,*
- *its observation of an increase in firms failing to file timely responses to information requests in connection with examinations and investigations,*
- *key sales practice issues,*
- *financial and operational issues and*
- *market integrity matters.*

Below are brief summaries of some of the more significant issues FINRA's letter raises. FINRA member firms should review their policies, procedures and business activities in light of FINRA's stated 2015 priorities. Firms should also review the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations' ("OCIE") Examination Priorities for 2015 which is described in our client alert available here. FINRA and OCIE will be focusing on many of the same issues in 2015.

General Compliance and Supervisory Challenges for FINRA Members

FINRA has observed that the following issues continue to contribute to compliance and supervisory breakdowns by firms and their registered representatives:

- A failure to put customer interests first;
- Poor firm culture;
- Insufficient supervisory and risk management systems and controls;
- Failures in new-product and service review processes and suitability assessments; and
- Failures to adequately address conflicts of interest.

FINRA encourages firms to address these issues and suggests that doing so will help to enable firms to get ahead of many of the concerns FINRA raises in its 2015 priorities letter.

Full and Timely Responses to FINRA Information Requests

FINRA has observed increased instances of firms repeatedly failing to provide timely responses to information requests made in connection with examinations and investigations. FINRA views these delays in production as unacceptable and emphasizes member firms' obligation to respond to inquiries in a full and timely fashion. FINRA further notes that failure to do so can expose firms to disciplinary action.

Key Sales Practice Issues

Product Specific Concerns. FINRA raises a variety of product-specific sales practice concerns centered around obligations to perform due diligence, make sound suitability decisions and describe product risks in a balanced and investor-friendly manner. FINRA's focus in product-related risk reviews in 2015 will be due diligence, suitability, disclosure, supervision and training. FINRA noted the following categories of products in particular:

- **Interest Rate-Sensitive Fixed Income Securities.** Given ongoing concerns about the current interest rate environment, FINRA examiners will look for concentrated positions in products that are highly sensitive to interest rates and test for suitability and adequate disclosures and communications.

- **Variable Annuities.** FINRA's focus will be on assessments of compensation structures, suitability of recommendations, statements made by registered representatives and adequacy of disclosures. FINRA will look at training and implementation of procedures in this area.
- **"Alternative" Mutual Funds.** FINRA is particularly concerned with how these funds are described in retail communications including their objectives and how these funds will respond to various market conditions.
- **Non-Traded REITs.** FINRA will be focused on suitability assessments and due diligence performed by firms. FINRA will also be looking at ongoing valuations and disclosures by firms related to these products.
- **Exchange-Traded Products Tracking Alternatively Weighted Indices.**
- **Structured Retail Products.** FINRA will be focused on communications (including making required filings with FINRA, where applicable) in addition to adequately addressing conflicts including appropriate adoption of Know-Your-Distributor policies and procedures.
- **Floating-Rate Bank Loan Funds.**
- **Securities-Backed Lines of Credit.** FINRA will be focused on marketing efforts, adequate monitoring of customer accounts and collateral shortfalls, and the existence of proper controls to supervise these programs.
- **Minimum Denomination Municipal Bonds.** FINRA will focus on firms that sell municipal bonds in less than the stated minimum denominations.

Supervisory Rules. FINRA's new supervision rules became effective on December 1, 2014 and FINRA examiners will contact and inspect firms to address regulatory questions and to become familiar with how firms are implementing new rule requirements.

Wealth Events. In 2015 FINRA examiners will focus on controls firms have in place related to wealth events like inheritances, life insurance payouts, sales of business or other major assets, divorce settlements or IRA rollovers, among other things. In particular FINRA will focus on compliance with supervisory, suitability and disclosure obligations. With regard to IRA rollovers, FINRA will focus on false and/or misleading communications regarding an IRA's fees and investors' options along with policies, procedures and controls in place with respect to registered representative recommendations.

Excessive Trading and Concentration Controls. In 2015 FINRA will focus on firms' supervisory processes, systems and controls concerning how firms monitor for excessive trading and product concentration. This will include reviews of customer communications and trading activities.

Private Placements. FINRA will continue to examine suitability analysis and due diligence processes for firms involved in private placements. FINRA will continue to review firms involved in private placements in areas where it has observed past deficiencies including appropriate filing of private placement materials under FINRA rules, issues associated with contingency offerings and deficiencies in escrow procedures.

High-Risk and Recidivist Brokers. FINRA will continue to focus on high-risk registered representatives who are engaged or have been engaged in high-risk conduct along with firms that hire or seek to hire high-risk brokers, including statutorily disqualified and recidivist brokers. FINRA will review firms' due diligence on prospective hires, adequacy of supervision and whether firms implement and document supervisory plans with respect to such brokers.

