Welcome and Opening Remarks
Wednesday, September 11, 2019
8:30 a.m. – 8:35 a.m.

Speaker: William St. Louis
Senior Vice President and Regional Director, Sales Practice
FINRA Northeast Region

Speaker Biography:

William St. Louis is Regional Director for FINRA's Northeast region and has responsibility for the sales practice examination and surveillance programs in FINRA's New York, Boston, Philadelphia, and New Jersey District offices. He also oversees FINRA's Membership Application Program (MAP). Prior to assuming the Regional Director role in March 2019, he was the District Director of FINRA's New York office. Before joining FINRA's examination program, Mr. St. Louis held senior roles in FINRA's Enforcement Department including serving as the Regional Chief Counsel for FINRA's North Region. Mr. St. Louis earned a B.A. from Baruch College and a law degree from New York University School of Law. Immediately after law school, Mr. St. Louis clerked for a New York state trial judge, and prior to law school he worked for several years in the Compliance Department of a NY-based broker-dealer.

Welcome and Opening Remarks

Panelist

- **Speaker**
  - **William St. Louis, Senior Vice President and Regional Director, Sales Practice, FINRA Northeast Region**

Fireside Chat Featuring FINRA President and CEO Robert Cook and Senior Vice President and Northeast Regional Director, Sales Practice William (Bill) St. Louis
Wednesday, September 11, 2019
8:35 a.m. – 9:05 a.m.

Speakers: Robert Cook
President and Chief Executive Officer
FINRA

William St. Louis
Senior Vice President and Regional Director, Sales Practice
FINRA Northeast Region

Fireside Chat Featuring FINRA President and CEO Robert Cook and Senior Vice President and Northeast Regional District Director, Sales Practice William (Bill) St. Louis Panelist Bios:

Speakers:

Robert W. Cook is President and CEO of FINRA, and Chairman of the FINRA Investor Education Foundation. From 2010 to 2013, Mr. Cook served as the Director of the Division of Trading and Markets of the U.S. Securities and Exchange Commission. Under his direction, the Division's professionals were responsible for regulatory policy and oversight with respect to broker-dealers, securities exchanges and markets, clearing agencies and FINRA. In addition, the Division reviewed and acted on over 2,000 rule filings and new product listings each year from self-regulatory organizations, including the securities exchanges and FINRA, and was responsible for implementing more than 30 major rulemaking actions and studies generated by the Dodd-Frank and JOBS Acts. He also directed the staff's review of equity market structure. Immediately prior to joining FINRA, and before his service at the SEC, Mr. Cook was a partner based in the Washington, DC, office of an international law firm. His practice focused on the regulation of securities markets and market intermediaries, including securities firms, exchanges, alternative trading systems and clearing agencies. During his years of private practice, Mr. Cook worked extensively on broker-dealer regulation, advising large and small firms on a wide range of compliance matters. Mr. Cook earned his J.D. from Harvard Law School in 1992, a Master of Science in Industrial Relations and Personnel Management from the London School of Economics in 1989, and an A.B. in Social Studies from Harvard College in 1988.

William St. Louis is Regional Director for FINRA's Northeast region and has responsibility for the sales practice examination and surveillance programs in FINRA's New York, Boston, Philadelphia, and New Jersey District offices. He also oversees FINRA's Membership Application Program (MAP). Prior to assuming the Regional Director role in March 2019, he was the District Director of FINRA's New York office. Before joining FINRA's examination program, Mr. St. Louis held senior roles in FINRA's Enforcement Department including serving as the Regional Chief Counsel for FINRA's North Region. Mr. St. Louis earned a B.A. from Baruch College and a law degree from New York University School of Law. Immediately after law school, Mr. St. Louis clerked for a New York state trial judge, and prior to law school he worked for several years in the Compliance Department of a NY-based broker-dealer.

