Report on FINRA Examination Findings

DECEMBER 2018

A REPORT FROM **THE FINANCIAL INDUSTRY REGULATORY AUTHORITY**

Introduction

FINRA's examination, surveillance and risk monitoring programs play a central role in supporting FINRA's mission of investor protection and market integrity. A main component of this program is FINRA's examinations of broker-dealers (firms or members), where FINRA prepares a report—which is available only to the relevant firm—addressing certain aspects of the firm's compliance with specific securities laws and regulations. Firms must address the issues identified by FINRA, and many do so by proactively taking corrective action before we conclude our exam. Through this sort of rapid remediation, firms strengthen their compliance and supervisory programs, which ultimately helps better protect investors and maintain the integrity of the markets.

FINRA is issuing this report as another resource for firms to strengthen their compliance programs and supervisory controls. Some firms have requested that FINRA make publicly available a summary of observations from the firm examination program so they can further improve their practices and processes based on the experiences of other firms, as well as better anticipate and address potential areas of concern in advance of their own examinations.

This report focuses on selected observations from recent examinations that FINRA considers worth highlighting because of their potential significance, frequency, and impact on investors and the markets. This report does not represent a complete inventory of observations from all FINRA examinations, nor does it indicate that any specific issues exist at any particular firms. In fact, an individual firm may not have any deficiencies identified in this report, or may have other deficiencies that are not identified. Further, readers should not interpret this report as creating new legal or regulatory requirements or new interpretations of existing requirements.

This report also describes practices FINRA has observed to be effective in certain circumstances, which firms may use as a resource to improve their compliance and supervisory programs. There should be no inference, however, that FINRA requires firms to implement any specific practices described in this report or those that extend beyond the requirements of existing securities rules and regulations.

FINRA expects that this reporting will evolve over time as we work to ensure that it supports firms' compliance, risk management and supervisory efforts. FINRA welcomes feedback on how we can improve the content, structure, format or other elements of future reports on examination findings. If you have suggestions, please contact Carlo di Florio, Executive Vice President, Member Supervision/Shared Services, at (212) 858-3908 or *carlo.diflorio@finra.org*; or Steven Polansky, Senior Director, Member Supervision/Shared Services, at (202) 728-8331 or *steven.polansky@finra.org*.

HIGHLIGHTED OBSERVATIONS

Suitability for Retail Customers

FINRA Rule 2111 (Suitability) establishes a fundamental responsibility for firms and associated persons to deal with customers fairly[1] and is composed of three main obligations: (1) reasonable-basis suitability; (2) customer-specific suitability; and (3) quantitative suitability. FINRA continues to observe unsuitable recommendations by associated persons to retail investors as well as deficiencies in some firms' supervisory systems for registered representatives' activities. Firms should also consider the guidance in *FINRA Regulatory Notice 18-15* to determine whether certain representatives engaging in repeated misconduct should be subject to special supervisory procedures, such as a heightened supervision plan.

FINRA observed situations where registered representatives did not adequately consider the customer's financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs and other investment profile factors when making recommendations; in others, they failed to take into account the cumulative fees, sales charges or commissions. In some cases, unsuitable recommendations involved complex products (such as leveraged and inverse exchange-traded products (ETPs), including exchange-traded funds (ETFs) and notes (ETNs)). In other cases, they involved overconcentration in illiquid securities, variable annuities, switches between share classes, and sophisticated or risky investment strategies. FINRA also remains concerned about recommendations of unsuitable mutual fund share classes and Unit Investment Trusts (UITs), as discussed in the *2017 Report on Examination Findings*. Inadequate product due diligence across product classes, including failure to understand the specific features and terms of products recommended to customers, was a common contributor to the challenges FINRA observed.

FINRA observed that firms with sound supervisory practices for suitability generally identified risks, developed policies, and implemented controls tailored to the specific features of the products they offered and their customer base.[2] These controls included, for example, restricting or prohibiting recommendations of products for certain investors, as well as establishing systems-based controls (or "hard blocks") for recommendations of certain products to retail investors to ensure that registered representatives adhered to those restrictions or prohibitions. Some firms also implemented methods to verify the source of funds for variable annuity transactions. In addition, certain firms required registered representatives, including principals with supervisory responsibilities, to receive training on specific complex or high-risk products before the representatives recommended them so the representatives understood the products' risks and performance characteristics, as well as the types of investors for whom the product might be suitable.

FINRA also observed some firms facing challenges with their supervisory systems and other operational issues relating to quantitative suitability. When a broker-dealer or associated person has "actual or *de facto* control" over a customer's account, there must be a reasonable basis that a series of recommended securities transactions are not excessive and unsuitable in light of the customer's investment profile.[3] Some firms developed parameters for trading volume and cost to identify and prevent excessive trading, as well as restrictions on frequency or patterns of clustered or single product exchanges. In some cases, customers whose accounts breached the firm's thresholds received telephone calls from principals or detailed activity letters setting forth the frequency and cost of trading over specific periods.

Selected Examination Findings

FINRA addressed product suitability in our *2017 Report on Examination Findings*, but we supplement those observations with the following additional insights from recent FINRA examinations, as well as our targeted examination (sweep) of volatility-linked products.

