Chapman and Cutler LLP

Chapman Client Alert

February 6, 2019 Current Issues Relevant to Our Clients

FINRA 2019 Risk Monitoring and Examination Priorities

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued its 2019 Risk Monitoring and Examination Priorities Letter. A copy of the letter is available here. The Risk Monitoring and Examination Priorities Letter also directs members to their 2017 and 2018 Reports on Examination Findings available here and here. Below are brief summaries of some of the more significant issues FINRA's letter raises.

Sales Practice Risks

Suitability assessment will continue to be a FINRA priority with a focus on deficient quantitative suitability determinations, investor overconcentration in illiquid securities and firm recommendations to purchase share classes that are not in line with an investor's investment time horizon. FINRA will also focus on suitability assessments in connection with novel products and packaged leveraged loans (e.g. collateralized loan obligations).

Protection of senior investors and investors at or nearing retirement will continue to be a FINRA priority with a focus on protection from fraud, sales practice abuse and financial exploitation. FINRA will also focus on firms' controls regarding obligations under amendments to FINRA Rule 4512 (requiring firms to make reasonable efforts to obtain information about trusted contacts) and Rule 2165 (where firms anticipate placing temporary holds on disbursements).

Outside business activities and private securities transactions will continue to be a FINRA priority with a focus on associated persons raising funds from their customers away from their firm and outside of their firm's supervision.

Operational Risks

Digital assets (e.g. cryptocurrency) continue to be a source of concern for FINRA, the Securities and Exchange Commission (the "SEC") and other regulators. This year, FINRA will review and assess all member firms' activities in this space in coordination with the SEC. FINRA encourages firms that plan to engage in digital asset activity to notify FINRA if they plan to engage in these activities.

Customer due diligence and suspicious activity reviews will be a FINRA priority item with a focus on firms' compliance with FinCEN's new Customer Due Diligence rule which became effective on May 11, 2018. More details on that rule are available in our Client Alert available here.

Market Risks

Firm best execution practices will be reviewed by FINRA with a focus on firms that routed all or substantially all customer orders to a small number of wholesale market makers which were affiliated, which provided payment for order flow or where a firm had some other financial interest. FINRA will also assess how firms check additional venues for potential price improvement. Among other things, FINRA will also focus on how firms manage the conflict of interest between their duty of best execution and inducements from routing or internalization of customer orders.

Additionally, FINRA will review firms' for:

- ***Market manipulation*** activities;
- ***Compliance with the Market Access Rule*** (Securities Exchange Act of 1934 Rule 15c3-5);
- ***Short sales*** to determine whether firms have structured their aggregation units consistent with the requirements of Exchange Act Rule 200(f); and
- ***Short tenders*** to determine how firms account for options position when tendering shares in an offer with an emphasis on compliance with Exchange Act Rule 14e-4.

Financial Risks

Credit risk identification, measurement and management practices will be reviewed by FINRA including a review of any risk exposures that may not be readily apparent (such as where a customer executes away from the firm without the firm's participation until after execution). FINRA will also focus on the extent to which firms identify and address all risks when they extend credit to their customers and counterparties.

Funding and liquidity risk planning will be a FINRA priority with a focus on whether firms have updated stress test assumptions in light of marketplace changes, the adequacy of firms' liquidity pools and firms' practices to review and update the reasonableness of stress test assumptions on a regular basis.

Other Highlighted Items

Online distribution platforms relying on Rule 506(c) of Regulation D and Regulation A of the Securities Act of 1933 will continue to be scrutinized by FINRA to determine whether firms are:

- selling or recommending securities (and implementing appropriate practices where FINRA determines that they are);
- conducting reasonable basis and customer-specific suitability analyses, adequately supervising communications and meeting anti-money laundering requirements;
- adequacy and risks associated with offering documents;
- adequacy of compliance programs to evaluate risks of sales to non-accredited investors, non-compliant escrow arrangements and risks of excessive or undisclosed compensation between firms and issuers.

New fixed income mark-up and mark-down disclosure practices under amended FINRA Rule 2232 and MSRB Rule G-15 will be reviewed by FINRA. These changes are described in detail in our Client Alerts available here, here and here. FINRA will also review for any changes in firm behavior taken to inappropriately avoid mark-up and mark-down disclosure obligations.

Regulatory technology implementation has been acknowledged by FINRA as having the potential to make compliance programs more efficient and effective. FINRA will continue to engage firms on their usage of these tools and review for potential risks, challenges and regulatory concerns.

Conclusion

Firms should consider the FINRA areas of focus as they conduct their annual reviews of policies, procedures and business activities or when introducing a new product, business line or compliance tool to their existing business.

For More Information

If you would like 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.

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