

Chapman Client Alert

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Current Issues Relevant to Our Clients

FINRA 2016 Regulatory and Examinations Priorities

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued its annual Regulatory Examination Priorities Letter. A copy of the letter is available [here](#). While not an exhaustive list, FINRA’s 2016 priorities letter focuses on:

- culture, conflicts of interests and ethics,
- supervisions, risk management and controls,
- liquidity,
- sale practices,
- financial and operations controls, and
- market integrity.

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 2016 priorities. Firms should also review the Securities and Exchange Commission’s (the “SEC”) Office of Compliance Inspections and Examinations (“OCIE”) Examination Priorities for 2016, which is described in our Client Alert available [here](#). FINRA and OCIE will be focusing on many of the same issues in 2016.

Culture, Conflicts of Interest and Ethics

Recognizing the influence firm culture has on how a firm conducts its business and manages its conflicts of interest, FINRA stated it intends to formalize its assessment of firm culture while continuing its focus on conflicts of interest and ethics. FINRA will focus on the framework that firms use to develop, communicate and evaluate conformance with their culture. FINRA stated it will assess five indicators of a firm’s culture:

- whether control functions are valued within the organization;
- whether policy or control breaches are tolerated;
- whether the organization proactively seeks to identify risk and compliance events;
- whether supervisors are effective role models of firm culture; and
- whether sub-cultures (e.g., at a branch office, trading desk or an investment banking department) that may

not conform to overall corporate culture are identified and addressed.

FINRA also advised that firms should take visible actions that help mitigate conflicts of interest and promote the fair and ethical treatment of customers.

Supervision, Risk Management and Controls

Firms are obligated to establish and maintain a system to supervise the activities of their associated persons. In 2016, FINRA indicated that it will particularly focus on supervision, risk management and controls related to incentive structures, investment banking and research business lines, information leakage and position valuation.

Management of Conflicts of Interest

- **Incentive Structures.** In 2016, FINRA will complete the targeted examination it launched in 2015 regarding incentive structures and conflicts of interest in connection with member firms’ retail brokerage business. FINRA’s review in this area includes firms’ conflict mitigation processes

regarding compensation plans for registered representatives and firms' approaches to mitigating conflicts of interest that arise through the sale of proprietary or affiliated products or products for which a firm receives third-party payments.

- **Investment Banking and Research Business Lines.** FINRA will assess whether firms' research analysts are inappropriately involved in their investment banking activities and whether investment banking personnel exercise undue influence on analysts.
- **Information Leakage.** FINRA will assess firms' controls to identify, minimize and mitigate information leakage within or outside a firm. FINRA stated that this type of leakage could occur in a variety of contexts, including inappropriate information leakage between different areas of a firm's trading activities, between a firm's trading activities and other parts of a firm, and through the front-running of pending rating changes.
- **Position Valuation.** FINRA will focus on assessing firms' supervision, control and validation of traders' pricing of illiquid, level 3 assets to ensure positions are fairly valued and, if necessary, expand the scope of examinations to determine whether traders or managers engaged in non-*bona fide* valuations to enhance compensation or other benefits.

Technology

- **Cybersecurity.** FINRA will review firms' approaches to cybersecurity risk management and, depending on a firm's business and risk profile, also examine governance, risk assessment, technical controls, incident response, vendor management, data loss and staff training. FINRA will also consider examining firms' abilities to protect confidentiality, integrity and availability of sensitive customer and other information. FINRA will also assess high-frequency and proprietary trading firms' ability to protect their systems from unauthorized accesses that could be used to affect the market.
- **Technology Management.** As a result of observed shortcoming in firms' management of technology systems, deficiencies in firms' risk management practices and insufficient user acceptance testing and quality assurance, FINRA will examine firms' technology governance and change management

practices and, where applicable, incorporate new system implementation reviews.

- **Data Quality and Governance.** FINRA will examine firms' data governance, quality controls and reporting practices to ensure the accuracy, completeness, consistency and timeliness of data reported to firm management and to firms' surveillance and supervisory systems.