- **Overconcentration –** Some firms maintained customer accounts that were concentrated in complex structured notes or sector-specific investments, as well as illiquid securities, such as non-traded real estate investment trust (REITs), which were unsuitable for customers and resulted in significant customer losses. Some registered representatives recommended structured notes or sector-specific investment strategies to customers who may not have had the sophistication to understand their features and without considering the customer's individual financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs and other investment profile factors. Some recommendations involved illiquid securities with limited price transparency, which made it difficult for investors to know the true value of their investment and led them to believe that their investments would not fluctuate in value. In some instances, firms did not have procedures or systems reasonably designed to identify and supervise the concentration of such products in customers' accounts.
- **Excessive Trading –** Some firms failed to establish and enforce an adequate supervisory system reasonably designed to identify and prevent potentially excessive trading in customer accounts. For example, some firms failed to review account alerts from their clearing firm or use other available compliance tools designed to detect excessive trading, commissions or trading losses in customer accounts. Some firms did not take into consideration the use of joint representative codes by combining all of the activity in each associated person's customer accounts when looking for problematic activity at a customer account level.

  Some firms maintained inadequate written supervisory procedures (WSPs) that, for example, identified key indicators of excessive account activity, but did not establish related specific threshold values or parameters for these indicators. In other instances, the indicators did not allow firms to identify potential quantitative suitability concerns (*e.g.*, identifying active accounts based solely on the quantity of trades executed while failing to consider other pertinent criteria, such as turnover ratio, cost-to-equity ratios, margin balances, total commissions, total fees paid, and profit and loss).

In certain cases, firms had an "active account" letter (sometimes also referred to as an "activity letter")[4] process, but did not adequately supervise that process, resulting in letters that were overly general and failed to include meaningful information regarding the relevant account activity. For example, the letters did not provide specific trading details, such as number of trades, commissions, cost- or commission-to-equity ratios, margin balances and account losses. Other firms provided such details, but failed to share plain language definitions of the data categories or explain why they were issuing the letters. Some firms were inconsistent in their usage of letters, sometimes not issuing active account letters for customer accounts engaged in similar, or even more active trading than accounts receiving such letters. Finally, in some cases, when customers did not return a signed letter, firms failed to follow their own procedures and restrict account activity.

- **Unsuitable Variable Annuity Recommendations –** FINRA observed that some firms failed to establish, maintain and enforce supervisory systems and WSPs reasonably designed to ensure that representatives' recommendations of variable annuities complied with suitability obligations. For example, FINRA observed unsuitable and largely unsupervised representative-driven recommendations to retail customers to exchange one annuity product for another. In many instances FINRA reviewed, the recommended exchange was inconsistent with the customer's objectives and time horizon, and resulted in—among other consequences—increased fees to the customer or the loss of material, paid-for accrued benefits. This occurred, for instance, when a registered representative effected transactions directly with the insurance company. Moreover, some representatives concealed the source of funds used to purchase new variable annuities by having customers take direct receipt of monies from existing securities or annuities, which created the appearance of un-invested cash being used to purchase a new variable annuity and, in some instances, may have resulted in unfavorable tax consequences for the customer.

  In addition, some firms experienced challenges training registered representatives, including those responsible for supervising variable annuity transactions, regarding how to assess fees, surrender charges and long-term income riders to determine whether an exchange was beneficial to a customer. FINRA observed, for example, some registered representatives who used guaranteed income riders[5] to persuade customers to sell or exchange their existing variable annuities, even though the surrender costs or loss of benefits did not support the purchase of or exchange to a new variable annuity. FINRA also observed representatives misrepresenting the cost of variable annuity riders through disclosure forms.[6] In some instances, firm supervision appeared to focus on exchange form completion, as opposed to the substantive factors involved in the decision.

  Finally, FINRA remains concerned about the accuracy and completeness of certain firms' data for annuity products, including general product information, share class, riders and exchange-based activity.

Findings From Targeted Examination of Volatility-Linked Products

During the two trading sessions covering February 5 and 6, 2018, the Dow Jones Industrial Average experienced roughly a 4 percent decline while the VIX rose over 100 percent. Volatility-linked products and, especially, products offering inverse or “short” volatility exposure experienced severe declines in value, with several products in the latter category suffering losses of 80 percent or more.[7] In response, FINRA conducted a sweep to assess the adequacy of firms’ supervisory systems and controls to meet their suitability obligations in connection with recommendations to retail customers regarding volatility-linked products.[8]

Many of the firms FINRA examined had comprehensive WSPs and controls regarding such products. Several firms prohibited or restricted representatives’ recommendations to retail clients for either all or some volatility-linked products, such as inverse or leveraged ETPs or other products. Controls to enforce such restrictions included system-based controls, stringent net worth conditions or other pre-qualification criteria; required signed risk acknowledgement forms; and completed written certifications attesting to customers’ product knowledge. Some firms also required registered representatives who made recommendations regarding volatility-linked products to participate in training that addressed these products’ specific performance and risk characteristics (*e.g.*, the risks of holding the product over an extended period).

Selected Examination Findings

While the observations below focus on volatility-linked products, FINRA urges firms that recommend any complex or risky products, such as leveraged and inverse ETPs, to consider the applicability of the following concerns to their activities. FINRA notes that the supervision of complex products was discussed in previous *Regulatory and Examination Priorities Letters* and *FINRA Regulatory Notices*, such as *FINRA Regulatory Notices* *12-03* and *17-32*.