Fireside Chat Featuring FINRA President and CEO Robert Cook and Senior Vice President and Northeast Regional Director, Sales Practice William (Bill) St. Louis

Panelists

- **Speakers**
  - **Robert Cook, President and Chief Executive Officer, FINRA**
  - **William St. Louis, Senior Vice President and Regional Director, Sales Practice, FINRA Northeast Region**

Supervision of Trading Desk Operations
Wednesday, September 11, 2019
9:15 a.m. – 10:15 a.m.

This session focuses on the supervision of trading desk activities. Join FINRA staff and industry practitioners as they view supervisory responsibilities, discuss surveillance controls that can be implemented to mitigate risk associated with trading desk operations, and review effective risk tools.

Moderator: Jeffrey Herrmann
Examination Manager, Sales Practice
FINRA New York District Office

Speakers: William Crooks
Senior Director, Trading and Financial Compliance Examinations (TFCE)
FINRA Market Regulation

Jill Ostergaard
Chief Compliance Officer
Exos Securities LLC

Dean Webber
Executive Director
Morgan Stanley

Supervision of Trading Desk Operations Panelist Bios:

Moderator:

Jeffrey Herrmann has been with FINRA for 13 years. He began his career in 1996, obtaining his series 7 and 63 registrations while conducting Broker Dealer sales to U.S. Retail and European Institutional Clients. Three year later, he joined the Market-Making Desk of Knight Capital Group where he obtained his series 55 registration. At Knight, Mr. Herrmann conducted Institutional Sales and Trading, specializing in semiconductor trading, merger arbitrage and technical analysis of cash and futures markets. Prior to joining FINRA, Mr. Herrmann also worked as an Operational Risk Specialist in the Global Asset Management business of a top-tier Broker-Dealer and traded his own capital as a registered Proprietary Equity Trader. Currently, Mr. Herrmann is an Examination Manager in FINRA's NY District Office. Additionally, he works with FINRA's Regulatory Specialist Program as a member of the Trading and Market Risk and Controls Subject Matter Expert Group and hosts the program's national conference calls on Algorithmic, Direct Market Access, High Frequency and Proprietary Trading Controls.

Speakers:

Bill Crooks is Senior Director in FINRA's Trading and Financial Compliance Examinations ("TFCE") group. TFCE conducts examinations focused on member firm's trading operations. Mr. Crooks has more than twenty years' experience conducting and managing TFCE examinations. Currently, Mr. Crooks oversees two teams of TFCE examiners located in New York and Chicago. Mr. Crooks has also been integral in the continued evolution of the TFCE program, including the incorporation of risk based scoping methodologies, developing guidance and overseeing training. In his various roles at FINRA, Mr. Crooks has led several projects and initiatives involving electronic trading topics, including Market Access, ATSs, and Algorithmic Trading Controls. Mr. Crooks began his career at FINRA as a Compliance Examiner in Member Supervision. Prior to joining FINRA, Mr. Crooks was employed as a Trading Clerk by an independent broker/dealer that operated on the American and New York Stock Exchanges.

Jill W. Ostergaard has more than 20 years of experience in strategic, risk management, legal and regulatory compliance matters in global financial markets. Currently, Ms. Ostergaard is a Partner and Chief Compliance Officer for Exos Securities LLC, an institutional broker-dealer with a focus on state-of-the-art technology. There, she is architecting the next generation compliance program from inception. Previously, Ms. Ostergaard was Managing Director and Head of Americas Compliance for Morgan Stanley and Barclays Capital. At Barclays, she also served as Chief Compliance Officer for the Intermediate Holding Company as well as the Swap Dealer. Early in her career she was Assistant General Counsel at Pershing where she developed a compliance program for Pershing Trading Company. Ms. Ostergaard began her career as an attorney with the SEC's Division of Market Regulation (Trading & Markets) and in the office of Commissioner Steven Wallman where she drafted a white paper on decimalization. Ms. Ostergaard is an active industry participant and served on FINRA's National Adjudicatory Council from 2012-2014 and was elected Chair in 2014; she also served 10 years on FINRA's Compliance Advisory Committee. Ms. Ostergaard has been a long-standing member of SIFMA's Compliance and Regulatory Policy Committee and served as Chair from 2006 – 2008. She also assisted in drafting the 2005 and 2013 SIFMA Whitepapers on the Evolving Role of Compliance. Ms. Ostergaard has been a speaker/moderator on several important compliance topics, including: behavioral economics, risk assessment, ethics, market structure, new products and supervision. She graduated cum laude from Hope College and received her J.D. from Loyola University of Chicago.

