Financial Industry Regulatory Authority

January 6, 2015

Introduction

This year marks the tenth edition of the Regulatory and Examinations Priorities Letter. Over the past decade, we have witnessed tremendous change to firms, markets and regulation.

Many changes have been positive. Firms have improved their review of new products by integrating business functions with independent perspectives, such as compliance and risk management, articulating standards, documenting decisions and monitoring product performance. Firms have taken steps to better manage conflicts of interest by aligning compensation more closely with customer interests or through risk-adjusted compensation.

The markets have become more transparent to retail investors with expanded trade report dissemination. FINRA took steps to enhance transparency in "dark pool" trading through the publication of reports on alternative trading systems' volume on a stock-by-stock basis. Both equity and debt markets have become more open internationally, enabling companies to raise capital where it is most advantageous and investors to diversify their portfolios.

Regulators have adopted more risk-based approaches, increased their use of data and analytics, and improved coordination and information sharing. FINRA's examination program is now substantially risk-based, enabling us to allocate our resources to higher-risk firms and individuals. For example, we identify registered representatives with higher risk profiles using analytics, resulting in expedited regulatory responses. FINRA is also sharing information more frequently with domestic and international securities and banking regulators, in particular with the U.S. Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB).

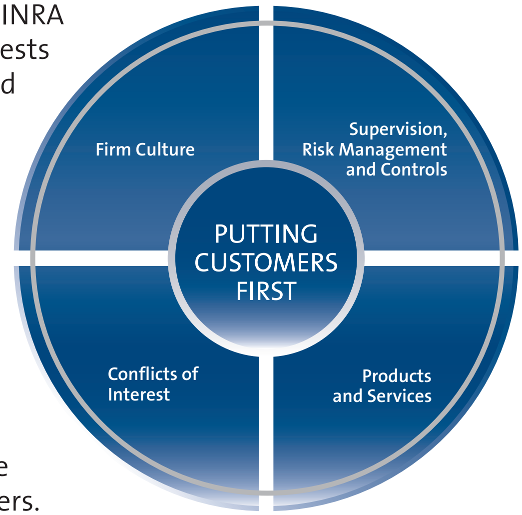
Recurring Challenges

In addition to the positive changes FINRA has observed, there are a number of lessons learned that firms can find instructive. Over the years, FINRA has observed that challenges in five areas contribute to firms and registered representatives at times compromising the quality of service they provide to customers as well as contribute to compliance and supervisory breakdowns. Addressing these challenges will enable firms to get ahead of many of the concerns that FINRA raises in this letter.

1735 K Street, NW
Washington, DC
20006-1506

t 202 728 8000
www.finra.org

Putting customer interests first: A central failing FINRA has observed is firms not putting customers' interests first. The harm caused by this may be compounded when it involves vulnerable investors (*e.g.,* senior investors) or a major liquidity or wealth event in an investor's life (*e.g.,* an inheritance or Individual Retirement Account rollover). Poor advice and investments in these situations can have especially devastating and lasting consequences for the investor. Irrespective of whether a firm must meet a suitability or fiduciary standard, FINRA believes that firms best serve their customers—and reduce their regulatory risk—by putting customers' interests first. This requires the firm to align its interests with those of its customers.



Firm culture: Many of the problems we have observed in the financial services industry have their roots in firm culture. A poor culture may arise, for example, if firm management places undue emphasis on short-term profits or pursues rapid growth without a concomitant concern for controls. Beyond creating the proper business environment for a good culture to flourish, firms' boards and senior executives must articulate and practice high standards of ethical behavior that are expected and visible throughout the organization and are embedded in the firm's incentives. These standards should come from the board and executives and not be viewed as a compliance task. The absence of stated standards can contribute to failures at the individual broker level (*e.g.,* disregard for customer needs in recommending securities) and can likewise bring about problems with potentially market wide implications (*e.g.,* manipulation of indices or the manufacture and marketing of unsuitable securities). Firms must protect their culture against individual bad actors, as well as firm wide behaviors that can gradually erode that culture. Firm policies should signify that poor practices, whatever the magnitude of the harm caused or potential implications, will not be tolerated.

Supervision, risk management and controls: A firm's systems of supervision, risk management and controls are essential safeguards to protect and reinforce a firm's culture. Maintaining the right culture includes having robust processes around basic functions such as hiring. Strong supervisory and risk management systems also prevent inadvertent harm to customers (*e.g.,* a firm failing to provide the proper breakpoint), as well as defend against deliberate acts of malfeasance (*e.g.,* a trader concealing position limit breaches or an executive manipulating accounting balances to make the firm's financial status and results appear stronger than they are). Proactive supervisory programs and controls play a crucial role in this effort and many firms have turned to data analytics to help identify problematic behavior. One indicator that a firm is succeeding in a proactive approach would be that it has already identified and addressed the concerns FINRA identifies in this letter.

Product and service offerings: While firms have improved new-product review processes, the sales of novel products and services remain a regulatory flashpoint. Some of the issues that have caused harm to investors and landed firms in regulatory difficulties include product complexity, opacity in the market for a product or its underlying components, insufficient or generic disclosure, enticing teaser rate fee structures and insufficient training for salespersons to understand the products. These challenges underscore the need for firms to continue to conduct rigorous new product reviews, assess reasonable-basis and customer-specific suitability prior to offerings and permit wealth management to make independent decisions about the products and services that are best for their customers.

