Financial Industry Regulatory Authority Issues Its 2018 Examination Priorities

On January 8, the Financial Industry Regulatory Authority (FINRA) released its annual Regulatory and Examination Priorities Letter (Letter) to highlight risks that FINRA believes could adversely affect investors and market integrity. FINRA will focus on these issues during its 2018 broker-dealer examinations. Similar to the previous year’s Letter, FINRA’s commentary reflects a transparent and cooperative spirit, as it gives serious consideration to feedback received during its current self-evaluation and organizational improvement initiative called FINRA360. The Letter highlights FINRA’s efforts to foster an ongoing dialogue with the securities industry and touts FINRA’s recent improvements to its examination processes and surveillance systems. The Letter also recognizes that FINRA must work to become a more effective and efficient self-regulatory organization by leveraging the expertise of member firms, especially when it comes to understanding new technologies and financial developments.

The Letter follows closely on the heels of the FINRA Examination Findings Report issued in December. The Examination Findings Report provided summaries of exam findings and common pitfalls to avoid. The findings were largely consistent with the priorities identified at the start of the year in the 2017 Priorities Letter. FINRA should be commended for its efforts in providing firms practical guidance outside of an enforcement context.

As always, firms should use the Letter to review their compliance and supervisory procedures carefully and make any necessary revisions. Firms also should be prepared to address their compliance and supervisory policies in these areas in their upcoming FINRA examinations. The following is a discussion of some of the more important points of the FINRA Letter.

**Fraud**

As mentioned in last year’s Letter,¹ FINRA intends to focus on microcap “pump and dump” schemes, especially those that target elderly investors. FINRA will employ new strategies and new rules, including Rule 2165 (Financial Exploitation of Specified Adults) and amendments to FINRA Rule 4512 (Customer Account Information), in furtherance of this goal. Regarding microcap stocks generally, FINRA will investigate brokers who use their own or their customers’ accounts to coordinate trading in microcap stocks with known or unknown counterparties, as this may be a strong indicator of participation in a fraudulent

---

scheme. Many of these matters are conducted by the Office of Fraud Detection and Market Intelligence (OFDMI). FINRA notes that it has recently made hundreds of referrals to the U.S. Securities and Exchange Commission (SEC) related to microcap schemes and other fraudulent activity such as insider trading, Ponzi-type schemes and issuer fraud.2

**High-Risk Firms and Brokers**

Consistent with last year’s Letter is FINRA’s focus on identifying high-risk firms and brokers. FINRA will continue to review firms’ controls regarding brokers’ outside business activities and will also review firms’ hiring and supervisory practices for high-risk brokers. The Letter mentions firms’ obligation to implement heightened supervisory procedures under Rule 3110 for high-risk individuals and specifically calls attention to firms’ remote supervision arrangements, supervision of point-of-sale activities and branch inspection programs.

Consistent with FINRA’s goal to identify financial exploitation of the elderly, FINRA intends to examine high-risk brokers’ recommendations for speculative or complex products to investors who may not have the necessary sophistication or experience or whose investment objectives are inconsistent with these products. In addition, FINRA will review situations where brokers act as a trustee or hold power of attorney over customer accounts or have future rights to customer assets as a named beneficiary on customer accounts.

**Operational and Financial Risks**

*Business Continuity Planning*

FINRA will review firms’ business continuity plans (BCPs) to determine how and under what circumstances firms activate their BCPs, how firms classify their systems (critical or secondary) and how firms coordinate with their affiliates and vendors during a business disruption. FINRA will also review firms’ recovery plans. Firms should maintain BCPs that are reasonably designed to enable them to meet their existing obligations to customers during a business disruption pursuant to Rule 4370.

*Customer Protection and Verification of Assets and Liabilities*

In 2018, FINRA will evaluate whether firms have implemented adequate controls to protect customer assets and have kept adequate financial records to verify their ability to protect those assets. FINRA will also assess whether firms maintain sufficient documentation to demonstrate that securities are held free of liens and encumbrances as required by SEC Rule 15c3-3. Focusing on foreign custodians, FINRA will assess whether firms’ foreign depositories, clearing agencies and custodial banks are good control locations under Rule 15c3-3 by reviewing the underlying arrangements with foreign custodians.

*Technology Governance*

In its Letter, FINRA notes that some firms have encountered issues due to faulty implementation of new systems or enhancements to existing systems. In 2018, FINRA will review firms’ technology management policies. FINRA observes that maintaining strong controls over technology changes is key for firms to

---

2 Although the numbers for 2017 are not publicly available, the FINRA website indicates that in 2016 alone, OFDMI made 785 referrals to the Securities and Exchange Commission (SEC) and others based on fraud surveillance, insider trading, “private investment in public equity” surveillance, and Office of the Whistleblower, and 435 insider trading referrals to the SEC. See referral information, available at [http://www.finra.org/industry/ofdmi](http://www.finra.org/industry/ofdmi).
prevent inaccurate, incomplete, untested or unauthorized changes to critical systems and production environments.