2019 FINRA Institutional Conference
September 11, 2019 | New York, NY

Supervision of Trading Desk Operations

Panelists

- **Moderator**
  - Jeffrey Herrmann, Examination Manager, Sales Practice, FINRA New York District Office
- **Panelists**
  - William Crooks, Senior Director, Trading and Financial Compliance Examinations (TFCE), FINRA Market Regulation
  - Jill Ostergaard, Chief Compliance Officer, Exos Securities LLC
  - Dean Webber, Executive Director, Morgan Stanley

Topic

- Supervisory Structures
- Qualification of Supervisory Personnel
- Supervision of Trading Activities
- Monitoring Electronic Communications

 |

Supervisory Structures

- Centralized
  - Localized supervision
  - Manual processes
- Decentralized
  - Specialized delegation units
  - Automated exception reports
- Industry Practices
  - Culture of Compliance
  - Descriptive procedures

Qualification of Supervisory Personnel

- Hiring
  - Sourcing candidates
- Training
  - New and experience candidates
- Quality assurance
  - Adequacy of reviews
  - Timeliness of reviews
  - Documenting escalations and dispositions

Supervision of Trading Activities

- **Firm Trading Accounts**
  - **Detecting and preventing:**
    - Rogue
    - Manipulative trading
- **Employee Brokerage Accounts**
  - **Approving accounts and monitoring employee transactions**
    - Preclearance
    - Post Trade Surveillance
    - Policy Restrictions

Monitoring Electronic Communications

- Selecting populations for review
  - Random sample
  - Lexicon
- Incorporating Communications Surveillance in Broader Surveillance Program

Closing Comments

- **Challenges**
  - What are the greatest compliance challenges that you are currently facing?
  - How are you preparing for those challenges?
- **Audience Questions**

Supervision of Trading Desk Operations
Wednesday, September 11, 2019
9:15 a.m. – 10:15 a.m.

Resources

FINRA Report

- 2019 Annual Risk Monitoring and Examination Priorities Letter

  www.finra.org/rules-guidance/communications-firms/2019-annual-risk-monitoring-and-examination-priorities-letter

SEC Reports

- Staff Summary Report On Examinations Of Information Barriers: Broker-Dealer Practices Under Section 15(G) Of The Securities Exchange Act Of 1934

  www.sec.gov/about/offices/ocie/informationbarriers.pdf

- Responses to Frequently Asked Questions Concerning Large Trader Reporting

  www.sec.gov/divisions/marketreg/large-trader-faqs.htm

FINRA Regulatory Notices

- FINRA *Regulatory Notice 19-21, Exchange-Traded Notes, Margin Requirements for Exchange-Traded Notes* (July 2019)

  www.finra.org/sites/default/files/2019-07/Notice_Regulatory_19-21.pdf

- FINRA *Regulatory Notice 19-18, Anti-Money Laundering (AML) Program, FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations* (May 2019)

  www.finra.org/sites/default/files/2019-05/Regulatory-Notice-19-18.pdf

- FINRA *Regulatory Notice 18-25, ATS Supervision Obligations, FINRA Reminds Alternative Trading Systems of Their Obligations to Supervise Activity on Their Platforms* (August 2018)

  www.finra.org/sites/default/files/Regulatory-Notice-18-25.pdf

- FINRA *Regulatory Notice 17-43, Short Interest Reporting, Guidance on Reporting Short Interest Positions Held in Master/Sub-Accounts or Parent/Child Accounts* (December 2017)

  www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-43.pdf

- FINRA *Regulatory Notice 15-09, Equity Trading Initiatives: Supervision and Control Practices for Algorithmic Trading Strategies, Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies* (March 2015)

  www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-09.pdf

2019 FINRA Institutional Conference

September 11 | New York, NY

Conflicts of Interest
Wednesday, September 11, 2019
10:30 a.m. – 11:30 a.m.