- **Unsuitable Recommendations –** Despite prospectuses and other materials that included risk disclosures, including explicit warnings about sales to retail customers, some firms nevertheless marketed volatility-linked products to retail customers who did not understand those products’ unique risks and made recommendations that were inconsistent with the investors’ investment profile, including risk tolerance and investment time horizon (*e.g.*, in many of those instances, customers held the securities far longer than the holding periods—frequently one trading day—recommended in the prospectus).
- **Inadequate Due Diligence –** In some cases, firms’ due diligence did not address volatility-linked products’ unique characteristics and risks, such as the potentially magnified impact volatility in the VIX index and VIX futures, as well as operational features of the volatility-linked products themselves, which could affect the products’ performance. As a result, some firms were not aware—either through their own testing and analysis or through reliance on a third party—that volatility-linked products, in particular those offering short-volatility exposure, could be susceptible to steep losses in value within a very short timeframe, even while equity markets experienced relatively moderate declines.
- **Insufficient Systems and Controls –** Some firms did not address the risks of offering complex leveraged, inverse and volatile products, including volatility-linked products, to retail customers. Other firms identified these risks, but lacked the operational capacity to enforce the limited conditions under which they permitted the sale of such products to retail investors. Further, some firms’ controls for volatility-linked products did not comply with the firms’ own WSP restrictions for such products. Other firms did not recognize when a new product on their platform was a volatility-linked product and, as a consequence, did not implement appropriate controls.

Fixed Income Mark-up Disclosure

On May 14, 2018, FINRA and the Municipal Securities Rulemaking Board (MSRB) implemented amendments to FINRA Rule 2232 (Customer Confirmations) and MSRB Rule G-15, which require firms to provide additional transaction-related information to retail customers for certain trades in corporate, agency and municipal debt securities (other than municipal fund securities).[9] This information includes the mark-up or mark-down for principal trades with retail customers that a firm offsets on the same day with other principal trades in the same security. Disclosed mark-ups and mark-downs must be expressed as both a total dollar amount for the transaction and a percentage of prevailing market price (PMP).[10] In addition, for all retail customer trades in corporate, agency and municipal debt securities (other than municipal fund securities), firms must disclose on the confirmation the time of execution and a security-specific link to the FINRA or MSRB website where additional information about the transaction is available, along with a brief description of the information available on the website.

To ensure effective implementation of the rules, firms should consider performing a regular review of confirmations to ensure that they include the new disclosures on all confirmations that require them. In particular, firms should consider reviewing samples of their confirmations for all of the required disclosure elements, including the mark-up or mark-down, the time of execution and the security-specific link (with CUSIP). In addition to sampling and review, correspondent firms should familiarize themselves with their clearing firms' processes for providing mark-up disclosure,[11] and firms that rely on vendors to determine PMP on their behalf should consider similar diligence and oversight over their vendors' processes. Firms should also consider whether they are maintaining consistent and correct disclosures for fixed income transactions executed across different vendors, platforms or trading desks.

Selected Examination Findings

FINRA observed that, in implementing the changes required by the amended FINRA and MSRB rules, some firms faced challenges relating to their confirmation review processes, systems and vendors.

- **Failure to Enter Information Into the Firms' Order Entry Systems –** Some firms' traders did not enter all of the necessary information, such as the PMP, into the firms' order entry systems. As a result, the confirmations included inaccurate mark-ups or mark-downs, or these were not disclosed when required.
- **Improper Adjustments to PMP –** FINRA observed that some firms adjusted the PMP in their order entry systems to subtract registered representatives' concession or sales credit from the mark-up, which resulted in inaccurate disclosures on customer confirmations.
- **Inadequate Disclosure for Trades Conducted on an Agency Basis –** Some firms failed to provide the security-specific hyperlink and time of execution on trade confirmations where the firm acted as agent rather than principal.[12]
- **Failure to Provide Disclosure for Structured Notes –** Some firms failed to provide disclosures on customer confirmations for trades in Trade Reporting and Compliance Engine® (TRACE®)-reportable structured notes because the firms did not realize the notes were subject to FINRA Rule 2232 (Customer Confirmations). In other cases, some clearing firms did not provide the mark-up on confirmations because they did not receive the PMP from the structured note distributors.
- **Incorrect Designation of Institutional Accounts –** Some firms failed to provide disclosures to certain customers because they identified those customers' accounts as "institutional" even though they did not meet that definition in FINRA Rule 4512(c) (Customer Account Information) or MSRB Rule G-8(a)(xi).

- **Improper Security-Specific Hyperlinks and Brief Descriptions –** Several firms failed to include a brief description with the security-specific hyperlink of the type of information that is available on the security-specific web page or did not provide the description "along with" the hyperlink.[13]
- **Vendor Challenges –** Some vendors did not always identify the correct PMP from which to calculate mark-ups and mark-downs. For example, instead of using the prices of a firm's own contemporaneous trades, which were available to be considered, a vendor's program incorrectly identified PMPs using lower levels of the "waterfall" as described in FINRA Rule 2121.02 (Fair Prices and Commissions) or MSRB Rule G-30.06. As noted in FINRA Fixed Income Confirmation Disclosure: Frequently Asked Questions (FAQ) Section 3.6 and MSRB Confirmation Disclosure and Prevailing Market Price Guidance Frequently Asked Questions Section 3.6, whenever firms engage third-party vendors to determine PMP on their behalf, firms retain compliance responsibility and must exercise due diligence and oversight.

