

Client Alert

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FINRA Issues a Packed Priorities Letter for 2015

By Daniel Nathan and Kerry Jones

FINRA opened 2015 with a lengthy and ambitious agenda of regulatory priorities. This year's Regulatory and Examination Priorities Letter is much longer than those issued the last two years, and repeats many of those years' priorities, while adding additional products and practices. Amidst this smorgasbord of priorities, several are highlighted in FINRA's accompanying press release, and so might have a favored place at the table:

- sale and supervision of interest-rate-sensitive and complex products, including alternative mutual funds;
- controls around the handling of wealth events in investors' lives;
- management of cybersecurity risks;
- treatment of senior investors; and
- high-risk brokers and removing bad actors from the securities industry.

In the letter, FINRA seeks to unify its priorities around a set of systemic issues that it believes differentiate good firms from non-compliant firms: putting customer interests first; firm culture; supervision, risk management and controls; product and service offerings; and conflicts of interest. FINRA will use data analytics to identify potential problem areas within firms, and expects firms to use similar methods to identify problems themselves.

We summarize below some of the more significant issues raised in the letter, along with our recommendations about how to prepare for a risk-based FINRA examination of these issues. As always, the best way for a broker-dealer to prepare for a FINRA examination and avoid enforcement interest is for the firm to put itself in the head of a FINRA examiner and address the areas that FINRA is likely to examine in light of the firm's business, history and supervisory structure.

SALES PRACTICES

Conflicts of Interest - Since issuing its October 2013 Report on Conflicts of Interest, FINRA often expresses its regulatory concerns in terms of conflicts of interest. While FINRA states in the letter that it has seen recent positive improvement in broker-dealers' focus on conflicts, this continues to be an area of active enforcement.

- **Recommendation**-Almost any broker-dealer activity, and certainly any time that a broker is on the other side of a securities transaction from a customer, might be viewed as presenting a potential conflict of interest. Firms should therefore take a top-down, enterprise-wide approach to identifying and addressing conflicts, and document their efforts. *More helpful information in this regard can be found in our Client Alert.*

Private Placements - FINRA continues to find fault with the due diligence done before private placements, building on themes strongly established in the series of cases related to the failed Medical Capital Holdings and Provident Royalties offerings. This unquestionably will continue to be an area of focus.

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- **Recommendations-**

- Firms must ensure that they are complying with due diligence procedures and acquiring enough information to support a determination that the investment is suitable not only for specific customers but for *any* customer.
- If there is a contingent offering, firms must ensure that investor funds are held in escrow at an independent bank and that if the condition is not met, a rescission offer is properly conducted.

Product-Related Risk Reviews - As in previous years, FINRA lists the products that are causing it the most heartburn, as well as identifying the issues common to all product-related risk reviews: due diligence, suitability, disclosure, supervision, and training. FINRA identifies the following products as being of particular interest:

Interest Rate-Sensitive Fixed Income Securities - FINRA continues to be concerned with the impact of the unusually low interest rate on customers holding interest rate-sensitive products. In 2015, FINRA will be on the lookout for firms with concentrated positions in products that are highly sensitive to interest rates, such as long-duration fixed income securities, high yield bonds, mortgage-backed securities, or bond funds. In particular, FINRA will look closely at floating-rate bank loan funds, which retail investors are increasingly using to protect against the threat of rising interest rates. However, according to FINRA, floating-rate bank loan funds carry risks such as credit and call risk, difficulty with valuation, longer settlement times, and illiquidity, and these risks must be addressed with customers.

- **Recommendation**-In marketing interest rate sensitive products, firms should ensure that their communications with customers, suitability reviews, and broker training address the potential impact of interest rate changes on the price of the product. In addition, firms should ensure that other risks inherent in these products are adequately disclosed.

Variable Annuities - Both new purchase and 1035 exchange variable annuities will be a priority for FINRA in 2015. FINRA's review will include: assessments of compensation structures to determine if they result in improper sale incentives, suitability of recommendations, statements made by registered representatives about these products, adequacy of disclosures made about material features of variable annuities, and an analysis of the design and implementation of procedures firms use to train their employees on compliance. Examinations will particularly focus on the sale and marketing of "L share" annuities.