Join FINRA staff and industry professionals as they discuss helpful tips and tools for managing conflicts of interest. Panelists describe practices that raise conflicts of interest concerns and how to mitigate these issues.

Moderator: Jonah Arcade
Examination Manager, Sales Practice
FINRA New York District Office

Speakers: Joshua Greenstein
President
Puma Capital, LLC

Philip Shaikun
Vice President and Associate General Counsel, Regulatory
FINRA Office of General Counsel

Carmine Venezia
Global Head of Merchant Banking Division Compliance and co-head of the Americas Regional Vetting Group
Goldman Sachs & Co.

Conflicts of Interest Panelist Bios:

Moderator:

Jonah Arcade has been with FINRA for nine years and is currently an Examination Manager in FINRA's NY District Office dedicated to large firm sales practice examinations. Mr. Arcade started his career at FINRA in 2010 as a Principal Examiner and was promoted to Examination Manager in 2015. Additionally, he works with FINRA's Regulatory Specialist Program as the head of the Research Subject Matter Expert Group. Prior to joining FINRA, Mr. Arcade spent five years with Bear, Stearns & Co. and one year with J.P. Morgan Securities LLC covering fixed income and equity research. While at Bear Stearns, he obtained the Series 7, 63 and 24 registrations. Mr. Arcade is a graduate of the University of Michigan and the American University Washington College of Law.

Speakers:

Joshua Greenstein is President of Puma Capital, LLC. Mr. Greenstein joined Puma Capital in December 2007 steering the firm through the initial FINRA NMA process. Mr. Greenstein also served in the role of Chief Compliance Officer through May 2015. Mr. Greenstein began his career in 1994 as an institutional, wholesale equities trader. He received an M.B.A. from the Zicklin School of Business and a B.A. in Political Science from the University of Vermont. Mr. Greenstein currently maintains his Series 7, 24, 57, and 63 designations.

Philip Shaikun is Vice President and Associate General Counsel in FINRA's Office of General Counsel, where he is responsible for developing and interpreting FINRA rules and providing legal and policy advice to FINRA management and staff. Mr. Shaikun's responsibilities involve a variety of regulatory areas, including research analyst conflicts, broker compensation practices, communications with the public, supervision, registration, and sales and trading practices. Mr. Shaikun also leads the Office of General Counsel's role in the retrospective review of FINRA rules. Mr. Shaikun previously served as an attorney in FINRA's (then NASD) Enforcement Department. Prior to joining FINRA, Mr. Shaikun was as a trial attorney with the U.S. Department of Justice, where he prosecuted civil fraud cases. Mr. Shaikun graduated with a bachelor's degree from Duke University, where he also has served as a visiting lecturer in public policy. He received a law degree from the University of Southern California. Mr. Shaikun is also a former reporter for the *St. Petersburg Times* in Florida.

Carmine A. Venezia is the global head of Merchant Banking Division Compliance. He is also co-head of the Americas Regional Vetting Group. Mr. Venezia joined Goldman Sachs in 2006 as a vice president and associate general counsel in the Legal Department. In 2009, he joined Global Compliance as global manager of Operations, Technology, Finance and Services Compliance. In 2014, he became the co-head of Americas Securities Division Compliance, a role he held until he assumed his current role in 2019. Mr. Venezia was named managing director in 2012. Prior to joining the firm, Mr. Venezia worked at Bear Stearns & Company as a senior managing director in the Legal Department for 10 years. Earlier in his career, Mr. Venezia worked in private practice with a large New York City law firm and was a staff accountant with Price Waterhouse before becoming an attorney. Mr. Venezia serves as a member of the Board of Trustees of Trinity Hall. He also represents the firm on a number of industry committees, including the FINRA Operations Advisory Committee. Mr. Venezia earned a BS in Accounting from Lehigh University and a JD *cum laude* from Brooklyn Law School. He is admitted to the New York and Pennsylvania bars and is a certified public accountant.

