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Key Takeaways From FINRA's 2016 Priorities Letter

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On Jan. 5, 2016, in an annual tradition, the Financial Industry Regulatory Authority issued its 2016 Regulatory and Examination Priorities Letter. The publication of a list of regulatory and examination priorities for the next year is part of an effort by FINRA, similar to that of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations, to educate and prepare brokers in advance of examinations, rather than to merely play "gotcha!" In addition to announcing broad categories of new priorities for 2016 in the letter, FINRA also emphasized many other areas of focus, several of which are described below in greater detail.

Broad Issues

The letter begins by addressing three broad areas of focus for 2015: (1) culture, conflicts of interest and ethics; (2) supervision, risk management and controls; and (3) liquidity.

Culture, Conflicts of Interest and Ethics

While recognizing that member firms may have different definitions of "firm culture," FINRA nonetheless notes its intent to craft its own definition of firm culture and formalize its assessments of culture in 2016. A firm's culture is identified as a significant factor in how a firm manages conflicts of interest and questions of ethics; accordingly, FINRA will assess five indicators of a firm's culture: (1) whether control functions are valued within an organization; (2) whether policy or control breaches are tolerated; (3) whether an organization proactively seeks to identify risk and compliance events; (4) whether supervisors are effective role models of firm culture; and (5) whether subcultures (e.g., at a branch office, trading desk or investment banking department) that do not conform to firm culture are identified and addressed.

Compliance professionals should note a theme among these indicators — while firm culture may be formally defined at the top of the organization, compliance personnel at all levels share responsibility not only for ensuring that the firm's culture appropriately travels downward throughout the organization, but also for communicating upward regarding violations of firm culture by their superiors — a much more difficult task, certainly. As the indicators make clear, nobody inside a firm's compliance department can abdicate their responsibility to inform their managers of violations, whether those violations come from an employee's supervisors or supervisees.

In a statement on June 29, 2015, on the need to support the role of chief compliance officers, SEC Commissioner Luis Aguilar, responding to an earlier statement by Commissioner Daniel Gallagher, noted that in the case against Pekin Singer Strauss Asset Management on June 23, the SEC suspended the firm's president for 12 months for, among other things, failing to provide the firm's CCO "with sufficient guidance, staff and financial resources, despite the CCO's pleas for help." There was no charge against the CCO. It is fair to assume that FINRA will examine the adequacy of the compliance resources available to the CCO.

Supervision, Risk Management and Controls

Noting that FINRA rules require firms to maintain systems to supervise activities of their associated persons to assist the firm in complying with securities laws and FINRA rules, the agency will focus on four areas where it has observed repeated concerns regarding firm business conduct and market integrity: management of conflicts of interest (in particular, a firm's incentive structures); technology (with an emphasis on cybersecurity); outsourcing (reminding firms that they remain responsible for supervision of third parties); and anti-money laundering (particularly, where certain customer transactions are automatically excluded from portions of AML surveillance, the reasoning for the decision should be documented for FINRA to check).

Liquidity

Noting that the failure to adequately manage liquidity by some firms has led to financial failure and systemic crises, FINRA said that it will continue to focus on firms' liquidity risk management practices, guided by the framework established by the agency in its Regulatory Notice 15-33. FINRA also plans to emphasize the adequacy of liquidity controls at high-frequency trading firms, given the ability of high frequency trading to have sudden effects on market liquidity.

Other Areas of Focus

FINRA also identified other areas of focus in the letter, including the following areas of particular relevance to compliance personnel.

Suitability and Concentration

FINRA notes that effectively discharging suitability obligations is a fundamental duty, particularly in the context of higher-risk products, such as interest rate-sensitive and alternative products. The agency has observed that the product review committees and training programs of many firms do not go far enough in educating employees about the potential risks of these products, and will continue to examine this shortfall. Relatedly, FINRA has noted that some member firms have failed to avoid excess concentration in products identified as higher-risk, which raises suitability issues and may exacerbate the effects of periods of market stress.

It is noteworthy that FINRA also identifies alternative mutual funds, emerging market funds and nontraditional exchange-traded products (ETPs) as potentially "high-risk" investments. The SEC regulates many of these products (some ETPs are excluded), and it will be interesting to see how FINRA adjusts its examination procedures for certain nontraditional ETPs and alternative mutual funds in light of the SEC's Dec. 11 proposal to adopt new Investment Company Act Rule 18f-4 limiting the use of derivatives by mutual funds and ETFs.