Cybersecurity

FINRA has made cybersecurity one of its points of emphasis in recent years by highlighting cybersecurity issues in multiple Exam Priorities Letters, a Special Report, and its recent Examination Findings Report. FINRA’s 2018 Letter echoes these previous publications and states that in 2018, FINRA will evaluate the effectiveness of firms’ cybersecurity programs to protect sensitive information, reviewing firms’ preparedness, technical defenses and resiliency measures, among other things. Firms should refer to the Exam Priorities Letters and the Special Report to assist in establishing effective cybersecurity practices.

Anti-Money-Laundering (AML)

FINRA continues to identify concerns related to firms’ AML programs, observing firms’ inadequacies in the following areas: procedures to detect and report suspicious transactions, resources for AML monitoring and independent testing required under FINRA Rule 3310(c). FINRA presented its concerns and recommendations in its recent Examination Findings Report. FINRA’s Letter also highlights risks related to foreign affiliates conducting transactions in microcap, dual-currency securities and activity related to securities-backed lines of credit.

Liquidity Risk

Another of FINRA’s operational/financial points of emphasis is firms’ liquidity planning. The Letter states that FINRA will evaluate whether a firm’s liquidity planning is appropriate for the firm’s business and customers and whether such planning addresses the appropriate scenarios. In addition, FINRA will examine the adequacy of firms’ material stress-testing assumptions; FINRA strongly suggests that firms review Regulatory Notice 15-33 for guidance related to developing liquidity management plans.

Short Sales

FINRA has recently observed instances where firms inappropriately charged inflated rates to customers for loans related to short sales. In 2018, FINRA will review whether firms calculate such rates in a manner consistent with their procedures.

Sales Practice Risks

Suitability

Because of the increase in new classes of financial products, FINRA will concentrate its attention on how firms identify products subject to new product approval and the controls that firms put in place to review

6 Id.
whether personnel make suitable recommendations, especially recommendations involving newly created complex products as well as products such as unit investment trusts.

FINRA also plans to conduct suitability review of firms’ practices related to recommendations that investors roll over accounts from employer-sponsored retirement plans to individual retirement accounts because employer plans play such a prominent role in individual retirement planning. In addition, FINRA will review situations where brokers’ recommendations require customers to pay unnecessary fees — for example, recommendations that customers purchase products subject to front-end sales charges with a further recommendation shortly thereafter to transfer the holdings to a fee-based advisory account.

*Initial Coin Offerings and Cryptocurrencies*

FINRA recognizes that regulators have paid significant attention to digital currency assets and initial coin offerings in the past year. FINRA will closely monitor developments in this area, especially if member firms begin to play a role in effecting transactions in such assets.

*Use of Margin*

FINRA has observed situations where brokers have solicited customers to engage in share purchases on margin but were unaware of the risks. FINRA has also recently observed many situations where brokers entered into margin transactions without their customers’ authority. Accordingly, FINRA plans to prioritize the assessment of disclosure and supervisory practices related to margin loans.

*Securities-Backed Lines of Credit (SBLOCs)*

The use of SBLOCs has rapidly increased — therefore FINRA intends to review firms’ compliance with regulatory obligations that apply to them. In particular, FINRA will assess the adequacy of firms’ risk disclosures in multiple areas, including disclosures related to a potential market downturn, rising interest rates and tax implications upon liquidation of pledged securities. Separately, FINRA notes that it will review firms’ controls to prevent unintended dual pledging of collateral securities.

*Market Integrity*

*Manipulation*

The Letter touts FINRA’s new surveillance capabilities developed to detect market manipulation. For example, FINRA recently launched the Cross Market Auction Ramping surveillance system, which leverages machine-learning techniques to identify aggressive and dominant trading surrounding the open or close. FINRA also enhanced its Cross Market Marking the Open and Close and Cross Market Layering surveillance systems for deployment in 2018. FINRA intends to further incorporate machine-learning techniques to develop new surveillance systems as markets evolve.

In 2018, FINRA will launch two new report cards to assist member firms in detecting and preventing potential manipulation:

- The Auto Execution Manipulation Report Card highlighting instances in which a market participant uses non-bona fide orders to move the national best bid and offer (NBBO)
- The Alternative Trading System (ATS) Cross Manipulation Report Card identifying instances in which a market participant engages in potential manipulation of the NBBO to modify midpoint prices on an ATS
FINRA expects its report cards to be integrated into firms’ compliance and supervisory reviews and that any potential violations and deficiencies be addressed.

