

## Examination Priorities for 2017 from FINRA and OCIE

By Jay Baris, Lloyd Harmetz, and Anna Pinedo

### Introduction

In these uncertain times, the predictability and regularity of the annual priorities letters from FINRA and the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) is well-received. As we discuss below, there were few surprises in the annual priorities letters, with the FINRA and the OCIE letters both discussing mainly topics that have been on the regulators' agenda for quite some time.

In characterizing the topics covered in the FINRA letter, FINRA President Robert Cook noted that the "focus on core 'blocking and tackling' issues of compliance, supervision and risk management." In the cover note accompanying the FINRA letter and in a subsequent speech, Mr. Cook struck a new tone, emphasizing FINRA's renewed emphasis on transparency and engagement. To that end, he committed to sharing with member firms a summary report regarding common exam findings, so that firms can learn from what FINRA is seeing at other firms.

OCIE has, from time to time, released summaries of findings from examinations focused on specific areas of review, which have provided helpful guidance to broker-dealers. For broker-dealers and advisers, both the annual priorities letters add additional details from examinations that provide useful insights that can shape their internal compliance initiatives, as well as inform their reviews of policies and procedures.

### About the Authors

**Jay Baris** is a Partner at Morrison & Foerster LLP, [www.mofo.com](http://www.mofo.com). He can be reached at [jbaris@mofo.com](mailto:jbaris@mofo.com).

**Lloyd Harmetz** is a Partner at Morrison & Foerster LLP. He can be reached at [lharmetz@mofo.com](mailto:lharmetz@mofo.com).

**Anna Pinedo** is a Partner at Morrison & Foerster LLP. She can be reached at [apinedo@mofo.com](mailto:apinedo@mofo.com).

This article was originally published in the February 2017 issue of *NSCP Currents*, a professional journal published by the National Society of Compliance Professionals. It is reprinted here with permission from the National Society of Compliance Professionals. This article may not be further re-published without permission from the [National Society of Compliance Professionals](http://National Society of Compliance Professionals).

### FINRA Annual Regulatory and Examination Priorities Letter

Consistent with its prior practice, FINRA addresses a broad array of topics in its priorities letter. However, it is important to note that the tone of this year's letter is somewhat different from the tone in prior years. In this letter, FINRA shares insights from its examinations. FINRA also notes that it has enhanced its risk-based surveillance and examination programs in order to apply a consistent approach nationally and focus on material conduct issues based on its assessments, which has, in FINRA's view, resulted in better-tailored examinations. These examinations will be supplemented by new electronic, off-site reviews that will focus on specific areas of concern. Initially, the off-site reviews will be introduced with a small number of firms that were not scheduled for a cycle exam in 2017. Below, we discuss a number of areas that may be of particular interest to a number of market participants, including some specific items that FINRA raises in its letter.

### High-Risk and Recidivist Brokers

Consistent with its recent inquiries regarding firm culture and hiring practices, FINRA will focus on the hiring and monitoring of "high-risk and recidivist brokers." FINRA will establish a dedicated exam unit to identify brokers that may pose high risks; this unit will review the interactions of the high-risk brokers with customers, including their compliance with know-your-customer and suitability obligations, their outside business activities, their private securities transactions, and commissions and fees. FINRA also will explore the implementation by member firms of supervisory and compliance controls for recidivist individuals. The letter indicates that FINRA will, among other things, review whether a firm or a third-party agent reviews available public records to verify the accuracy of the relevant individuals' form filings. FINRA will also scrutinize applications by firms to associate with statutorily disqualified persons. Finally, FINRA will evaluate firms' branch office inspection programs and the supervisory systems for branch and non-branch locations. In the context of these reviews, FINRA notes that it will focus on supervision of account activity, advertising and communications with customers, including social media, the use of websites, outside business activities, the use of consolidated account statements, and operational activities.

### Sales Practices

**Senior Investors.** FINRA continues to take a strong interest in protecting senior investors. FINRA's concern arises from its observations that brokers have continued to recommend unsuitable products to senior investors, including complex or

novel exchange-traded products, structured products, leveraged and inverse exchange-traded funds, non-traded REITs, and non-traded BDCs. FINRA also notes that it will focus on instances of microcap fraud and boiler room schemes, because it has observed an increase in such activities in recent years and senior investors often fall prey to these schemes. In fact, various FINRA enforcement actions have begun with a review of sales of products that are unsuitable for senior investors.