Private Placements, the Jobs Act and Public Offerings

FINRA's examinations of private placements will emphasize concerns regarding suitability, disclosure and due diligence, and will particularly reflect the recent development of the permissibility of general solicitation pursuant to Rule 506(c) of Regulation D under the Securities Act of 1933. The agency will also review clearance filings made pursuant to the so-called Regulation A+ amendments of the Jobs Act, including reviewing the regulatory histories of issuers, insiders and broker-dealers involved in the placements; monitoring noncompliance with escrow agreements; and checking indicators of inadequate underwriter due diligence. The agency will also more broadly track the development of the Jobs Act's incipient public offerings market.

Nontraded REITs and Direct Participation Programs (DPPs)

FINRA notes that many sponsors of nontraded real estate investment trusts and DPPs, in anticipation of the agency's Customer Account Statement Rule and DPP Rule (each going effective in April 2016), have restructured their products and added new share classes. These sponsors are also offering unlisted business development companies (BDCs) to their product lines. Noting that each of these new products will be available to retail investors, who may be vulnerable to the complexity, high fees and illiquidity of these investments, the agency will subject these products to "rigorous reviews."

Outside Business Activities

FINRA plans to focus on evaluating firm procedures related to outside business activities (OBAs), as required by FINRA Rule 3270 or, where applicable, Rule 3280, which requires firms to determine whether OBAs should be treated as a private securities transaction. Some firms with registered representatives who also act as investment adviser representatives of an affiliated or third-party investment adviser have already been examined with respect to their supervision of the advisory activities of those representatives. In Notice to Members 91-32 and 94-44, FINRA (then the NASD) announced its conclusion that placing orders for an advisory client is a "private securities transaction" if done for compensation, which it almost always is. OBAs do not require the same level of supervision as private securities transaction, but in Regulatory Notice 12-25, providing further guidance on the newly amended suitability rule, Rule 2111, FINRA warned of the obligation of firms to monitor situations involving the overlap of securities and nonsecurities transactions (see question 10). Such would be the case, for example, where a registered representative recommends that a customer place a second mortgage on her house in order to purchase securities. With respect to OBAs, the agency notes that one of its most common exam findings is firms' failure to adequately assess their registered representatives' written notifications of OBAs.

Client Onboarding

Noting that firms facing capital and liquidity issues generally have poor practices related to onboarding professional clients (e.g., institutional, trading, hedge fund and broker-dealer clients), FINRA will assess member firms' client onboarding policies and controls. In addition to examining practices related to onboarding individual clients, the agency will also review how firms aggregate onboarding information to conduct aggregate risk assessment.

Regulation SHO

The agency will scrutinize member firms' compliance with SEC Regulation SHO (applicable to short sales)

and particularly Rule 204, which requires closeout of fail to deliver positions. The scrutiny comes as a result of FINRA examinations uncovering deficiencies with firms' compliance with the regulation's requirement to be net flat or net long on the Rule 204 closeout date. Additionally, FINRA is concerned about the ability of authorized participants for ETPs to ensure that they have sufficient shares in their possession to prevent overredemptions and potential violations of Rule 204.

Exchange-Traded Funds (ETFs)

FINRA will review broker-dealers' role as authorized participants (APs) in the process of transacting with ETFs in creation and redemption baskets. Because of the rapid growth of the ETF market and the significant role of APs in providing liquidity and structural integrity to the ETF marketplace, FINRA will continue to monitor the credit risk of APs in the creation and redemption process, particularly by monitoring the way APs reflect their counterparty credit risk computations as part of their net capital computations per Rule 15c3-1 of the Securities Exchange Act of 1934.

Conclusion

Though FINRA's 2016 letter contains broad statements of policy concerning culture, risk management and conflicts of interest, FINRA members are encouraged to use as guidance the more specific policies and procedures that the agency plans to implement in enforcing its 2016 examination priorities. Reference should be made to FINRA's regulatory notices and weekly update emails, as well as FINRA's website where appropriate, to keep apprised of developments to, and further explication of, the agency's 2016 priorities. And compliance personnel should take heed of FINRA's stance that ensuring firm compliance is not just the responsibility of supervisors, but of everyone on the compliance team.

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