Conflicts of interest: Conflicts of interest are a contributing factor to many regulatory actions FINRA (and other regulators) have taken against firms and associated persons. In October 2013, FINRA highlighted effective practices in identifying and managing conflicts of interest. While we have observed positive change since we issued the Report on Conflicts of Interest, FINRA has also recently announced enforcement actions involving firms' failure to adequately address conflicts of interest by offering favorable research in connection with potential investment banking business.[1] We are also reviewing situations where market access customers self-monitor and self-report suspicious trading despite this inherent conflict of interest. And, we continue to focus on fee and compensation structures that lie at the heart of many conflicts and which can at times compromise the objectivity registered representatives provide to customers. FINRA underscores the importance of firms moving to identify and mitigate conflicts of interest.

Areas of Focus in 2015

FINRA's 2015 priorities focus on key sales practice, financial and operational and market integrity matters. Before discussing the priorities, we highlight an important issue that cuts across all of FINRA's regulatory programs. Specifically, FINRA has experienced an increasing number of situations where some firms have repeatedly failed to provide timely responses to its information requests made in connection with examinations and investigations. This is particularly troubling as FINRA discusses large and complex information requests with firms and is flexible with respect to due dates, rolling productions, scope and format—as long as the integrity of the regulatory matter is not compromised. These situations are not acceptable, as timely productions of information (as well as oral information through interviews and on-the-record testimony) are critical to FINRA achieving its investor protection and market integrity mission by identifying and shutting down bad practices and bad actors at the earliest possible time. FINRA reiterates firms' obligation to respond to FINRA inquiries in a full and timely fashion, and cautions firms that production failures expose firms to disciplinary action.

Sales Practice

Products

In this section, FINRA discusses product-focused concerns. These concerns may include features of the product itself as well as sales or distribution practices. Some of the products we address are complex and may be subject to substantial market, credit, liquidity or operational risks. In some cases, products previously available only to sophisticated investors have been modified and are now offered to retail investors. These products require firms and registered representatives to perform due diligence, make sound suitability decisions and describe product risks in a balanced manner that retail investors can understand. As always, firms and registered representatives should be attentive to changing circumstances—such as the precipitous fall in oil prices or the rapid fall in some emerging and frontier market indices—that may affect suitability decisions and risk descriptions. Training registered representatives about product features, pricing and valuation, and providing guidance around suitability are important steps in meeting these challenges. With these concerns in mind, FINRA's 2015 surveillance and examination activities that include product-related risk reviews will routinely focus on due diligence, suitability, disclosure, supervision and training.

Interest Rate-Sensitive Fixed Income Securities

The United States has experienced a period of sustained and unusually low interest rates. FINRA's 2014 Regulatory and Examination Priorities letter detailed FINRA's concerns regarding the interest rate environment and the potential harm to customers holding interest rate-sensitive products that could result from shifts in that environment. Those concerns remain unchanged. FINRA also recognizes, however, that fixed income products play an important role in a well-constructed portfolio. What is critical is that firms' communications discuss the impact of interest rate changes on price when marketing products that are interest rate sensitive. In 2015, FINRA examiners will look for concentrated positions in products that are highly sensitive to interest rates—such as long-duration fixed income securities, high yield bonds, mortgage-backed securities, or bond funds composed of interest rate-sensitive securities—and test for suitability and adequate disclosures. Examiners may also review firms' efforts to educate registered representatives and customers about such products.

Variable Annuities

FINRA's focus on sales practice issues with variable annuities—both new purchases and 1035 exchanges—will include assessments of compensation structures that may improperly incent the sale of variable annuities, the suitability of recommendations, statements made by registered representatives about these products and the adequacy of disclosures made about material features of variable annuities. FINRA examiners will also focus on the design and implementation of procedures and training by compliance and supervisory personnel to test the level of brokers' and supervisors' product knowledge, to prevent and detect problematic sales practices in variable annuities and to assess compliance with requirements that firms file retail communications concerning variable annuities with FINRA within 10 business days of first use. FINRA will particularly focus on the sale and marketing of "L share" annuities as these shares typically have shorter surrender periods, but higher costs.

Alternative Mutual Funds

Sales of alternative mutual funds ("alt funds" or "liquid alts") have increased rapidly over the past several years, with hundreds of new funds launched and currently available. Estimates place assets under management in alternative funds at over $300 billion as of November 2014, up from less than $50 billion at year-end 2008. Net inflows for 2014 through November reportedly exceeded $40 billion.[2]

Alternative mutual funds are often marketed as a way for retail customers to invest in sophisticated, actively-managed hedge fund-like strategies that will perform well in a variety of market environments. Alternative mutual funds generally purport to reduce volatility, increase diversification, and produce non-correlated returns and higher yields compared to traditional long-only equity and fixed-income funds, all while offering daily liquidity. There is no standard definition of alternative mutual funds, but if a fund's strategy involves non-traditional asset classes, non-traditional strategies or illiquid assets, the fund could be considered an alt fund. FINRA recommends firms refer to such funds based on their specific strategies, as opposed to bundling them under one umbrella category. In this regard, firms must ensure that their communications regarding alternative funds accurately and fairly describe how the products work, ensuring that the descriptions of the funds are consistent with the representations in the funds' prospectuses. For example, a retail communication that includes a discussion of an alternative fund's objectives that is inconsistent with the objectives included in the fund's prospectus, or that does not clearly indicate there is no assurance that the objectives will be met, would not meet regulatory requirements.[3]

Despite their possible benefits, alternative mutual funds raise concerns when compared to conventional funds. In particular, FINRA is concerned that registered representatives and customers will not understand how the funds will respond to various market conditions or even the strategy in which the fund's adviser will engage in various market scenarios. In addition, FINRA has learned that some firms are not reviewing alt funds through their new-product review process, especially if the firm already has an existing agreement with the fund company.