- **Recommendation**-Firms should have in place compliance procedures and training by compliance personnel to ensure brokers have sufficient knowledge to provide full and accurate disclosure to customers and sell them appropriate products. Supervisors should also have product knowledge to prevent and detect problematic sales.

Alternative Mutual Funds - FINRA plans to increase its review of sales of alternative mutual funds in the wake of an increase in these sales from less than \$50 billion in 2008 to \$300 billion in 2014. FINRA noted that alternative funds are marketed as a sophisticated product that allows retail customers to invest in a hedge-fund like product. FINRA worries that some retail customers may not fully understand how alternative funds could respond to different market conditions.

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- **Recommendation**-Firm communications regarding funds whose strategies involve non-traditional asset classes, non-traditional strategies or illiquid assets must accurately and fairly describe how the products work and that explanation must be consistent with the representations in a fund's prospectus. This can be particularly difficult given the complexity of strategies followed by certain alternative funds. The need for concise risk disclosure in this area has also been identified as a priority of the SEC staff (see our recent [blog entry](#)).

Non-Traded Real Estate Investment Trusts (REITs) - FINRA continues to have concerns with the high fees, liquidity, and valuation difficulty inherent in these products. REITs were a priority last year and as a result new rules were passed by both FINRA and the SEC requiring broker-dealers to provide a more accurate per share estimated value on customer account statements, in addition to other disclosures. These changes will go into effect on April 11, 2016.

- **Recommendation**-Firms should perform due diligence on an ongoing basis for all REITs they recommend.

Structured Retail Products (SRPs) - FINRA is concerned that these complex, less-traditional products present investors with unique or unfamiliar risks, especially given the uncertain impact of a changing interest rate environment. In particular, FINRA will be looking at incentives to increase revenues from product sales through distribution channels that may not have adequate controls and conflicts that might arise where the distributor and wholesaler are affiliated companies.

- **Recommendation**-Wholesalers should have robust Know-Your-Distributor policies and procedures designed to ensure there are adequate controls and systems in place to mitigate the risks created by sales incentives.

Securities-Backed Lines of Credit (SBLOCs) - These are revolving non-purpose loans that allow investors to borrow using fully paid-for securities held in brokerage accounts as collateral. As more firms offer SBLOCs, FINRA is increasing its scrutiny and wants customers to be fully aware of how changing market conditions can lead to collateral shortfalls that may affect their brokerage accounts and their ability to draw on the SBLOC.

SUPERVISION

Timely Reporting of Disclosable Information - FINRA is concerned that firms are not timely filing required U4 and U5 updates. As a result, available information may not be accurate and useful to appropriately advance investor protection. To increase compliance, FINRA will be making changes to its registration review process, rules, and examination program. FINRA will also be checking member firms to ensure they are complying with recent amendments to Rule 3110, which require firms to perform public records checks when registering associated persons to verify the accuracy and completeness of U4 filings. The amended Rule goes into effect in July 2015.

New Supervision Rules - On December 1, 2014, FINRA's new supervision rules came into effect, modifying requirements related to:

1. Supervising offices of supervisory jurisdiction and inspecting non-branch offices;
2. Managing conflicts of interest in a firm's supervisory system;

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3. Performing risk-based review of correspondence and internal communications;
 4. Carrying out risk-based reviews of investment banking and securities transactions;
 5. Monitoring for insider trading, conducting internal investigations and reporting related information to FINRA; and
 6. Testing and verifying supervisory control procedures.
- **Recommendation**-FINRA has flagged these areas as topics it will focus on in its examinations, so firms should review their entire compliance program and make sure it is consistent with the new rules. *For a further discussion of the new rules, see our [Client Alert](#).*

High-Risk and Recidivist Brokers - FINRA continues to increase regulation to protect the public from brokers engaged in misconduct or unreasonably high risk investments. FINRA will continue to use data mining, analytics, specially targeted examinations, and expedited investigations and enforcement actions to remove these high-risk brokers from the securities industry.