Reasonable Diligence for Private Placements

FINRA has observed instances where some firms that have suitability obligations under FINRA Rule 2111 (Suitability) failed to conduct reasonable diligence on private placements and failed to meet their supervisory requirements under FINRA Rule 3110 (Supervision). *FINRA Regulatory Notice 10-22* describes the circumstances under which firms have an obligation to conduct a "reasonable investigation" by evaluating "the issuer and its management; the business prospects of the issuer; the assets held by or to be acquired by the issuer; the claims being made; and the intended use of proceeds of the offering."

FINRA has observed that firms that performed reasonable diligence conducted meaningful, independent research on material aspects of the offering; identified any red flags with the offering or the issuer; and addressed and resolved concerns that would be relevant to a potential investor. Depending on their size, firms' diligence processes included creating a due diligence committee (at larger firms) or otherwise formally designating one or more qualified persons (at smaller firms), and charging them with investigating and determining whether to approve the offering for sale to investors. As part of their process, firms independently verified information that was key to the performance of the offering, and some received support from due diligence firms, experts and third-party vendors.

Further, in offerings involving issuers that were affiliates of the firm or whose control persons were also employed by the firm, firms used the reasonable diligence process to mitigate conflicts of interest, ensured that the offerings were suitable for investors in spite of such conflicts of interest, and developed comprehensive disclosures. Firms also used insights from the diligence analysis to establish post-approval processes and investment limits based on the complexity or risk level of the offering. After the offering, firms conducted ongoing diligence to ascertain whether offering proceeds were used in a manner consistent with the offering memorandum, particularly when the firms engaged in ongoing sales of an offering after initial closing.

FINRA reminds firms conducting diligence required by the reasonable-basis suitability obligation to document both the "process and results" of such reasonable diligence analysis.[14] Although firms may use a risk-based approach to documenting compliance with the suitability rule,[15] even when using such an approach, firms ordinarily would be expected to document their diligence efforts regarding recommendations of private placements.

Selected Examination Findings

FINRA has observed instances where some firms' reasonable diligence was not sufficient in scope or depth to be considered a "reasonable investigation of the issuer and the securities."

- **No Reasonable Diligence –** Some firms failed to perform reasonable diligence on private placement offerings prior to recommending the offerings to retail investors. In some instances, firms performed no additional research about new offerings because they relied on their experience with the same issuer in previous offerings. In other instances, some firms reviewed the offering memorandum and other relevant offering documentation, but did not discuss the offering in greater detail with the issuer or independently verify, research or analyze material aspects of the offerings. FINRA also observed that some firms did not investigate red flags identified during the reasonable diligence process. For example, in offerings involving conservation tax easements,[16] some firms did not investigate red flags that included, but were not limited to, significant risk of the Internal Revenue Service (IRS) disallowing tax deductions, as well as concerns regarding land appraisals.
- **Overreliance on Third Parties –** Where some firms obtained and reviewed due diligence reports provided by due diligence consultants, experts or other third-party vendors, they sometimes did not independently evaluate the third parties' conclusions, respond to red flags or significant concerns noted in the reports, or address concerns regarding the issuer or the offering that were apparent outside the context of the report.
- **Potentially Conflicted Third-Party Due Diligence –** Some firms used third-party due diligence reports that issuers paid for or provided in their due diligence analysis. While some of these reports provided valuable and relatively objective information, in some cases, firms did not consider the related conflicts of interest in their evaluation and assessment of the reports' conclusions and recommendations.

Abuse of Authority

Customers give registered representatives authority to act on their behalf when they provide authorization to engage in discretionary trading or permit registered representatives to act as trustees or co-trustees, hold Powers of Attorney or serve as executors or beneficiaries. FINRA reminds firms that these roles can expose investors to material risks—*e.g.*, unsuitable or excessive trading—unless firms implement appropriate controls.

Registered representatives may engage in discretionary trading when they execute a securities transaction in a customer's account after receiving prior written authorization from the customer. NASD Rule 2510 (Discretionary Accounts) also establishes other obligations that reduce the risks associated with discretionary trading by requiring firms to accept discretionary accounts only in writing, prohibiting firms from effecting transactions that are excessive in size or frequency relative to the financial resources and character of the account, and requiring firms to approve discretionary orders in writing and review discretionary accounts at frequent intervals.

FINRA has observed that some firms prohibit the use of all discretionary customer accounts. Firms that permit such accounts generally established and maintained robust supervisory procedures and controls, such as automated systems to detect potential excessive trading in customer accounts, inconsistencies or errors related to the completion of customer new account forms, and indications of customers granting discretionary authority to their registered representatives. Some firms also used monthly, quarterly, semi-annual, or annual attestations from registered representatives indicating whether they maintained any discretionary customer accounts or exercised discretion when servicing customer accounts. In addition, firms trained their registered representatives on the requirements of NASD Rule 2510 (Discretionary Accounts), including authorization and acceptance of discretionary accounts, review and approval of discretionary transactions, and exceptions to the rules' requirements. Finally, firms tested their procedures and controls on discretionary accounts to verify that they reasonably ensured registered representatives' compliance with FINRA requirements and maintained documentation to demonstrate evidence of such testing and its results.