Non-Traded Real Estate Investment Trusts (REITs)

FINRA identified several concerns with non-traded REITs in last year's letter, including general lack of liquidity, high fees and valuation difficulty. FINRA had noted risks to investors who may be attracted to the projected yields of these securities.[4] These risks remain relevant with respect to customer-specific suitability obligations that firms must perform when recommending non-traded REITs to clients. FINRA also emphasizes that firms should perform due diligence on an ongoing basis on REITs they allow their representatives to recommend. "Red flags" arising from a REIT's financial statements or management may cause firms to change the types of clients to whom the firm recommends the product or even to discontinue sale of the product.

FINRA also notes that on October 10, 2014, the SEC approved proposed amendments to the Customer Account Statement Rule and the Direct Participation Program (DPP) Rule regarding how these products are valued on customer account statements.[5] Because the offering price, typically $10 per share, often remains constant on customer account statements during the offering period even though various costs and fees have reduced investors' capital, FINRA amended the rule to require broker-dealers to provide a more accurate per share estimated value on customer account statements, as well as various important disclosures. Firms that sell REITs should read and understand the full requirements of the amendments in *Regulatory Notice 15-02*, which also contains the effective date of the rule amendments.

Exchange-Traded Products (ETPs) Tracking Alternatively Weighted Indices

Indexing has continued to expand beyond traditional market capitalization-weighted methods to alternatively weighted strategies, (*e.g.,* using equally weighted, fundamentally weighted, volatility weighted indices).[6] These indices provide exposure to specific investment risk factors or strategies. Products tracking such indices may be marketed as providing superior risk-adjusted performance relative to products tracking more traditional capitalization-weighted indices. The exchange-traded products market, in particular, has seen significant growth in the use of alternatively weighted indices in terms of products and investor assets.

For individual investors, products tracking these indices may be complex or unfamiliar. Moreover, ETPs tracking these indices may be thinly traded and have wide bid-ask spreads, making these funds more costly to trade, in addition to their generally higher expenses. Some alternatively weighted indices may have significantly higher turnover than more traditional indices, leading to greater transaction costs for ETPs that track them. While back-tested results and some academic research have highlighted the potential efficacy and attractiveness of alternatively weighted indices, it remains an open question how the indices and products tracking them will behave in different market environments going forward.

Structured Retail Products (SRPs)

FINRA continues to see firms creating and distributing SRPs, including structured notes, with complex payout structures and using proprietary indices as reference assets. Complex features, long maturities, and linkages to less-traditional or less well-understood reference assets in some structured retail products may present investors with unique or unfamiliar risks. FINRA is concerned that some brokers and retail investors may not be familiar with the complexities of SRPs, compounded by the uncertain impact of a changing interest rate environment. FINRA reminds firms that retail communications concerning derivatives registered under the Securities Act of 1933, including SRPs, must be filed with FINRA within 10 business days of first use.

In addition, we are focused on the incentive to increase revenue from structured (and other) product sales through distribution channels that may not have adequate controls to protect customers' interests, such as the distribution of structured or complex products through retail distributors that have insufficient expertise to make sound suitability reviews. To mitigate the risk that sales incentives create, wholesalers should have robust Know-Your-Distributor policies and procedures reasonably designed to ensure potential distributors have adequate controls and systems in place. FINRA examiners will focus attention on additional conflict issues that might arise where the distributor and wholesaler are affiliated companies.

Floating-Rate Bank Loan Funds

These products primarily invest in floating-rate bank loans. While such loans are typically geared to institutional investors, retail investors have increased their exposure to these products through mutual funds, closed-end funds and exchange-traded funds (ETFs) in an effort to protect against the threat of rising interest rates. Despite the promise of hedged exposure to interest-rate risk, these loans can carry significant credit and call risk.

In addition, they are difficult to value, have longer settlement times than other investments and are relatively illiquid. As a consequence, funds investing in these loans could face liquidity challenges if a significant number of investors make redemption requests at the same time.

Securities-Backed Lines of Credit (SBLOCs)

SBLOCs are revolving, non-purpose loans that allow investors to borrow money from lending institutions using fully paid-for securities held in their brokerage accounts as collateral. FINRA has observed that the number of firms offering SBLOCs is increasing and is concerned about how they are marketed. They are now offered by a large number of firms and we see some clearing firms offering SBLOCs to retail investors via their correspondents. Proceeds are typically used to purchase a second home, luxury items or pay other expenses. Eligible securities collateralizing SBLOCs include stocks, bonds and mutual funds that are held in fully paid, cash accounts.

Broker-dealers offering SBLOCs should have proper controls in place to supervise these programs. Customers should be fully apprised of program features, including loan restrictions and how changing market conditions may affect their brokerage account and their ability to draw on the SBLOC. Moreover, firms should have operational procedures that enable them to interact with the lending institution to monitor the customer's account, keep adequate records and ensure that customers are promptly notified when collateral shortfalls occur.