Conflicts of Interest

Panelists

- **Moderator**
  - Jonah Arcade, Examination Manager, Sales Practice, FINRA New York District Office
- **Panelists**
  - Joshua Greenstein, President, Puma Capital, LLC
  - Philip Shaikun, Vice President and Associate General Counsel, Regulatory, FINRA Office of General Counsel
  - Carmine Venezia, Global Head of Merchant Banking Division Compliance and co-head of the Americas Regional Vetting Group, Goldman Sachs & Co.

To Access Polling

- Under the “Schedule” icon on the home screen,
- Select the day,
- Choose the Conflicts of Interest session,
- Click on the polling icon: 

Polling Question 1

- Does your firm have an office / role dedicated to conflicts?
  - Yes
  - No

Polling Question 2

- **Does Regulation BI affect your firm's conflicts management framework with respect to its institutional business?**
  - Yes
  - No

A REPORT FROM THE
FINANCIAL INDUSTRY REGULATORY AUTHORITY

Report on Conflicts of Interest

OCTOBER 2013

Contents

EXECUTIVE SUMMARY

Conflicts of interest can arise in any relationship where a duty of care or trust exists between two or more parties, and, as a result, are widespread across the financial services industry. While the existence of a conflict does not, *per se,* imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly. Indeed, many of the foundational pieces of legislation governing financial services in the United States contain provisions crafted precisely to address conflict situations.[1]

This report focuses solely on broker-dealers, the entities the Financial Industry Regulatory Authority (FINRA) regulates. Broker-dealers are subject to comprehensive regulation under the federal securities laws, Securities and Exchange Commission (SEC) rules and FINRA rules.[2] Conflicts of interest are an SEC and FINRA priority and have been addressed through rulemaking, oversight and enforcement action.[3] (*See* Appendix I for a non-exhaustive list of conflicts-related rules.)

This report carries those efforts forward. It recognizes that many broker-dealer firms have made progress in improving their conflicts management practices, but emphasizes that firms should do more to manage and mitigate conflicts of interest in their businesses.

To assist in these efforts, FINRA launched its conflicts initiative in July 2012[4] to review firms' approaches to conflicts management and to identify effective practices.[5] We used firms' responses to FINRA's conflicts review letter, in-person meetings and a follow-up compensation questionnaire to develop the observations detailed in this report.

The report is not intended as an inventory of conflicts that firms face, nor does it cover many conflicts that federal securities laws and SEC and FINRA rules already address, such as investment banking-research separation, outside business activities, soft dollars, payment for order flow or securities allocations to customers. Instead, FINRA's objective is to focus on firms' approaches to identifying and managing conflicts in three critical areas—firms':

- enterprise-level frameworks to identify and manage conflicts of interest;
- approaches to handling conflicts of interest in manufacturing and distributing new financial products; and
- approaches to compensating their associated persons, particularly those acting as brokers for private clients.

The enterprise-level framework discussion examines how firms address conflicts across their business lines from a top-down perspective. The new product and new business discussion explores how firms address conflicts related to the introduction of new products and services. Together, these areas play critical "gatekeeper" roles. Specifically, if firms are effective with enterprise-level frameworks and handling conflicts with new products, they can be proactive in identifying and managing conflicts. The focus on compensation provides insight on financial incentive structures that may create, magnify or mitigate conflicts of interest.

The report identifies effective practices that FINRA observed at firms or that, based on experience and analysis, FINRA believes could help firms improve their conflicts management practices. It also contains more general observations and commentary on firms' practices that we share for the industry's information. FINRA recognizes that the effective practices and observations in this report are drawn from discussions with large firms and, as a result, will not in all cases be directly applicable to small firms.