We also observed that certain firms prohibited registered representatives from acting in some positions of trust, such as trustees or co-trustees, Powers of Attorney, executors or beneficiaries. Other firms mitigated the potential conflicts of interest involved in such roles by implementing additional supervision and review procedures. For example, certain firms asked customers to fill out questionnaires or annual attestations to confirm their intent to have representatives acting as trustees, co-trustees or in other significant roles such as Power of Attorney, executor or beneficiary.

Selected Examination Findings

FINRA has observed situations where some firms or registered representatives exposed investors to unnecessary risks and firms had not established controls—including those to comply with obligations under NASD Rule 2510 (Discretionary Accounts)—to mitigate those risks.

- **No Authorization –** Some registered representatives exercised discretion in customer accounts without the customers' prior written authorization or the firm's approval of the discretionary account. In some instances, this occurred when a registered representative executed transactions in a single security across multiple customer accounts in a short period of time. Additionally, FINRA found that some registered representatives violated the requirements of NASD Rule 2510 (Discretionary Accounts) when they executed transactions in customer accounts as an accommodation without receiving specific customer authorization to execute that transaction.
- **Expired Authorizations –** In some cases, registered representatives exercised discretion *after* the authority to do so had expired (*e.g.*, pursuant to NASD Rule 2510(d)(1) (Discretionary Accounts), grants of authority to exercise time or price discretion typically terminate at the end of the business day on which they are granted).
- **Mismarking Order Tickets –** Some registered representatives mismarked order tickets to obscure unauthorized discretionary trading by indicating that trades were executed in an unsolicited capacity, when, in fact, customers did not initiate the transactions and were unaware of the trading occurring in their accounts. In other instances, registered representatives mismarked order tickets and placed trades in customer accounts that did not comply with the securities' threshold limitations or trading restrictions.
- **False Statements and Blank Forms –** In some situations, registered representatives made false statements on the firm's compliance questionnaires and attestations regarding discretionary authorization, or had customers sign blank suitability or new account forms.
- **Abuse of Trustee Status –** Some registered representatives convinced senior investors to establish trusts and name the representatives as trustees or co-trustees in order to take control of the trust assets and direct funds to themselves. FINRA also remains concerned about registered representatives maintaining other significant roles in customer accounts, such as Power of Attorney, executor or beneficiary.

SUMMARY OF ADDITIONAL OBSERVATIONS

Anti-Money Laundering

FINRA continues to observe challenges in some firms' compliance with their anti-money laundering (AML) obligations pursuant to FINRA Rule 3310 (Anti-Money Laundering Compliance Program), the Bank Secrecy Act (BSA) and U.S. Department of the Treasury regulations.[17] Further, FINRA notes that FinCEN's Customer Due Diligence (CDD) rule became effective on May 11, 2018, and requires that firms identify beneficial owners of legal entity customers, understand the nature and purpose of customer accounts, conduct ongoing monitoring of customer accounts to identify and report suspicious transactions, and—on a risk basis—update customer information.[18] FINRA observed some firms facing new challenges as well as continuing to grapple with issues discussed in the *2017 Report on FINRA Examination Findings*.

- **Questionable Ownership Status of Foreign Legal Entity Accounts –** FINRA has observed increased trading by foreign legal entity accounts in similar low-float and low-priced securities. In some instances, firms considered these accounts unrelated, but uncovered shared commonalities, which raised concerns about potential ownership or control by similar beneficial owners. Examples of these commonalities included trading directed from the same Internet Protocol locations, account funds sent from the same branches of a specific bank, accounts with the same authorized traders, and accounts established with the same mailing address.
- **No Documentation of Investigations of Potentially Suspicious Activity –** Some firms that use exception reports did not document initial reviews and investigations into potentially suspicious activity identified by the reports. This was particularly troubling where those firms failed to establish and implement a formal investigation management process or document how they decided whether to file or not file Suspicious Activity Reports (SARs).
- **Irregular and Undocumented 314(a) Searches –** FINRA has found that some firms failed to comply with Section 314(a) of the USA PATRIOT Act, and did not conduct reviews of FinCEN's Secure Information Sharing System (SISS) on a bi-weekly basis or did not document their reviews after the searches were complete.[19] In other instances, firms also did not follow FinCEN's guidance to print a confirmation page from the SISS upon completing the review to evidence that they had performed the search and maintain records of positive search results.

In addition, FINRA continues to find problems with the adequacy of some firms' overall AML programs; allocation of AML monitoring responsibilities, particularly responsibilities for trade monitoring; data integrity in AML automated surveillance systems, especially in suspense accounts for processing foreign currency money movements and conversions; firm resources for AML programs; and independent testing of AML monitoring programs. For further information on these topics, please see the Anti-Money Laundering Compliance Program section of the *2017 Report on FINRA Examination Findings*.

Accuracy of Net Capital Computations

Securities Exchange Act of 1934 (Exchange Act) Rule 15c3-1 (Net Capital Rule) requires that firms must at all times have and maintain net capital at levels as specified under the rule. The Net Capital Rule is designed to help protect customers and creditors of broker-dealers from monetary losses that can occur when a broker-dealer fails. Some firms have faced challenges in complying with this rule and related guidance from the SEC staff.