As a result, in its examinations, FINRA will assess the supervisory controls that are in place in order to prevent problematic sales practices. FINRA reminded firms of a variety of tools that can be used to help protect elderly clients from exploitation under questionable circumstances, including contacting the investor about orders placed through an online brokerage account, or about instructions to transfer funds to persons who may be linked to an issuer.

*Product Suitability and Concentration.* FINRA remains concerned that brokers are recommending unsuitable complex products to customers. Accordingly, examinations will assess how firms discharge their reasonable basis and customer-specific suitability obligations. The letter notes:

...we will assess how firms conduct reasonable-basis and customer-specific suitability reviews. This may include examining firms' product vetting processes, supervisory systems and controls to review recommendations. Firms should be attentive to the adequacy of their supervision and training when new products come to market, new features of existing products are introduced or market conditions change in ways that could affect product performance. Firms that hire registered representatives who sell products with which the firm is not familiar should educate themselves on the products and then carefully evaluate their ability to supervise recommendations. Training should ensure that registered representatives, compliance and supervisory staff understand the objectives, risks and pricing factors of the products sold, including any changes in the features of those products.

FINRA will also focus on the controls that brokers use to monitor recommendations that could result in excess concentration in client accounts.

### **Excessive and Short-Term Trading of Long-Term Products**

FINRA will evaluate firms' ability to monitor the short-term trading of long-term products. FINRA's concern is that registered representatives may recommend that clients trade long-term products, including mutual funds, closed-end funds, and UITs, on a short-term basis, resulting in increased costs to clients or other adverse results. This review follows on the heels of FINRA's September 2016 targeted exam relating to UIT rollovers. FINRA believes that some registered representatives use early UIT rollovers to increase their sales credits to the detriment of clients.

In addition, FINRA urges firms to evaluate whether their supervisory systems can detect activity intended to evade automated surveillance for excessive switching activity. For example, FINRA believes that some registered representatives

may be switching customers across products to evade surveillance that focuses on switching within the same product class.

### **Outside Business Activities and Private Securities Transactions**

FINRA will evaluate procedures used to vet whether a registered representative may engage in an outside business activity. FINRA also will focus on the procedures employed to track investments in private securities transactions.

### **Social Media**

FINRA will review firms' compliance with their supervisory and record-retention obligations with respect to social media and other electronic communications.

### **Financial and Operating Risks**

*Financial Stability.* The FINRA letter addresses a number of issues related to member firm financial stability and continuity planning. For example, FINRA notes that it will review the funding and liquidity plans of member firms in order to ensure that firms are able to withstand periods of financial stress, and to determine whether firms have adequate contingency funding plans. The letter references Regulatory Notice 15-33, which was directed at senior managers and risk officers of firms that hold inventory positions or that clear and carry customer transactions. In the Regulatory Notice, FINRA reported on the practices it found effective from a liquidity management perspective based on a review of practices at 43 firms from 2014 to 2015 related to managing liquidity needs under a stressed environment. FINRA also notes that it will ask a select group of firms how they would react to specific stress scenarios in order to understand better their financial risk management approach. FINRA also will review compliance with certain margin requirements for covered agency transactions.

*Cybersecurity.* The priorities letter highlights as a key operational risk cybersecurity threats, and notes that it has observed in its examinations repeated cybersecurity control shortcomings. As a result, FINRA will review, among other things, methods for preventing data loss, controls used to monitor and protect data, firm management of vendor relationships, and the controls used to protect sensitive information from insider threats.

*Supervisory Controls Testing.* FINRA will assess the effectiveness and regularity of the testing of internal supervisory controls. The FINRA letter notes that during examinations, FINRA has observed breakdowns of systemic controls as a result of significant changes in a firm's business and operations, as well as in connection with the implementation of new compliance systems.

*Customer Protection and Segregation of Client Assets.* As evidenced by recent enforcement actions, regulators are focused on compliance with firm obligations to protect customer assets, including policies and processes used to identify which securities are held in custody, compliance with reserve and segregation requirements, and related matters.

*Regulation SHO.* FINRA indicates that it will continue to assess firms' compliance with SEC Regulation SHO. The letter notes:

In light of recent SEC enforcement actions, FINRA will focus on the locate process to ensure firms have reasonable grounds to believe securities are available for borrowing prior to accepting a short sale. FINRA will assess firms' preparation and use of the easy-to-borrow list as well as evaluate the adequacy of firms' automated locate models. FINRA has observed fails-to-deliver on settlement date, when locates are granted without the requisite reasonable grounds to believe that the security could be borrowed. Firms should continue to monitor their close-out processes and ensure that they appropriately close out fails-to-deliver by the designated close-out date pursuant to Rule 204 of Regulation SHO.

