

# Client Alert.

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## FINRA Provides Early Guidance About Its Exam Priorities; Firms Should Take Notice

By Hillel T. Cohn and Kelley A. Howes

In its [annual summary of regulatory and examination priorities](#), the Financial Industry Regulatory Authority (FINRA) signaled that it will aggressively pursue market misconduct. The January 11, 2013 report follows closely on FINRA's recent [announcement](#) of the increased high profile regulatory and disciplinary actions it brought in 2012. Member firms should carefully review their compliance policies and procedures in light of FINRA's stated areas of focus.

Consistent with its mission of protecting investors by ensuring that the securities industry operates fairly and honestly, FINRA's priorities focus heavily on retail investors as well as supervisory issues and regulation and operations of increasingly complex systems, products and markets.

### RETAIL INVESTORS

FINRA is concerned about the potential for sales practice abuses that may result in the current slow growth, low-interest rate market environment. In particular, FINRA believes that member firms and their associated persons may not fully understand the risks inherent in complex products that they offer to retail investors. Accordingly, FINRA will focus its examination efforts on compliance with its recently revised suitability rule ([FINRA Rule 2111](#)).

FINRA emphasized that broker-dealers and their associated persons who sell complex products must adequately understand the products and their inherent risks. This understanding is essential because broker-dealers must have a reasonable basis to recommend a financial product and to evaluate its suitability for a particular customer.

FINRA exams typically will focus on a broker's understanding of the product, due diligence in assessing investors' risk tolerance, and, in keeping with its recent theme of supervising conflicts of interest at broker-dealers, how particular product sales could affect a broker's compensation (for more information on conflicts of interest, see our recent [News Bulletin](#) regarding FINRA's sweep examination). The annual summary also expresses FINRA's concern that brokers may fail to explain to customers the risk-versus-return profile of certain products, and specifies the need to explain the market risk, credit risk and liquidity risk of complex products. FINRA identifies several products, including business development companies (BDCs), leveraged loan products, structured products, exchange-traded products, closed end funds and variable annuities that provide particular opportunities for abuse.

- BDCs, which are a category of closed-end investment companies operated for the purpose of making investments in small and developing businesses or financially troubled businesses, may offer attractive yields through high credit risk exposures amplified by leverage. FINRA believes that BDCs may be over-leveraging their portfolios, and it has particular concerns about risks inherent in non-traded BDCs. (For more information regarding pending legislation related to BDCs and, among other things, their use of leverage, see our [client alert](#) regarding the Next Steps for Credit Availability Act.)

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- Funds that invest in leveraged loans (*i.e.*, floating rate loans extended to companies that have a high amount of debt relative to equity) may be subject to significant credit, valuation and liquidity risks. FINRA is concerned that brokers may not give investors adequate information about the risks inherent in such products, particularly in light of their relative illiquidity and the difficulty in valuing these products.
- FINRA raises issues about sales practices involving structured products, emphasizing that risks of these products need to be adequately disclosed, particularly due to the lack of an active secondary market.
- Exchange-traded products continue to proliferate. FINRA is concerned that retail investors may not fully understand the differences among various types of exchange traded pools and the risks inherent in such products, particularly those that employ leverage. This appears consistent with the Securities and Exchange Commission's recent confirmation that it will continue to impose a moratorium on granting exemptive relief to certain ETFs that use significant amounts of derivatives and leverage.
- Given the low interest rate environment, retail investors may be attracted to closed-end funds' distribution rates. FINRA is concerned that investors may not understand that funds are returning capital to meet the high distribution rates, and that as a result these funds may be trading at an inflated premium to NAV.
- While recognizing that variable annuities may be suitable for investors seeking predictable income streams, FINRA cautions that they may be inappropriate investments for retail investors with relatively short-term liquidity needs. FINRA is focused on the high fees and expenses of these products, and the effect of high commissions generated by these products on switching funds in client accounts.

## SUPERVISORY ISSUES

FINRA highlights concerns about the adequacy of firms' policies and procedures to ensure that high risk activities are conducted in accordance with FINRA rules and the federal securities laws. Microcap fraud, a perennial threat to customer protection and market integrity, is the subject of a list of policies and procedures that are designed to prevent and detect abusive activities. Similarly, FINRA encourages firms to review their information barriers and risk controls to ensure that they are adequate to prevent and detect insider trading, a top regulatory priority for securities regulators. The annual summary provides a helpful list of examples of such controls (for more information on information barriers, see our recent News Bulletin). Other recent FINRA priorities, private placements and anti-money laundering, receive similar treatment. A member firm will benefit from conducting a review of its micro-cap, insider trading, private placement and AML procedures, with FINRA's exam letter as guidance.

## CYBER-SECURITY AND DATA INTEGRITY

FINRA noted its continuing concerns about the cyber-security issues affecting the financial services industry. The increase in frequency and intensity of attacks presents a challenge to broker-dealers, both in terms of potential disruption of service and unauthorized access to customer data. The Notice indicates that FINRA will utilize both examinations and targeted investigations to evaluate the adequacy of firm policies and information technology systems to protect sensitive customer information.

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## MARKET OPERATIONS AND REGULATION

FINRA remains concerned about whether brokers are adequately capitalized and will look at a firm's procedures to ensure that it complies with net capital requirements and the rules designed to protect customer assets. Member firms should review procedures to ensure that they comply with their books and records obligations, securities valuation policies and generally accepted accounting principles (GAAP). In particular, FINRA is focusing on: the treatment of contingencies and guarantees under GAAP; firms' margin lending practices (including whether the margin required by centralized swap clearing facilities is adequate); and whether firms are assessing the liquidity risk inherent in a member firm's balance sheet separately from that of its corporate parent.

FINRA is also looking at how firms supervise the development of algorithms and trading systems. FINRA will carefully assess the adequacy of firms' testing and controls related to high-frequency trading and other trading strategies and systems, and it anticipates targeted investigations related to these trading practices.

Member firms should ensure that they have adopted procedures for testing these trading strategies both pre- and post-launch to ensure they do not result in abusive trading. FINRA identifies particular areas of concern, including:

- "momentum-ignition strategies," including the use of wash sales together with layering trades to give the appearance of bona fide transactions at artificial prices;
- trading activities by sponsored participants that initiate activity from outside the United States; and
- options mini-manipulation strategies.

FINRA also raises concerns about whether alternative trading systems are providing adequate disclosure about their operations to market participants.

FINRA advises member firms that it continues to focus on trading issues, including best execution and fair valuation, in the fixed-income market. It has created surveillance programs that identify troubling patterns involving potentially problematic behavior such as wash sales and marking the close. Finally, FINRA is currently conducting a sweep of firms to help determine the significance of order miscoding in the options industry; it has identified that large options positions reporting is an area of weakness for many firms' compliance systems.

## SOME PRACTICE SUGGESTIONS

Broker-dealers should carefully review FINRA's nine pages of priorities. There is little doubt that, with FINRA's risk-based exam focus, its examiners will have a keen focus on many of these issues when they seek information from you, or arrive at your offices to conduct a cycle exam. Firms should review their systems and procedures using FINRA's priorities as a road map and bear in mind that it is never too late to fix or improve them.

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**Contact:**

**Hillel T. Cohn**

(213) 892-5251

[hcohn@mofo.com](mailto:hcohn@mofo.com)

**Kelley Howes**

(303) 592-2237

[KHowes@mofo.com](mailto:KHowes@mofo.com)

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