- **Insufficient Documentation Regarding Expense-Sharing Agreements –** Staff of the SEC Division of Trading and Markets issued guidance in 2003 regarding the application of the Net Capital Rule to, among other situations, when a third party agrees to assume responsibility for payment of a firm's expenses via expense-sharing agreements. Some firms did not maintain sufficient documentation to substantiate their methodology for allocating specific broker-dealer costs to the firm or an affiliate. Other firms' expense-sharing agreements have not clearly set forth a method of allocation for payment of certain expenses by the firm as opposed to a third party. As a result, the books and records of such firms may not accurately reflect their operating performance and financial condition.

- **Incorrect Inventory Haircuts –** Some smaller firms did not adequately design or document policies and procedures for assessing and monitoring the creditworthiness of certain securities or money market instruments to determine whether these products have a "minimal amount of credit risk" pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(i).[20] As a result, some firms may not have applied the correct haircuts to these products for purposes of computing their net capital.
- **Inaccurate Operational Charges –** Some firms miscalculated their operational charges due to misinterpretations of the Net Capital Rule, *e.g.*, by failing to take appropriate haircuts in non-purpose equity securities borrowed transactions or in certain underwritings.[21] Further, in some instances, firms encountered challenges with calculating operational changes—*e.g.*, suspense or aged fail charges—as a result of human error and limited spreadsheet controls.

Liquidity

An effective liquidity risk management program helps protect customers by supporting firms' operations under normal and stressed conditions. *FINRA Regulatory Notice 15-33* describes the elements of such programs, which include rigorously evaluating a firm's liquidity needs, devoting sufficient resources to risk management, developing contingency plans, conducting stress tests and having a training plan. FINRA observed that many firms have substantially strengthened their liquidity management practices, but some firms may benefit from expanding the breadth and scope of their stress testing.

- **Extended Stress Test Period –** Some firms' stress test analyses were limited to a single time horizon, but performing stress tests over multiple time horizons helps firms assess whether they have sufficient liquidity to cover potential funding shortfalls.
- **Improvements to Business Models –** Some firms did not incorporate the results of their stress tests into their business model.

Segregation of Client Assets

Exchange Act Rule 15c3-3 (Customer Protection Rule) imposes certain requirements on firms that are designed to protect customer funds and securities. Firms that are obligated to maintain custody of customer securities and safeguard customer cash must segregate these assets from the firm's proprietary business activities. FINRA observed that some firms faced challenges complying with this rule.

- **Inconsistent Check-Forwarding Processes –** Firms that claim an exemption from the Customer Protection Rule are required to forward customer checks promptly to their clearing firm. Some firms with an independent contractor business model faced challenges with implementing consistent processes for check forwarding across their branch network.
- **Challenges With Possession and Control –** In some instances, FINRA found that some firms improperly used customer fully-paid-for or excess-margin securities to fund their operational needs.
- **Inaccurate Reserve Formula Calculations –** The Customer Protection Rule requires firms to maintain certain special reserve bank accounts and provides a reserve formula to determine the amounts that must be deposited in such accounts. Some firms did not accurately complete their reserve formula calculations because of errors in coding. At some of these firms, limited training and staff turnover contributed to the coding deficiencies. Other firms made incorrect reserve formula calculations because of challenges with spreadsheet control, coordination between various internal departments and performance of reconciliation calculations.

Operations Professional Registration

FINRA Rule 1230 (Associated Persons Exempt from Registration) and *FINRA Regulatory Notice 11-33* state that certain firm personnel engaged in "back office" covered functions must qualify and register as Operations Professionals because they play an important role in helping firms comply with their regulatory responsibilities relating to customer funds, accounts and transactions. FINRA has observed that some firms continued to permit unregistered staff to engage in certain activities that would require Operations Professional registration.

- **Unregistered Individuals Approving General Ledger Journal Entries –** Some firms designated unregistered individuals to approve general ledger journal entries.
- **Unregistered Supervisors –** In some instances, firms designated unregistered individuals to act as supervisors of various financial functions, including disbursement of funds, settlement, buy-ins and fails and possession or control.
- **Unregistered Individuals Approving Business Requirements –** Some firms allowed unregistered staff to approve the business requirements of trading systems related to covered functions.

Customer Confirmations

Customer confirmations help protect investors by allowing them to verify the terms of their transactions, alerting them to potential conflicts of interest, safeguarding against fraud and providing them with information to evaluate the costs of their transactions and the quality of their broker-dealer's execution. In particular, FINRA observed that some firms did not maintain adequate supervisory programs relating to confirmations or comply with certain confirmation disclosure requirements under Exchange Act Rule 10b-10 and FINRA Rule 2232 (Customer Confirmations) for transactions with customers in equity securities.

- **Inaccurate Disclosure of Capacity –** Some firms inaccurately disclosed their trading capacity (such as agent, dual agent, principal or riskless principal, as necessary), including whether they served in multiple capacities.
- **Mislabeled Disclosure of Compensation –** In some instances, firms mislabeled their compensation because they did not list it as commission, mark-up or mark-down, or commission equivalent, as appropriate.
- **Incorrect Disclosure of Average Price –** Some firms did not disclose the average price for customer orders executed at multiple prices or incorrectly included the average price language when filling an order with a single execution.
- **No Disclosure of Market Maker Status –** In some cases, firms did not disclose that they were a market maker when they filled orders from a market making account.
- **Inadequate Supervision –** Many of the deficiencies described above were the result of programming errors that produced numerous inaccurate or incomplete customer confirmations over a number of years. In particular, some firms failed to monitor or review confirmations generated on their behalf by clearing firms or other vendors, and did not use available internal and external supervisory resources, including internal records, compliance tools and third-party reports.