Supervision Rules

FINRA's new supervision rules (FINRA Rules 3110, 3120, 3150 and 3170) became effective on December 1, 2014.[7] These new rules modify requirements relating to, among other things: (1) supervising offices of supervisory jurisdiction and inspecting non-branch offices; (2) managing conflicts of interest in a firm's supervisory system; (3) performing risk-based review of correspondence and internal communications; (4) carrying out risk-based review of investment banking and securities transactions; (5) monitoring for insider trading, conducting internal investigations and reporting related information to FINRA; and (6) testing and verifying supervisory control procedures. FINRA regulatory coordinators and examiners will contact and inspect their assigned firms to address regulatory questions and become familiar with how the firms are implementing the new rule requirements.

Individual Retirement Account (IRA) Rollovers (and Other "Wealth Events")

FINRA is focused on firms' controls around the handling of wealth events in investors' lives. Wealth events refer to those situations where an investor faces the decision about what to do with a large amount of money arising from an inheritance, life insurance payout, sale of a business or other major asset, divorce settlement or an IRA rollover, among other events. A broker's recommendations made in connection with a wealth event can have long-lasting consequences for the customer. In 2015, examiners will focus on the controls firms have in place related to wealth events, with an emphasis on firms' compliance with their supervisory, suitability and disclosure obligations. Firms' systems should be reasonably designed to help ensure that financial incentives to the associated person or the firm do not compromise the objectivity of suitability reviews.

Part of FINRA's focus will be IRAs, one of the principal vehicles Americans use to save for their retirement. According to the Investment Company Institute, over one-quarter of Americans' retirement savings are held in IRAs and this percentage is growing. Rollovers from employer plans—such as 401(k) plans—play an important role in funding these IRAs.[8] FINRA has stated that, whether in retail communications or an oral marketing campaign, it would be false and misleading to imply that a retiree's only choice, or only sound choice, is to roll over plan assets to an IRA sponsored by the broker-dealer.[9] Any communications that discuss IRA fees must be fair and balanced,[10] and the broker-dealer may not claim that its IRAs are "free" or carry "no fee" when the investor will incur costs related to the account, account investments or both.

If a broker-dealer does not intend for its registered representatives to recommend securities transactions as part of the IRA rollovers of their customers, then the broker-dealer should have policies, procedures, controls and training reasonably designed to ensure that no recommendation occurs. Similarly, if registered representatives are authorized to provide educational information only, a firm's written supervisory procedures should be reasonably designed to ensure that recommendations are not made. Without strong oversight, investors may not obtain the information necessary to make an informed decision, and firms may fail to detect recommendations otherwise prohibited by firm policy.

Excessive Trading and Concentration Controls

FINRA has observed shortcomings in firms' supervision of quantitative suitability and concentration, for example, through the failure to supervise for compliance with issuer concentration guidelines (such as those contained in the prospectus for some REITs).[11] In 2015, FINRA examiners will focus on firms' supervisory processes, systems and controls concerning how firms monitor for excessive trading and product concentration. FINRA examiners will review the criteria for exception reports firms use and the adequacy of firms' follow-up on such exceptions. FINRA has provided firms with practices that may help bolster their supervision of suitability determinations.[12] FINRA examiners will also review customer communications and account activity to determine whether aggressive trading strategies were recommended, and whether broker-recommended transactions, or series of transactions, constitute excessive trading or result in a customer's portfolio becoming over-concentrated.

Private Placements

Private placements continue to raise concerns and will be an area of focus in 2015. Broker-dealers participate in private offerings in a number of capacities, and common concerns across these capacities include inadequate due diligence and suitability analysis. These concerns remain relevant regardless of the investment sector, investment type (*e.g.,* EB-5 investment funds, pre-Initial Public Offering investment funds, virtual currency funds), or the type of investor. Firms must file most private placement materials with FINRA pursuant to Rules 5122 or 5123. FINRA reviews firms' private placements to determine whether broker-dealers performed sufficient due diligence on the issuer and the offering prior to recommendations to customers. We have learned that in some cases, the level of due diligence 1) did not comply with the broker-dealer's procedures, and 2) appeared to be inadequate to support a suitability determination. Furthermore, FINRA staff has identified offering documents and communications containing misrepresentations, omissions of material information or inconsistencies with FINRA's communication rules.

FINRA's review of private placement filings has also revealed a number of problems associated with contingency offerings and escrow procedures. Pursuant to Securities Exchange Act of 1934 (SEA) Rule 10b-9, a broker-dealer selling an offering pursuant to a contingency is required to return investor funds if the terms of the contingency are not met or have been materially amended. SEA Rule 15c2-4(b) requires broker-dealers to ensure that investor funds are properly segregated. In a number of instances, an offering's terms were amended and a rescission offer was not properly conducted. In other instances, broker-dealers participating in an offering with a contingency failed to either establish escrow procedures or had deficient procedures such as not employing an independent bank as the escrow agent.

FINRA also notes that amendments to Rule 506 of Regulation D[13]—which, pursuant to the Jumpstart Our Business Startups Act, became effective September 23, 2013—permit general solicitation and advertising when offering private placements, provided that all purchasers of the offering are accredited investors. FINRA and the SEC have reminded investors to be prudent when evaluating the risks of these types of investments, especially as, under the new rules, it is expected that investors will be more exposed to private placement sales pitches and advertising.[14]

High-Risk and Recidivist Brokers

The activities of certain high-risk brokers cause outsized risk to investors, including the heightened potential to become a fraud victim. FINRA devotes substantial attention to brokers that may pose greater risk to the investing public and to quickly stopping those engaged in actual misconduct. To do this, FINRA is expanding its use of data mining, analytics, specially targeted examinations, and expedited investigations and enforcement actions to remove from the securities industry unscrupulous registered representatives who prey on investors.