*Best Execution*

FINRA intends to expand its best execution surveillance program to assess the degree to which firms provide price improvement when routing customer orders for execution or when executing internalized customer orders. FINRA will soon be able to analyze frequency and degree of price improvement provided by brokers compared to other execution venues.

In 2018, FINRA will continue to review how brokers manage the conflict of interest that exists between the duty of best execution and brokers’ financial interests. Part of this review will include whether broker-dealers’ procedures provide for a regular and rigorous evaluation of execution quality. FINRA also will expand execution quality review to include Treasuries, which were required to be reported to FINRA’s Trade Reporting and Compliance Engine (TRACE) beginning on July 10, 2017.

*Regulation SHO*

FINRA plans to place an increased focus on firms’ practices related to Rule 201 of Regulation SHO, which requires firms to develop policies and procedures to prevent the execution or display of a short sale order at a price that is equal to or less than the national best bid when a short sale circuit breaker is in effect for a National Market System security. Firms should develop an appropriate supervisory system to comply with Rule 201 or to determine whether short sale activity in which they participate qualifies for a Rule 201 exemption.

*Fixed Income*

FINRA began surveillance of Treasury data in 2017, following the commencement of trade reporting of Treasuries to TRACE. FINRA is now able to identify instances of late reporting, failing to report interdealer trades, misreporting of interdealer trades and inaccurate execution time reporting. As such, FINRA will expand examinations to include Treasury securities when reviewing for complete, timely and accurate reporting of TRACE-eligible securities.

FINRA announced that it expects to launch a new Fixed Income Mark-up Report Card. The Report Card will provide information to firms (e.g., median/mean percentage markups for each firm) and to the industry based on certain criteria such as investment rating and length of time to maturity. This is a welcome development because until now firms, in some instances, have been made aware of FINRA determinations of unreasonable markups only in an examination and/or enforcement setting. The provision of this information combined with the new FINRA/Municipal Securities Rulemaking Board markup disclosure rules should serve as a significant benefit to the investing public and industry participants.

*Options*

FINRA developed new surveillance systems in 2017 to detect potential front-running in correlated options products and will remain focused on this area in 2018. FINRA will also focus on “marking the close” schemes where individuals post orders immediately prior to market close with the intent to affect the NBBO at the end of the trading day. In addition, FINRA will conduct reviews of potential violations of Securities Exchange Act (SEA) Rule 14e-4, which governs partial tender offers.
Market Access

FINRA will maintain focus on broker-dealers’ compliance with SEA Rule 15c3-5 (the Market Access Rule). FINRA’s Letter instructs firms to review the Examination Findings Report for additional information about FINRA’s observations regarding concerns and effective practices related to Market Access Rule issues.

ATS Surveillance

FINRA will review ATSs’ supervisory systems, continuing to focus on reviews/examinations opened because of surveillance alerts related to ATS activity. FINRA notes that as registered broker-dealers and FINRA members, ATSs must maintain supervisory systems that are reasonably designed to achieve compliance with applicable laws and regulations.

Conclusion

Although FINRA’s Letter appears to reflect a cooperative tone, it is nonetheless important for firms to review whether their compliance programs incorporate guidance from the Letter and other recent FINRA publications. As reflected in the FINRA Examinations Finding Report, its exam findings in 2017 closely mirrored the issues identified in the 2017 Priorities Letter. Firms should review their policies and procedures in each of the priority areas and should make revisions where appropriate in preparation for their next examination.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work or James Brigaglano
Partner
jbrigaglano@sidley.com
+1 202 736 8135

W. Hardy Callcott
Partner
hcallcott@sidley.com
+1 415 772 7402

Kevin J. Campion
Partner
kcampion@sidley.com
+1 202 736 8084

Michael D. Wolk
Partner
mwolk@sidley.com
+1 202 736 8807

Timothy B. Nagy
Counsel
tnagy@sidley.com
+1 202 736 8054

Andrew J. Sioson
Associate
asioson@sidley.com
+1 202 736 8351

Sidley Securities & Derivatives Enforcement and Regulatory Practice

Sidley’s Securities & Derivatives Enforcement and Regulatory group advises and defends clients in a wide range of securities- and derivatives-related matters. With more than 150 lawyers in 10 offices worldwide, we provide comprehensive regulatory, enforcement, and litigation solutions in matters involving the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), self-regulatory organizations (SROs), state attorneys general and state securities regulators. Our team is distinctive in that it combines the strength of nationally recognized enforcement lawyers with the skills of equally prominent counseling lawyers. We work collaboratively to provide our clients with informed, efficient and effective representation.

To receive Sidley Updates, please subscribe at www.sidley.com/subscribe.