DBAs and Communications With the Public

While FINRA does not prohibit the use by a registered representative of a "doing business as" or "DBA" name, some registered representatives used such names to conceal outside business activities that were not disclosed as FINRA Rule 3270 (Outside Business Activities of Registered Persons) requires. Additionally, FINRA observed deficiencies relating to FINRA Rule 2210 (Communications with the Public) at some firms that permit their registered representatives to conduct firm business activities using a DBA name. Some firms using the independent contractor business model faced additional challenges because of the relative autonomy of their registered representatives and branches. In particular, FINRA observed that certain firms did not maintain sufficient WSPs and controls, or provide adequate disclosures regarding the use of DBA names.

- **Failure to Disclose Firm Name –** Some registered representatives' retail communications and correspondence concerning firm business did not comply with FINRA Rule 2210(d)(3) (Communications with the Public) because those communications included the representative's DBA name, but did not prominently disclose the firm's name and the fact that securities were offered through the firm.
- **No Hyperlink to FINRA's BrokerCheck® –** Some registered representatives' websites did not contain a "readily apparent reference" and hyperlink to FINRA's BrokerCheck on the webpages that included the representatives' professional profiles, as FINRA Rule 2210(d)(8)(A) (Communications with the Public) requires.
- **Inadequate WSPs or Controls –** In some instances, firms did not maintain or implement WSPs, establish adequate controls over registered representatives' use of DBA names, or monitor retail communications, websites, social media accounts, seminars or external email accounts through which representatives communicated on the firm's behalf.

Best Execution

As discussed in the *2017 Report on FINRA Examination Findings*, FINRA has observed firms that receive, handle, route or execute customer orders encountering challenges with meeting their duty of best execution in equities, options and fixed income securities trading. In particular, in 2018, FINRA observed that some firms did not comply with FINRA Rule 5310[22] (Best Execution and Interpositioning) because they relied upon a deficient "regular and rigorous review" of customer order execution quality. As a result, such firms failed to assure that order flow was directed to markets providing the most beneficial terms for their customers' orders. FINRA reiterates its concern from the *2017 Report on FINRA Examination Findings* that firms should not allow conflicts of interest relating to financial benefits from routing orders to particular venues adversely to affect the objectivity of their "regular and rigorous" review. Examples of some deficiencies FINRA observed are discussed below.

- **No Execution Quality Assessment of Competing Markets –** Some firms did not compare the quality of the execution obtained via their existing order routing and execution arrangements (including order-by-order review for the internalization of order flow)[23] against the quality of execution they could have obtained from competing markets.
- **No Review of Certain Order Types –** In some instances, firms did not conduct adequate reviews on a type-of-order basis.
- **No Evaluation of Required Factors –** FINRA observed some firms that did not consider certain factors set forth in FINRA Rule 5310 (Best Execution and Interpositioning) when conducting a "regular and rigorous review," including, among other things, speed of execution, price improvement and the likelihood of execution of limit orders.

TRACE Reporting

TRACE facilitates the mandatory reporting of over-the-counter (OTC) transactions in certain fixed income securities and provides increased price transparency to market participants and investors. The FINRA Rule 6700 Series (Trade Reporting and Compliance Engine (TRACE)) addresses transaction reporting requirements to TRACE and, effective July 10, 2017, firms were required to report to TRACE certain transactions in U.S. Treasury Securities.

FINRA observed that some firms engaging in institutional sales of fixed income securities did not comply with certain key TRACE reporting rules, specifically FINRA Rules 6730(a)(7), 6730(b)(1) and (2), 6730(c)(8) and 6730(d)(4)(E) (Transaction Reporting) (as well as many of the same rules discussed in the *2017 Report on FINRA Examination Findings*).

- **Overreliance on FINRA List –** Some firms failed to report transactions in TRACE-eligible securities[24] because they relied on the master list of TRACE-eligible securities published by FINRA and did not have a system or process to determine whether a reportable transaction involved a TRACE-eligible security that was not yet set up in TRACE at the time of the transaction.
- **Late and Inaccurate Reporting –** Some firms reported transactions to TRACE late—more than 15 minutes from the time of execution—and inaccurately provided the time the transaction was entered into the firms' order management system as the execution time, not the actual time of execution.
- **Inaccurate Indicators and Identifiers –** In some instances, firms reported transactions with non-member affiliates using an inaccurate contra-party identifier and incorrectly appended the non-member affiliate-principal transaction indicator to transactions with their non-member affiliates without satisfying the requirements necessary to append the indicator.
- **Insufficient WSPs –** Some firms failed to detect deficiencies, such as those described above, because they failed to establish and maintain a supervisory system reasonably designed to achieve compliance with certain TRACE reporting obligations.

Market Access Controls

Exchange Act Rule 15c3-5 (Market Access Rule) requires broker-dealers with market access or that provide market access to their customers to "appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system."[25] FINRA has observed that some firms continue to encounter challenges with intra-day adjustment of pre-trade financial thresholds and oversight of third-party vendors.