Firms that hire or seek to hire high-risk brokers, including statutorily disqualified and recidivist brokers, can expect rigorous regulatory attention. FINRA will cover all aspects of this topic, including hiring and supervision practices. With respect to hiring, FINRA will review firms' due diligence on prospective hires. Examiners will also assess the supervision of high-risk registered representatives to determine whether it is tailored to specifically address the risks associated with the particular individual based on prior misconduct and regulatory disclosures. We will also assess whether a firm implements and documents a stated supervisory plan.

Sales Charge Discounts and Waivers

FINRA has observed that in some instances customers do not receive the volume discounts (breakpoints) or sales charge waivers to which they are entitled when purchasing products like non-traded REITs, Unit Investment Trusts, Business Development Corporations and mutual funds.[15] FINRA addressed this issue through examinations and enforcement actions in the last few years and will make it a priority again in 2015. FINRA will determine if firms have an adequate system to ensure breakpoints and sales charge waivers are provided to their customers for products they sell that possess these features. Further, as some products offering volume discounts can have a direct impact on a broker's compensation, FINRA examiners will consider whether brokers disclose that the volume discount is available and make appropriate recommendations to customers.

Senior Investors

The population of senior investors is large and growing; between 2012 and 2020, the number of Americans aged 65 or greater is projected to increase from 43 million to 56 million, and to 73 million by 2030.[16] The consequences of unsuitable investment advice can be particularly severe for this investor group since they rarely can replenish investment portfolios with fresh funds and lack time to make up losses. Reflecting concern about the treatment of senior investors, FINRA recently completed an examination initiative on senior issues. Preliminary findings show that many firms are increasingly proactive in dealing with senior investors by developing specific internal guidelines to strengthen suitability decisions and providing training on the needs of these investors, including, in some cases handling individuals experiencing diminished capacity or elder abuse. FINRA urges firms to review their procedures to identify ways they may be able to improve their treatment of senior investors. FINRA examiners will continue to review communications with seniors; the suitability of investment recommendations made to seniors, including with respect to the products discussed above; the training of registered representatives to handle senior-specific issues; and the supervision firms have in place to protect seniors. Firms that conduct seminars directed to senior investors must ensure that the presentations are fair, balanced and not misleading. Protecting senior investors also means compliance with requirements apart from the federal securities laws and FINRA rules that, for example, require reporting or the intervention of court-appointed guardians when elder abuse is detected.

Anti-Money Laundering (AML)

FINRA will focus on certain types of accounts, including Cash Management Accounts (CMAs) and certain Delivery versus Payment/Receipt versus Payment (DVP/RVP) accounts. CMAs are brokerage accounts used for activity typically associated with bank accounts. FINRA will review the adequacy of firm surveillance systems and processes to identify potentially suspicious transfers to and from CMA accounts, and to verify the business purpose of activity conducted through these accounts. FINRA will also focus on DVP/RVP accounts of foreign financial institutions. FINRA has observed an increase in microcap activity and foreign currency conversion activity in DVP/RVP accounts, which may be based in jurisdictions with weak regulatory regimes. DVP/RVP accounts may provide less transparency as to the source of the shares being sold. FINRA has observed that some firms are not monitoring activity in DVP/RVP accounts for suspicious activity, and are not conducting adequate due diligence to ensure that securities being sold are registered under Section 5 of the Securities Act of 1933 or the transaction is subject to an exemption from registration.

FINRA examiners will also focus on the adequacy of firms' surveillance of customer trading. Firms should tailor customer trading surveillance around the AML risks inherent in their business lines, products and customer bases.[17] Customer trading activity can involve different types of suspicious activity reportable on Suspicious Activity Reports, including market manipulation, insider trading and microcap fraud. FINRA examiners will evaluate whether firms have systems to monitor for red flags indicative of suspicious customer trading activity. In fact, FINRA has found that firms' due diligence in microcap securities for AML and Section 5 compliance is at times inadequate, regardless of whether they receive shares from another broker-dealer or transfer agent, and whether in physical form or electronically. FINRA's continued emphasis on microcap fraud and insider trading is evident through the more than 700 referrals to the SEC and other federal or state law enforcement agencies in 2014, involving potential fraudulent conduct through insider trading, private investment in public equity transactions, microcap fraud and market manipulation.

Municipal Advisors and Securities

Municipal Advisor Registration

In 2015, FINRA examiners will focus on current SEC and MSRB municipal advisor requirements, reviewing for proper application of exclusions and exemptions, and potential unregistered activity. Examiners will adjust their reviews to include new rules as they become effective.

In addition to statutory requirements promulgated under Dodd-Frank Act amendments to the SEA, the SEC's municipal advisor registration rules became effective July 1, 2014. FINRA has observed through onsite examination and regulatory coordinator outreach that some firms do not realize that the activities in which they engage subject them to municipal advisor registration requirements. Specifically, any firm that provides advice to customers that are municipal entities or obligated persons, whether with respect to an issuance of municipal securities or to the investment of proceeds from such an issuance (or municipal escrow investments) may be required to register as a municipal advisor. The SEC has published a set of frequently asked questions providing guidance about statutory exclusions and rule-based exemptions from the municipal advisor registration requirement. Further, the MSRB has developed a regulatory framework for municipal advisors and is currently developing municipal advisor rules regarding standards of conduct, supervision requirements, professional qualification requirements, pay-to-play, gifts and gratuities, and duties of solicitors.