Sales Charge Discounts and Waivers. FINRA has observed that customers have not received volume discount (breakpoint) or sales charge waivers when purchasing certain non-traded REITs, unit investment trusts, business development companies and mutual funds. This will continue to be an examination priority for FINRA and FINRA will further look at the adequacy of firms breakpoint monitoring procedures and systems as well as the level of disclosure by brokers as to the availability of breakpoints.

Senior Investors. Given the continued concern about the treatment of senior citizen investors, FINRA will continue to review firms' communications with seniors with particular focus on senior-specific suitability assessments, training of registered representatives and supervision of activity.

Anti-Money Laundering ("AML"). FINRA will focus on firms' AML processes with certain types of accounts including cash management accounts (CMAs) and certain delivery versus payment/receipt versus payment (DVP/RVP) accounts.

Municipal Advisors. FINRA will focus on current SEC and Municipal Securities Rulemaking Board (*"MSRB"*) municipal advisor requirements including identifying firms that are not currently but may be required to register as a municipal advisor.

Key Financial and Operational Priorities

Funding, Liquidity and Valuation. FINRA will continue to examine the quality of firms' liquidity risk management and funding programs with a focus on their valuation processes and supervisory controls.

Tax-Exempt and FDIC Insured Product Sales. FINRA has observed certain actions by firms causing customers to lose tax-exempt status on interest payments or FDIC protections that customers believe they might have. In particular, FINRA will examine firms' creation and resolution of short positions in securities with these characteristics which frequently cause these problems for investors.

Cybersecurity. FINRA expects to publish the results of its 2014 cybersecurity sweep examination and will focus on firms' approaches to cybersecurity risk management in their examinations. FINRA will specifically review firms' approaches to ensuring compliance with Rule 17a-4 under the Securities Exchange Act of 1934 in the event of a cyber attack that destroys data.

Outsourcing. Outsourcing by firms will be a priority area of review during examinations, including analysis of due diligence, risk assessment and supervision implemented by firms for all outsourced activities and functions.

Timely Reporting of Disclosable Information. FINRA has observed firms failing to promptly disclose to FINRA reportable U4 and U5 events, including regulatory actions, customer complaints, bankruptcy filings, liens, judgments and criminal charges. FINRA will review firms' compliance including conducting its own review of public records of all active registered persons. FINRA filed proposed amendments to Rule 3110 requiring firms to perform public record checks when registering associated persons to verify the accuracy and completeness of initial and transfer Form U4 filings and will review whether firms have performed appropriate investigations and reporting.

Market Integrity

Supervision and Governance of Trading Technology. FINRA will review firms' technology and related controls with an emphasis on development and ongoing supervision of algorithms. Additionally, FINRA will focus on firms' risk management and financial and operational controls with a focus on net capital that can become a significant issue for high-frequency trading firms.

Cross-Market and Cross-Product Manipulation. FINRA continues to enhance its equities and options-cross market surveillance to identify manipulative activity by market participants on single or multiple markets.

Order Routing Practices, Best Execution and Disclosure. FINRA is presently conducting a sweep on firms that route significant portions of their orders to firms providing the highest trading rebates which raise potential conflicts of interest issues. FINRA will continue focus on firms' supervision and controls over best execution and pricing practices to ensure customers are receiving best execution and avoiding excessive mark-ups. FINRA is also examining intermediating transactions in structured products where firms may not have disclosed information to customers about how customers would be charged and FINRA encourages firms who position a trade for purposes of taking a spread to look at whether they are meeting customer expectations about execution and dealer compensation. FINRA is also launching a program to conduct fixed income-based examinations on trading issues and controls that will focus on items including alternative trading systems trading fixed income instruments, books and records, supervision and order execution practices.

Market Access. FINRA has continued to see examples of firms' inadequate market access controls related to manipulation and erroneous activity and plans to commence a pilot program in 2015 to provide firms intended to supplement firms' supervision efforts with respect to detecting and preventing manipulative trading activity.

Audit Trail Integrity (including TRACE Reporting). FINRA will continue to focus on late reporting in TRACE-eligible and municipal securities resulting from inadequate processes and procedures.

Conclusion

Firms should consider the FINRA priorities along with recently released SEC 2015 Examination Priorities as they conduct their annual reviews of policies, procedures and business activities. Where firms observe deficiencies in their own practices, adjustments should be made before they find themselves the subject of a FINRA or SEC investigation, examination or enforcement action.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.