- **Inadequate Pre-Trade Financial Controls –** Some firms FINRA examined did not maintain effective pre-trade financial controls, and other firms could not substantiate credit and capital thresholds for clients. For instance, in one examination, FINRA noted that a firm set a credit limit at several billion dollars for a client whose daily average credit usage was in the hundreds of thousands of dollars. Other firms failed to establish policies and procedures to govern intra-day changes to their credit and capital thresholds, including requiring or obtaining approval prior to adjusting credit or capital thresholds, documenting justifications for any adjustments, and ensuring thresholds for temporary adjustments revert back to their pre-adjusted values.
- **Overreliance on Third-Party Vendors –** In some instances, firms delegated to third-party vendors oversight of, or the power to make adjustments to, controls for pre-trade validations without the prior approval of the firms. Further, some firms engaged third-party vendors with ineffective controls or did not perform sufficient due diligence to ensure that the third-party controls were reasonably designed to comply with the Market Access Rule.

ENDNOTES

1. FINRA Rule 2111.01 ("Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing.")

2. *See NASD Notice to Members 05-26* for a discussion of best practices for reviewing new products.

3. FINRA Rule 211.05(c) (Suitability); *FINRA Regulatory Notice 18-13* requested comment regarding revising the quantitative suitability obligation and removing the control element.

4. Active account or activity letters are a communication from the broker-dealer to notify the customer of the level of trading activity in the customer's account.

5. Many variable annuities offer riders with unique insurance-backed benefits and guarantees providing for predictable income, which can be purchased at an added percentage cost. Variable annuities generally require that the investment be subjected to a surrender period where the customer incurs a penalty for certain withdrawals made over time.

6. FINRA Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities) requires firms to factor the costs and features of the existing and recommended variable annuities into their recommendation and approval of the transaction.

7. The one-day decline in value for one ETN tracking the inverse of VIX futures prices triggered an automatic liquidation of the product and a mutual fund with a short-volatility strategy also was liquidated as a result of the event. In addition, two VIX futures-tracking ETPs subsequently reduced the degree of their leveraged or inverse exposure, which led to the termination of other ETPs that incorporated them as part of their strategies.

8. The targeted examination letter regarding that review is available here.

9. Specific information on the MSRB requirements is available at here. FINRA and the MSRB also published FAQs designed to assist firms with implementing the new rule requirements (FINRA FAQs, MSRB FAQs).

10. PMP must be determined in a manner consistent with FINRA Rule 2121.02 (Fair Prices and Commissions) or MSRB Rule G-30.06, as applicable.

11. As noted in FINRA FAQ 1.9 and MSRB FAQ 1.9, although an introducing or correspondent broker-dealer may use the assistance of a clearing broker-dealer to generate confirmations, the introducing or correspondent broker-dealer bears the ultimate responsibility for compliance with the disclosure requirements.

12. FINRA Rule 2232(e) (Customer Confirmations) and MSRB Rule G-15(a)(i)(D)(4) require disclosure of the security-specific hyperlink and the time of execution for all transactions with non-institutional customers.

13. FINRA Rule 2232(e) (Customer Confirmations).

14. *See FINRA Regulatory Notice 10-22*.

15. *See* FINRA Rule 2111 (Suitability) FAQ, Question A3.1 ("The suitability rule allows firms to take a risk-based approach with respect to documenting suitability determinations. For example, the recommendation of a large-cap, value-oriented equity security generally would not require written documentation as to the recommendation. In all cases, the suitability rule applies to recommendations, but the extent to which a firm needs to evidence suitability generally depends on the complexity of the security or strategy in structure and performance and/or the risks involved.")

16. Land conversation easements are unique private offerings structured to generate land conservation charitable contribution tax deductions for investors.

17. FINRA provides a free template for small firms to assist them with fulfilling their responsibilities to establish the AML compliance program required by the BSA, the relevant federal regulations and FINRA Rule 3310 (Anti-Money Laundering Compliance Program). The template was updated on July 18, 2018, and provides text examples, instructions, relevant rules and links to other resources.

18. *See FINRA Regulatory Notices 17-40* and *18-19* for additional information.

19. Section 314(a) of the USA PATRIOT Act requires firms to access SISS on a bi-weekly basis to view FinCEN's requests; search their records for accounts maintained by the listed persons and businesses during the preceding 12 months and transactions conducted within the last six months; and respond to FinCEN within two weeks of the posting date.

20. These requirements are set forth in the SEC's 2013 credit ratings amendments. *See* Exchange Act Release No. 71194 (Dec. 27, 2013), 79 Fed. Reg. 1522 (Jan. 8, 2014).

21. For additional information about non-purpose equity securities borrowed transactions, *see* Net Capital Requirements for Brokers or Dealers, Non-Purpose Equity Securities Borrowed Transactions, SEA Rule 15c3-1(c)(2)(iv)(B)/093, available here. For additional information about underwritings, *see* Net Capital Requirements for Brokers or Dealers, Moment to Moment Net Capital, SEA Rule 15c3-1(a)/001 and Haircuts on Contractual Commitments, SEA Rule 15c3-1(c)(2)(viii)(C)/03, available here.

22. FINRA Rule 5310 (Best Execution and Interpositioning) requires that, in any transaction for or with a customer or a customer of another broker-dealer, firms use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

23. *See FINRA Regulatory Notice 15-46*.

24. FINRA Rule 6710(a) (Definitions).

25. Exchange Act Release No. 63241, 75 Fed. Reg. 69792 (Nov. 3, 2010).

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