- **Recommendation**-Firms should evaluate their hiring policies to determine if they are rigorous enough to ferret out unduly risky brokers before they are hired. Firms also need to adequately supervise their employees to ensure employees are not engaging in these practices. Also, firms should familiarize themselves with the new rules.

Individual Retirement Account (IRA) Rollovers and Other “Wealth Events” - Given the growing number of Americans approaching retirement, FINRA is increasing scrutiny of the controls in place at firms related to wealth events, especially IRA rollovers. In particular, FINRA will be looking at the advice and recommendations made to customers surrounding these rollover events. FINRA will also be looking closely at firm policies to ensure that they appropriately address the unique challenges faced by elderly investors.

- **Recommendations**-
 - Firms should develop policies to ensure compliance with their supervisory, suitability, and disclosure obligations for wealth events. Firms should especially ensure that no communications with customers imply that a retiree’s only sound option is rolling the plan over to an IRA managed by the broker-dealer. *See our [Client Alert](#) for an extensive discussion of this issue.*
 - Firms should train their employees on how to meet the needs of elderly investors, including a discussion of issues surrounding diminished capacity and elder abuse. *For more on this issue see our [Blog Post](#).*

Anti-Money Laundering (AML) - AML will continue to be a major FINRA priority. Twelve years after FINRA first instructed the industry on these requirements, in Notice to Members 02-21, FINRA continues to find substantial gaps in firms’ procedures. FINRA demonstrates the importance of this information-gathering tool by pointing to the over 700 AML referrals to the SEC and other law enforcement agencies last year.

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This year, FINRA will focus on Cash Management Accounts (CMAs) -- brokerage accounts used for activity typically associated with bank accounts -- and in particular the failure of firms to identify potentially suspicious transfers and verify the business purpose of activity conducted through those accounts. FINRA has noticed an increase in microcap activity and foreign currency conversion related to Delivery versus Payment/Receipt versus Payment (DVP/RVP) accounts and wants to make sure firms are monitoring them closely.

- **Recommendations-**

- Firms should monitor accounts carefully to identify potentially suspicious transfers, and surveillance methods should be tailored to the specific risks inherent in a firm's business lines, products, and customer bases.
- In particular, firms should monitor CMA accounts to verify the business purpose of activity conducted through those accounts and monitor DVP/RVP accounts to ensure that securities being sold are registered under Section 5 of the Securities Act of 1933 or the transaction is subject to an exemption from regulation.

Cybersecurity - With FINRA's focus on obtaining information on cybersecurity practices, we anticipate that 2015 will include new suggestions and/or regulations regarding cybersecurity. In particular, FINRA is concerned with cyber-attacks that destroy data, and wants to make sure that the electronic recordkeeping requirements under SEC Rule 17a-4(f) are enough to protect records in the event of a cyber-attack.

- **Recommendation**-Firms should ensure that their cybersecurity policies are ready to handle the cyber threats of 2015. They should also be on the lookout for FINRA's review of cybersecurity policies which is due out the beginning of this year and which will likely include additional suggestions for best practices. *For more recommendations on cybersecurity, see our [Client Alert](#).*

Outsourcing - As firms outsource more key operational functions, FINRA wants to make sure that they know that outsourcing does not diminish a broker-dealer's responsibility to comply with applicable federal security laws and regulations, as well as FINRA and MSRB rules and to supervise a service provider's performance.

CONCLUSION

As firms prepare for 2015, they put themselves in the best position to prepare for examinations and avoid enforcement interest when they are aware of FINRA's priorities. FINRA expects firms to be the first line of defense, so firms need to be monitoring their own data for potential misconduct. Strong internal compliance practices and an awareness of FINRA's examination priorities will help firms position themselves for a 2015 in which stress is limited to the extent possible in a regulated environment.

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