This report is a point-in-time review of several facets of conflicts of interest. Given conflicts' pervasiveness and potential to cause customer harm, FINRA will continue to assess firms' conflicts management practices and the effectiveness of those practices in protecting customers' interests. FINRA will also monitor the effectiveness of approaches to conflicts regulation used internationally.

FINRA expects firms to consider the practices presented in this report, and to implement a strong conflict management framework. If firms do not make adequate progress on conflicts management, FINRA will evaluate whether rulemaking to require reasonable policies to identify, manage and mitigate conflicts would enhance investor protection.

FINRA stresses that this report is not intended to express any legal position, and does not create any new legal requirements or change any existing regulatory obligations. Throughout the report, we identify conflicts management practices that we believe firms should consider and tailor to their business model as they strengthen their own conflicts frameworks.

Conflicts of Interest Framework

The first focus of this report is firms' enterprise-level conflicts of interest frameworks. We use the term *framework* to mean the combination of underlying ethics culture, organizational structures, policies, processes and incentive structures that, in their totality, shape a firm's management of conflicts of interest.

An effective practice is for firms to implement an articulated, firm-wide framework to manage conflicts of interest, and FINRA observed a number of firms that implemented many facets of such a framework. The key to making such a framework effective begins with the tone from the top. To be effective, firm leadership should require not only adherence to the letter of the law, but a commitment to the highest ethical standards and to putting customers' interests first. Of course, reliance on the tone from the top to address conflicts of interest is insufficient by itself. As appropriate to the scale and complexity of a firm's business, elements of an effective practice framework for managing conflicts of interest include:

- defining conflicts of interest in a way that is relevant to a firm's business and which helps staff identify conflict situations;
- articulating employees' roles and responsibilities with respect to identifying and managing conflicts;
- establishing mechanisms to identify conflicts in a firm's business as it evolves;

- defining escalation procedures for conflicts of interest within and across business lines;
- avoiding severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;
- disclosing conflicts of interest to clients, taking into consideration the different needs of retail and institutional clients;
- training staff to identify and manage conflicts in accordance with firm policies and procedures; and
- reporting on significant conflicts issues, including on a firm's own measures to identify and manage conflicts, to the Chief Executive Officer (CEO) and board.

New Product Conflicts

The second focus of this report is the introduction of new financial products. Firms at the forefront of financial innovation are in the best position, and are uniquely obligated, to identify the conflicts of interest that may exist at a product's inception or that develop over time.

There are a number of effective practices firms can adopt to address such conflicts. First, firms can use a new product review process—typically through new product review committees—that includes a mandate to identify and mitigate conflicts that a product may present.

Second, firms should disclose those conflicts in plain English, with the objective of helping ensure that customers comprehend the conflicts that a firm or registered representative have in recommending a product.[6] These conflicts may be particularly acute where complex financial products are sold to less knowledgeable investors, including retail investors.[7]

Third, product manufacturing firms can implement effective Know-Your-Distributor (KYD) policies and procedures. These KYD measures help mitigate the incentive to increase revenue from product sales by using distribution channels that may not have adequate controls to protect customers' interests.

Fourth, firms can perform post-launch reviews of new products to identify potential problems with a product that may not have been readily apparent during the initial review—or that may have arisen as a result of economic events—and take remedial action.

Fifth, firms can carefully evaluate and decline to offer products to customers when the conflicts associated with those products are too significant to be mitigated effectively.

To reduce conflicts, firms' private wealth businesses should operate with appropriate independence from other business lines within a firm. FINRA is encouraged by firms' general adoption of open product architectures (*i.e.*, the sale of third party in addition to proprietary products). Nonetheless, firms involved in both the manufacture and distribution of products should maintain effective safeguards to alleviate pressure to prefer proprietary products to the detriment of customers' interests. This is particularly important as firms seek to leverage their brokerage and other platforms to cross-sell products and services. Equally important, firms with revenue sharing or other partnering arrangements with third parties should exercise the necessary diligence and independent judgment to protect their customers' interests.