*Anti-Money Laundering and Suspicious Activity Monitoring.*

Both FINRA and the SEC remain actively focused on anti-money laundering programs. The FINRA letter cites shortcomings observed during examinations, including gaps in automated trading and money movement surveillance systems caused by data integrity problems, poorly set parameters, or surveillance patterns that fail to capture suspicious microcap activity. We discuss below the OCIE letter addressing suspicious activity reporting, which raises concerns consistent with those raised by FINRA.

*Municipal Advisor Registration.* FINRA will focus on whether certain entities have failed to register correctly with both the SEC and the Municipal Securities Rulemaking Board, whether the firm information is properly updated, whether all of the individuals involved in municipal advisor activity are properly identified, and whether firms are providing services under permitted exemptions and exclusions from the registration requirements.

### **Market Integrity**

*Manipulation.* The letter discusses the importance of deterring manipulation. In that regard, FINRA notes that it has amended its Order Audit Trail System (OATS) rules to require alternative trading systems to submit broader order book information to OATS and to require FINRA member firms to capture in their OATS reports the identity of non-FINRA member firms participating on the OTC market. In its examinations, FINRA will assess compliance with these reporting requirements. FINRA also monitors other activities that may indicate manipulative behavior, such as aggressive and dominant trading on one side of the market to benefit a position on the other side of the market, monitoring of layering and spoofing activity, and other potentially manipulative trading practices.

*Best Execution.* The FINRA letter reminds member firms of their best execution obligation for equities, options, and fixed income transactions.

*Market Access Rule.* The FINRA letter notes that member firms need to do a better job evidencing their compliance with the Market Access Rule, and suggests various improvements that can be undertaken, such as better documenting market access controls, providing the rationale for decisions regarding setting controls, identifying the individuals responsible for monitoring

controls, monitoring the effectiveness of the controls employed, etc.

### **The OCIE Priorities Letter**

OCIE's National Examination Program announced that its examination priorities in 2017 will focus on three general areas: retail investors, risks specific to elderly investors and retirement investing, and assessing market-wide risks.

### **Protecting Retail Investors**

Consistent with the Commission's heightened concerns in recent years regarding the sale of complex products to retail investors, the sale of alternative investment products to retail investors, and advice provided to retirement accounts, OCIE identified several examination initiatives that are all designed to address potential dangers faced by retail investors, including the following:

*Robo-advisers.* For the first time, OCIE will focus on investment advisers and broker-dealers that provide automated online investment advice, including so-called "robo-advisers." OCIE will likely examine compliance programs, marketing practices, the formulation of investment recommendations, data protection, and conflicts of interest disclosures. OCIE also intends to review compliance practices for overseeing the advisers' algorithms that generate investment recommendations. As robo-advisers grow in popularity, so will the regulatory focus.

*Wrap Fee Programs.* OCIE will expand its focus on wrap fee programs, which charge investors a bundled fee for advisory and brokerage services. Examinations will focus on investor suitability, disclosures, and conflicts of interest. Some wrap fee programs in the past have been scrutinized for "reverse churning," a practice that minimizes trades in a client's account in an effort to reduce out-of-pocket expenses to an adviser charging a fixed fee. This focus is consistent with OCIE's interest in identifying and preventing potential conflicts of interest that concerns about potential conflicts of interest of advisers and broker-dealers that when providing advice to clients.

*Exchange-Traded Funds.* With record inflows into U.S. listed ETFs in 2016, it is no surprise that OCIE has identified as a priority a review of the sales practices and disclosures involving ETFs, as well as a review of the manner in which ETFs comply with SEC exemptive orders. The OCIE release also notes that examinations will consider the suitability of recommendations to purchase ETFs with niche strategies. This is consistent with the questions raised by SEC representatives as to whether retail investors understand more complex or alternative trading strategies.

*Never-Before-Examined Investment Advisers.* OCIE will expand its focus on newly formed advisers and those that have never been examined. In 2014, OCIE sent a letter to registered investment advisers that it has never examined, with priority to advisers that have been registered for more than three years. The letter put these advisers on notice that they can expect an OCIE visit soon, and explained that the examinations will focus on compliance programs, filings and disclosure, marketing



efforts, portfolio management and custody of assets, among other things.

*Recidivism.* OCIE will step up its attempts to identify individuals with a track record of misconduct at investment advisers and broker-dealers, as well as the diligence efforts undertaken by the advisers and broker-dealers that employ them. Recidivism also was a focus during last year's exam cycle.