Minimum Denomination Bonds

In 2015, FINRA will focus on firms that sell municipal bonds in less than the minimum denomination, in violation of MSRB Rule G-15. Issuers often set high minimum denominations for lower-rated bonds that may make the investments inappropriate for retail investors. Investors who buy the bonds in smaller denominations may find limited liquidity, and thus poor pricing, when they choose to sell the bonds.

Financial and Operational Priorities

Funding and Liquidity: Valuing Non-High-Quality Liquid Assets

Broker-dealers need to develop and monitor funding and liquidity risk management programs. A cornerstone of any such programs is the accuracy of the price firms assign to securities. FINRA has observed that at times firms' funding and liquidity plans rely on being able to sell or enter into repurchase transactions at or very near to the prices at which the firms have marked their inventory to market. The issue of mark-to-market pricing is particularly acute with respect to infrequently traded positions in corporate, asset-backed and municipal debt securities. Accordingly, FINRA will examine for the integrity of marks-to-market for such securities and for supervisory controls surrounding the overall valuation process.

Sales to Customers Involving Tax-Exempt or Federal Deposit Insurance Corporation (FDIC)-Insured Products

Firms that sell tax-exempt securities or FDIC-insured instruments, or products with similar characteristics, should be aware that in certain circumstances firm actions may cause customers to lose the tax-exempt status on interest payments or the FDIC protection they believe they have. These risks can arise if a firm is in a short position with respect to the security (*e.g.*, if a firm sells more securities to customers than it has purchased or holds in inventory, or it has a fail-to-receive allocated to a customer position). In the case of tax-exempt securities, the short position creates a situation where a customer expecting tax-exempt income will, in fact, receive taxable "substitute interest" from the firm.

Similarly, for FDIC-insured certificates of deposit, the firm's short position may create a situation where the customer's certificate of deposit may be denied status as an insured deposit from the FDIC if the issuing bank or savings and loan association becomes insolvent. Thus, the customer is at risk with respect to both FDIC insurance and with respect to priority of his or her claim in the event of an insolvency of the issuing depository institution. FINRA will examine for the creation and resolution of such short positions, including compliance with the SEA Rule 15c3-3(d) possession or control requirements and the adequacy of supervisory processes in place for the expeditious resolution of these positions.

Cybersecurity

FINRA examiners will review firms' approaches to cybersecurity risk management, including their governance structures and processes for conducting risk assessments and addressing the output of those assessments. In January 2014, FINRA initiated a sweep to understand better the type of threats to which member firms are subject, as well as their responses to those threats. FINRA expects to publish the results of that sweep in early 2015. That report will include principles and effective practices firms should consider in developing and implementing their cybersecurity programs, for example, with respect to their overall approach to cybersecurity, the use of frameworks and standards, the role of risk assessments, the identification of critical assets, and the implementation of controls to protect those assets based on the scale and business model of the firm.

In addition, FINRA observes that recent events have highlighted the potential adverse consequences of cyber attacks that destroy data. In accordance with SEA Rule 17a-4(f), firms are permitted to store records electronically, provided that the media "(p)reserve the records exclusively in a non-rewriteable, non-erasable format." In a 2003 Interpretation to SEA Rule 17a-4, the SEC noted that the rule does not specify the type of storage technology that may be used, but rather sets forth standards that the electronic storage media must meet to be considered an acceptable method of storage. In its 2003 interpretation, the SEC clarified that firms may use integrated hardware and software control codes to store data, provided "the electronic storage system prevents the overwriting, erasing or otherwise altering of a record during its required retention period." Given the widespread use of electronic storage media for record storage and the fundamental importance of firms' books and records to their ability to conduct business, a cyber attack that permanently destroys data may severely impact a firm's ability to continue operating. In 2015, FINRA examiners will review firms' approaches to ensuring compliance with Rule 17a-4(f) in the event of a cyber attack.

Outsourcing

As firms continue to outsource key operational functions to reduce expenses and focus on core business activities, FINRA reminds firms that outsourcing covered activities in no way diminishes a broker-dealer's responsibility for 1) full compliance with all applicable federal securities laws and regulations, and FINRA and MSRB rules, and 2) supervising a service provider's performance.[19] Outsourcing will be a priority area of review during 2015 examinations, and will include an analysis of the due diligence and risk assessment firms perform on potential providers, as well as the supervision they implement for the outsourced activities and functions.

Investor Protection Requires Timely Reporting of Disclosable Information

Through its BrokerCheck® and Central Registration Depository (CRD®) systems, FINRA provides comprehensive information on firms and associated persons as a key part of its investor protection mission. Investors, regulators and firms rely on this information and depend on it to be complete and accurate. Much of this information is derived from Form U4 and Form U5 registration filings. The FINRA By-Laws require that associated persons of member firms promptly disclose to FINRA reportable U4 and U5 events, including, but not limited to, regulatory actions, customer complaints, bankruptcy filings, liens, judgments and criminal charges.

Despite its importance, FINRA has found that in a number of instances firms do not report this information, or do not do so in a timely manner. FINRA is making changes to its registration review process, rules and examination program to address this noncompliance. This includes a public records review of all active registered persons. FINRA will continue this review process on a periodic basis for all registered persons.