Outsourcing

FINRA will focus on firms' due diligence and risk assessment of providers of outsourced services and their supervision of those services. While certain activities can be performed by third-party providers, FINRA reiterated that the responsibility to supervise covered activities for compliance with applicable laws, regulation and rules remains with the member firm. Firms must avoid outsourcing functions that are required to be performed by qualified registered persons.

AML Controls

- **Suspicious Activity Monitoring.** FINRA will continue to assess the adequacy of firms monitoring for suspicious activity, including surveillance of both money movements and trading activity. These assessments will include firms' monitoring of high-risk customer accounts and transactions, including activity that occurs in cash management accounts where banking services are offered to brokerage customers.
- **Microcap Securities.** FINRA will continue to focus on high-risk activity involving microcap securities. FINRA stated the importance of firms' reviewing deposits of microcap securities to determine compliance with or exemptions from registration requirements. In addition, with respect to customer trading activity in microcap securities, FINRA stated that firms should have processes in place to identify suspicious trading activity.

Liquidity

Because FINRA has identified failures to manage liquidity that have contributed to both individual firm failures and systemic crises, FINRA will continue to review the adequacy of firms' contingency funding plans in light of their business models. FINRA will focus on the adequacy of high-frequency trading firms' liquidity planning and controls given the nature of these firms' businesses and the potential for liquidity challenges. The framework for these reviews will consider many of the

practices identified in FINRA's September 2015 Regulatory Notice, which is described in our Client Alert available [here](#).

Sales Practice

Suitability and Concentration

As part of its previous examinations, FINRA indicated that it has observed firms failing to tailor their systems to the specifics of their product offerings, shortcomings in firms' product review committees and training programs, and deficiencies in firms' ability to adequately monitor for excess concentration. As a result, FINRA will assess firms' policies and processes that govern monitoring for excessive concentrations, as well as suitability determinations for recommended transactions or investment strategies, including whether registered representatives adequately consider, for example, factors such as credit risk, duration and leverage as relevant to specific fixed income, complex and alternative products.

Seniors and Vulnerable Investors

FINRA will continue to make the treatment of senior and other vulnerable investors a priority in 2016. The scope of examinations in these areas will include the suitability and concentration concerns discussed above, as well as recommendations regarding higher-cost products.

Sales Charge Discounts and Waivers

FINRA will continue its focus on member firms' failures to provide appropriate volume discounts or sales charge waivers for products such as mutual funds, unit investment trusts, non-traded real estate investment trusts and business development companies. FINRA pointed to multiple past enforcement actions where firms failed to apply eligible sales charge waivers, including instances where firms systemically failed to apply eligible volume, rollover and exchange discounts to unit investment trust transactions.

529 College Savings Plans

In light of a relatively large amount of C share purchases by customers of 529 college savings plans, FINRA will focus on firms' recommendations of specific share types for customers in these plans to ensure that fee and expense structures are appropriate for such customers, given their investment time horizon and needs.

Private Placements, the JOBS Act and Public Offers

- **Private Placements.** FINRA's focus on private placements will address concerns with respect to suitability, disclosure and due diligence. Examinations in this area will reflect recent regulatory developments, such as the ability to conduct general solicitations in certain Regulation D offerings and the crowdfunding rules which will become effective in 2016.
- **Public Offerings.** Beginning in 2015, firms desiring to participate in public offerings pursuant to the SEC's Regulation A+ amendments must first file with and receive clearance from FINRA. In reviewing such filings, FINRA will consider possible red flags such as the problematic regulatory history of the offering participants, conflicts of interest, non-compliance with escrow requirements and disclosures that indicate inadequate due diligence.
- **Non-Traded REITs, Non-Traded BDCs and Direct Participation Programs.** FINRA stated that it will subject unlisted real estate investment trusts, unlisted business development companies and direct participation programs to rigorous reviews.
- **Excessive Charges to Customers in New Bond Sales.** FINRA will review whether firms have processes in place to ensure that investors in public offerings of bonds are treated fairly, that firms are complying with fair pricing obligations and that they conduct *bona fide* public offerings. FINRA will also assess secondary market trading, particularly by syndicate participants, subsequent to the completion of the offering to ensure customers are receiving fair and reasonable prices.