*Multi-Branch Advisers.* OCIE will continue to focus on advisers that provide advisory services from multiple locations. In 2016, OCIE published compliance guidelines for multi-branch advisers, which provide some insight regarding OCIE's areas of concern. As a result of an increase in the number of advisers that maintain branch offices and have geographically dispersed locations, OCIE believes that there may be compliance risks. OCIE seeks to understand the adequacy of compliance and supervision policies and procedures, especially under circumstances in which those responsible for testing and enforcing the policies may be in a different physical location.

### **Senior Investors and Retirement Investments**

As discussed above, for some time now, NASAA, FINRA, and the SEC's Division of Enforcement have focused on cases involving sales of securities to at-risk investors, including senior citizens. In 2015, OCIE announced its multi-year Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative. The initiative focuses on the types of services offered by investment advisers and broker-dealers to investors with retirement accounts. In this year's letter, OCIE notes that the examination will consider recommendations relating to variable insurance products and target date funds in retirement accounts. OCIE also will look at how pension plans of government entities manage conflicts of interest in managing retirement assets and focus on "interactions" with senior investors with a view to identifying "financial exploitation."

### **Market-Wide Risks**

Consistent with last year's letter, OCIE again has identified a number of market structure risks that will be considered during examinations.

*Money Market Funds.* OCIE will focus on how money market funds comply with recent changes to the rules that govern them, including the amendments that became effective in October 2016. OCIE will peak inside the boardroom to assess how fund boards oversee fund compliance with the new money market reform rules, especially policies and procedures relating to stress testing and reporting.

*Payment for Order Flow.* OCIE will focus on ensuring that broker-dealers comply with their duty to seek best execution when routing customer orders for execution, a perennial favorite issue for examiners.

*Clearing Agencies.* Using a risk-based approach, OCIE will continue to focus on "systemically important" clearing agencies pursuant to the authority granted to the SEC by the Dodd-Frank Act. In September 2016, the SEC adopted a final rule with an April 2017 effective date that establishes standards for the operation and governance of "covered clearing agencies."

Systemically important clearing agencies are subject to requirements regarding governance, recovery planning, risk management, and disclosures to market participants.

*FINRA.* OCIE will enhance its oversight of FINRA, including inspections of FINRA's operations and regulatory programs, with a focus on assessing how well FINRA examines individual broker-dealers.

*Regulatory Systems Compliance and Integrity (SCI).* In 2014, the SEC adopted Regulation SCI, which applies to SCI entities, which include certain self-regulatory organizations, including registered clearing agencies, alternative trading systems, plan processors, and exempt clearing agencies. These SCI entities are required to design, develop, test, and maintain surveillance systems, as well as to comply with SEC requirements related to stress tests, collection of market data, and other detailed obligations. OCIE will step up examinations of SCI entities to ensure the integrity and efficiency of their systems.

*Cybersecurity.* Cybersecurity continues to be a top priority of OCIE examiners.

*National Securities Exchanges.* OCIE will continue risk-based examinations of national securities exchanges, focusing on operational and procedural controls.

*Anti-Money Laundering (AML).* OCIE will review broker-dealer AML programs in order to ensure that these programs are tailored to address the specific risks that a firm faces. OCIE will review how broker-dealers monitor suspicious activity at the firm and compliance with the requirement to file suspicious activity reports ("SARs"). Recent FINRA and SEC enforcement actions have targeted non-compliance with SAR filing requirements and have identified other compliance violations through a review of SAR filings.

### **Other OCIE Initiatives**

OCIE will also allocate resources to examinations of municipal advisors, transfer agents, and private fund advisers. In connection with examinations of transfer agents, OCIE will focus on transfer agents that serve microcap issuers in order to detect issuers engaged in unregistered securities offerings. Recent SEC enforcement efforts have highlighted many instances of microcap fraud.

### **Conclusion**

The exam priorities have a broad scope. Broker-dealers and investment advisers likely will draw from a broad array of compliance, sales and operational areas to address the issues that FINRA and OCIE raise in their examinations. The exam priorities address not only the recurring legal issues that form the bread and butter of the work of compliance personnel, but a variety of other financial, trading, operational and technology areas as well. Accordingly, we encourage firms to review the exam priorities set forth in these letters across a broad cross-section of personnel, with a view to assessing how well a firm, and its policies and procedures, would pass muster under the rules and expectations of these regulators. ★