In addition, FINRA has filed amendments to its Rule 3110 that requires firms to perform public records checks when registering associated persons to verify the accuracy and completeness of initial or transfer Form U4 filings. In 2015, FINRA examiners will review whether required disclosures are complete, accurate and made within the required time periods; determine whether firms have controls, processes and procedures in place to ensure timely filings; and determine whether public records reviews are occurring. Finally, FINRA expects firms to investigate representatives that fail to report appropriately.

Market Integrity

Maintaining fair and orderly markets is a central objective for FINRA and is critical to restoring and preserving investor confidence in the U.S. capital markets. FINRA is adapting its surveillance program to identify potentially violative conduct made possible by advances in technology and changes in market structure, (*e.g.,* abusive algorithms). Firms also must be more vigilant in detecting and preventing misconduct. Firms are well positioned to serve as the first line of defense in identifying bad actors through, among other things, the analysis of market participants' activities on their systems.

Supervision and Governance Surrounding Trading Technology

Maintaining a robust technology governance framework for electronic trading is a key responsibility for broker-dealers. FINRA has identified a number of concerns in this area, and in 2015, FINRA examination teams will review firms' technology and related controls with an emphasis on the development and ongoing supervision of algorithms. For example, FINRA examiners will review the adequacy of firms' formal supervisory processes—and related controls—for the development and testing of technology changes. Part of this review is a heightened focus on unscheduled trading technology changes that may not have benefitted from offline testing before handling live trades. FINRA examiners also will review the segregation of duties for technology staff performing various functions, namely, developing, testing, deploying, and modifying new and existing technologies. Examiners will also focus on firms' risk management and financial and operational controls, with a focus on firms' net capital, because the speed with which orders enter the market and are executed, often in numerous symbols on multiple markets, can introduce risk to the financial soundness of high-frequency trading firms.

Abusive Algorithms

FINRA views abusive trading algorithms and deficient supervision for potential manipulation as among the most significant risks to the integrity of the markets. For that reason, FINRA will continue to pursue firms whose traders or customers use algorithms to manipulate the markets, including through layering, spoofing, wash sales and marking the close, among other means. In addition, FINRA will continue to further enhance its surveillance program to detect new types of potentially manipulative trading activity brought about through the use of abusive trading algorithms. FINRA will also continue to review whether firms' supervisory and other controls failed to appropriately detect abusive activity by the firm's traders or its customers.

Cross-Market and Cross-Product Manipulation

Fragmented markets provide opportunities for market participants to disguise misconduct by trading in multiple markets. In 2015, FINRA will continue to enhance both its equities and options cross-market surveillance patterns. FINRA's cross-market surveillance now covers over 99 percent of the U.S. equity markets. Along with identifying potentially manipulative activity by single market participants on either a single or multiple markets, the cross-market surveillance patterns also identify potential relationship trading activity, that is, activity involving two or more market participants apparently acting in concert through one or more markets to engage in manipulative activity. These patterns mark a material step forward in promoting market integrity.

With the Chicago Board Options Exchange and C2 Options Exchange outsourcing most of their regulatory functions to FINRA starting in January 2015, FINRA will also now provide surveillance services to approximately 65 percent of the options market. As with equities, FINRA will continue to enhance its cross-market options surveillance capabilities in 2015 by addressing new threat scenarios.

In 2014, on behalf of some of FINRA's options exchange clients, FINRA also brought an action against a firm for cross-product manipulation. The case involved multiple instances of coordinated equity and options market activity designed to create momentary, artificial options prices that enabled the trader to purchase or sell options at more favorable prices. In 2015, FINRA plans to continue to expand its cross-product reviews and potentially bring additional actions.

Order Routing Practices, Best Execution and Disclosure

Last year, FINRA began the process to assess whether trading-fee rebates create conflicts of interest that compromise the execution quality of customer orders. Specifically, FINRA is presently conducting a sweep of firms that route a significant percentage of their unmarketable customer limit orders to trading venues that provide the highest trading rebates for providing liquidity. The concern is that firms may receive inferior executions of their customers' unmarketable limit orders because of market movements during the pendency of the orders, while the firm still collects a trading rebate. As part of the sweep, FINRA is in the process of reviewing routing decisions for marketable versus non-marketable orders and how such decisions are impacted by rebates. While the review is ongoing, the assessment has revealed that some firms do not have active best execution committees or other supervisory structures in place to meet their obligation to regularly and rigorously evaluate the quality of customer order executions. We will use the knowledge of our 2014 efforts to enhance our approach in determining whether firms base routing decisions on benefits to the firms without thoroughly evaluating the potential conflicts presented and the quality of execution they receive for customer orders.

We have also seen evidence of firms failing to meet their duty of best execution in routing some customer options orders. We have initiated reviews of firms that appear to have ignored a better market on one options exchange to achieve a clean cross on another market. FINRA will continue to review whether options floor brokers meet their best execution obligations and conduct appropriate reviews of the execution quality they receive on their customers' behalf.

Regarding fixed income, the evolution of market structure and the related expansion in electronic trading of debt securities has contributed to firms having access to improved data and tools to evaluate best execution and mark-ups. In 2015, FINRA will increase its emphasis on reviewing firms' pricing practices, including whether firms have the supervision and controls in place to ensure they are using reasonable diligence and employing their market expertise to achieve best execution for their customers and avoiding excessive mark-ups (and mark-downs).

In addition, in our fair pricing reviews, we are looking for instances in which firms that are intermediating transactions in structured products may not have disclosed information to their customers about how they would charge the customer. Dealers that position a trade for the purpose of taking a spread when their customer has agreed to pay the dealer an explicit fee for the transaction, should look closely at whether they are meeting the customer's expectations about how the dealer should execute the trade and be compensated.