Outside Business Activities

FINRA will evaluate firms' procedures to review outside business activities as required under FINRA rules. FINRA noted that failure to adequately assess registered representatives' written notifications of proposed business activities is one of the most common examination findings.

Financial and Operational Controls

Market-Maker Net Capital Exemptions

FINRA will focus on whether firms have properly claimed an exemption from and operated consistently with the SEC's net capital requirements for broker-dealers. FINRA will also

assess whether firms are engaged in *bona fide* market-making and permissible hedging transitions under the net capital rule.

Exchange-Traded Funds (“ETFs”)

FINRA will review broker-dealers’ role as authorized participants in the ETF creation and redemption process, including the processes firms use to measure and monitor the impact of overnight counterparty risk, and to reflect this accurately in their net capital computations. FINRA has observed that ETF creation and redemption can expose authorized participants to substantial counterparty risk on an intra-day or overnight basis.

Fixed Income Prime Brokerage

Given anticipated opportunities some firms may realize to enter into or expand their prime brokerage business in the wake of more stringent constraints on bank holding companies, FINRA will focus on settlement practices for fixed income trades to understand how the operational and credit risks are managed when large trades are executed away from the prime broker. FINRA will also review industry practices with respect to disaffirming trades and the legal documentation that supports the settlement process, as well as the financing practices for fixed income where extensive leverage is offered.

Internal Audit

FINRA will focus on the organization and governance of firms’ internal audit functions, including internal audit’s processes for identifying and prioritizing risks, the interactions between the audit committee and the board of directors, the involvement of internal audit in committees and major projects, and the execution of the audit plan specific to coverage of select business and control functions. FINRA will also look at how issues are tracked through resolution and evaluate how internal audit deficiencies are incorporated into business risks.

Client Onboarding

FINRA will assess firms’ policies and controls related to onboarding clients and correspondents. FINRA will review firms’ practices to determine, for example, a client’s credit worthiness and the impact of its trading strategy on that credit worthiness, projected liquidity usage arising from client trading practices, and estimated margin lending requirements (and the impact of that lending on a firm’s capital and liquidity). FINRA will also review how firms aggregate this information to develop an overall risk assessment.

Transmittal of Customer Funds

Following several recent enforcement actions against firms that failed to supervise the transmittal of funds to third-party accounts, FINRA will assess whether firms implement adequate supervisory controls to test and verify systems to prevent the improper transmittal of customer funds. This will include firms’ controls to review and monitor transmittals from customer accounts to (1) third-party accounts that would result in a change of beneficial ownership, (2) outside entities, (3) locations other than a customer’s primary residence and (4) firms’ registered representatives.

Market Integrity

Vendor Display Rule

In line with its December 9, 2015 Regulatory Notice, FINRA reminded firms and registered representatives of their obligations under the SEC’s vendor display rule when providing quotation information to customers.

Market Access

In early 2016, FINRA expects to deliver compliance report cards to firms derived from its cross-market equity manipulation surveillance program and will continue to issue these report cards monthly. FINRA will examine how firms use this new information to take steps to identify and address the potential misconduct.

Fixed Income

FINRA will continue to review fixed income order handling, markups and related controls. FINRA will also focus on wash sales, marking the close and trading ahead. FINRA will also continue to review alternative trading systems.

Regulation SHO

FINRA will assess a firms’ compliance with SEC Regulation SHO, including whether firms are implementing supervisory processes to ensure compliance with the “net-flat” or “net-long” position requirements of Rule 204 of Regulation SHO. In addition, FINRA will evaluate the adequacy of authorized participant controls on exchange traded product redemption orders.

Cross-Market and Cross-Product Manipulation

FINRA will focus on coordinated equity and options market activity designed to create momentary, artificial prices intended to affect the settlement prices of related products.

Audit Trail Integrity

FINRA will focus on identifying potential audit trail issues not typically detected through routine compliance sweeps, including late reporting of TRACE-eligible and municipal securities and errors in the equity audit trail.

Conclusion

Firms should consider the FINRA priorities along with recently released SEC 2016 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.

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