Lastly, starting in 2015, FINRA will launch a pilot program to conduct fixed income-based examinations focusing on trading issues, including related controls. As with other trading examination programs, the fixed income program will focus on areas that complement FINRA's surveillance program. Among other things, the fixed income examinations will focus on the operation of alternative trading systems trading fixed income instruments, books and records, supervision and order execution practices.

Market Access

While the four years since the SEC adopted Rule 15c3-5 (the "Market Access Rule") have seen improvements in firms' risk management controls, we continue to find examples of firms' inadequate market access controls in both the equities and options markets related to potential rules violations (*e.g.,* manipulation) and erroneous activity (*e.g.,* erroneous quotes). Similarly, we have observed confusion regarding the applicability of the Market Access Rule to the fixed income markets. We have frequently found that firms have not developed sufficient financial controls around fixed income market access with respect to principal trading activity.

FINRA recognizes the control challenges firms face when customers conduct potentially manipulative activity through multiple broker-dealers. Therefore, beginning in 2015, FINRA plans to commence a pilot program to leverage the relationship trading alert activity detected in its cross-market surveillance program to provide firms with information intended to supplement firms' supervision efforts with respect to detecting and preventing manipulative trading activity.

Audit Trail Integrity

FINRA will continue to focus on late reporting in TRACE-eligible and municipal securities that appears to result from inadequate processes and procedures on trading desks. In many cases, firms appear to report larger-sized trades up to several hours late. These delays in reporting potentially affect FINRA's audit trail and its ability to assess whether a firm was at risk when executing a trade.

FINRA has created a new team to focus on identifying potential equity audit trail issues not typically detected through routine compliance sweeps and reviews. An important objective of this group is to resolve reporting errors promptly so that surveillance patterns can scan the most accurate data possible, reducing the risk of false alerts and potentially unnecessary inquiries to firms. The team looks at Order Audit Trail System, trade reporting and exchange audit trail data to identify potential reporting errors.

Conclusion

FINRA urges firms to review their business in light of the concerns addressed in this letter. Serving the interests of the investing public and entities raising capital in a fair manner should be a guiding principle as firms pursue their business in 2015. It is also important for firms to stay current on new and existing priorities and developments as they arise throughout the year. As always, we urge you to contact your firm's regulatory coordinator with specific questions or comments. In addition, if you have general comments regarding this letter or suggestions on how we can improve it, please send them to Daniel M. Sibears, Executive Vice President, at *dan.sibears@finra.org*.

Endnotes

1 *See* FINRA press release, FINRA Fines 10 Firms a Total of $43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection With Toys"R"Us IPO, Dec. 11, 2014.

2 Based on data from Morningstar.

3 *See* FINRA Rule 2210.

4 *See* FINRA Investor Alert, Public Non-Traded REITs—Perform a Careful Review Before Investing.

5 *See* Order Approving Proposed rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities, Exchange Act Release No. 34-73339; File No. SR-FINRA-2014-006 (Oct. 10, 2014), 79 Fed. Reg. 62,489 (Oct. 17, 2014). *See also* NASD Rule 2340 and FINRA Rule 2310 respectively.

6 These funds are referred to using a variety of terms, including smart beta, strategic beta, and alternative beta.

7 These rules revise and consolidate NASD Rules 3010, 3012 and 3110(i) and other corresponding NYSE rule provisions. Firms can find more information about the rules in *Regulatory Notice 14-10*.

8 *See* Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2013,"19 ICI Research Perspective pp. 1-2, (Nov., 2013), available at: www.ici.org/pdf/per19-11.pdf.

9 *See* *Regulatory Notice 13-45*.

10 *See* *Regulatory Notice 13-23*.

11 *See* FINRA press release, FINRA Fines LPL Financial LLC $950,000 for Supervisory Failures Related to Sales of Alternative Investments, Mar. 24, 2014; and FINRA Fines Berthel Fisher and Affiliate, Securities Management & Research $775,000 for Supervisory Failures Related to Sales of Non-Traded REITs and Leveraged and Inverse ETFs, Feb. 24, 2014.

12 *See* *Regulatory Notice 13-31*.

13 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Exchange Act Release No. 69959 (July 10, 2013), 78 Fed. Reg. 44,771 (July 24, 2013).

14 *See* FINRA Investor Alert: Private Placements – Evaluate the Risks Before Placing Them in Your Portfolio. *See also* SEC Office of Investor Education and Advocacy, Investor Alert: Advertising for Unregistered Securities Offerings.

15 *See* FINRA press release, FINRA Fines Merrill Lynch $8 Million; Over $89 Million Repaid to Retirement Accounts and Charities Overcharged for Mutual Funds, June 16, 2014.

16 *An Aging Nation: The Older Population in the United States*, Population Estimates and Projections, Current Population Reports, United States Census Bureau, May 2014, p. 6.

17 *See* FINRA press releases, FINRA Fines Brown Brothers Harriman a Record $8 Million for Substantial Anti-Money Laundering Compliance Failures, Feb. 5, 2014; FINRA Fines COR Clearing LLC $1 Million for Extensive Regulatory Failures; Anti-Money Laundering, Financial Reporting and Supervisory Responsibilities Neglected Over Four-Year Period, Dec. 16, 2013.

18 MSRB Municipal Advisor Resources.

19 FINRA's *Notice to Members 05-48* provides guidance on this subject.