Compensation Practices

The final focus of this report is compensation. Although the primary focus is on brokerage compensation (and related supervisory and surveillance systems), the report also addresses the application of tools to mitigate conflicts of interest in compensation for associated persons more generally. Many firms have considered and taken steps to mitigate these conflicts directly through changes to compensation arrangements and through supervision of registered representatives' sales activities.

The use of "product agnostic" compensation grids (also referred to as "neutral grids") can be an effective practice to reduce incentives for registered representatives to prefer one type of product (*e.g.*, equities, bonds, mutual funds, variable annuities) over another.[8] These grids typically pay a flat percentage of the revenue a registered representative generates, regardless of product recommended. FINRA notes, however, that while this eliminates one variable that may influence recommendations, registered representatives still have an incentive to favor products with higher commissions because these produce larger payouts. Consequently, to reduce conflicts, firms should take measures to mitigate biases that differences in compensation by product may create.

Another effective practice is for firms to link surveillance of registered representatives' recommendations to thresholds in a firm's compensation structure to detect recommendations, or potential churning practices, that may be motivated by a desire to move up in the compensation structure and, thereby, receive a higher payout percentage.

Enhancing supervision and surveillance of a registered representative's recommendations as that person approaches other significant compensation or recognition milestones is a related effective practice. A number of firms perform specialized supervision and surveillance of recommendations as a registered representative approaches the end of the period over which performance is measured for receiving a back-end bonus. In addition, some firms perform additional surveillance to assess the suitability of recommendations as a registered representative approaches the threshold necessary for admission to a firm recognition club (*e.g.*, a President's Club or similar).

An effective practice is enhancing supervision and surveillance of a registered representative's recommendations around key liquidity events in an investor's lifecycle, such as the point where an investor rolls over her 401(k). The recommendations a representative makes at this stage of an investor's life have profound implications for the investor and deserve thorough scrutiny and review.

Another effective practice is for firms to reduce the incentive for a registered representative to prefer one mutual fund or variable annuity family over another by capping the credit a registered representative may receive for a comparable product across providers. For example, different mutual fund families might offer gross dealer concessions (GDC) of 5, 4 and 3.5 percent on a comparable fund. Some firms cap the GDC for that particular type of fund at 4 percent, which reduces the incentive for the registered representative to recommend the fund that pays a 5 percent GDC to enhance his compensation. FINRA observed several firms that implement this practice.

Finally, imposing compensation adjustments on registered representatives who do not properly manage conflicts of interest is an effective practice.

Questions/Further Information

Inquiries regarding the Report may be directed to Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, at (202) 728-6911; George Walz, Vice President, Regulatory Programs/Shared Services, at (202) 728-8462, or Steven Polansky, Senior Director, Regulatory Programs/Shared Services, at (202) 728-8331.

ENTERPRISE-LEVEL CONFLICTS GOVERNANCE FRAMEWORK

Introduction

Virtually every financial firm, including those regulated by FINRA, faces potential conflicts of interest in its business. In order to address those conflicts, a firm should be able to recognize conflict situations and take measures to manage them appropriately. Firms should address conflicts through proactive decision making, not ad hoc responses to conflicts-related events. The framework for this proactive decision making depends on the scope and scale of a firm's business.[9] It will look vastly different for a small introducing broker than for a large firm with multiple affiliates engaged in a broad range of businesses on a national or global scale.

Large firms may address conflicts of interest through their enterprise risk management or operational risk frameworks. Components of such programs, such as risk and control self-assessments, may provide an opportunity to identify conflicts of interest within a firm's business and evaluate their possible impacts. Efforts to quantify those impacts might still be in their early stages, but as operational risk techniques advance, these efforts may provide firms with additional tools to help focus their conflicts of interest management efforts.

By contrast, the conflicts management framework at a small firm selling basic products might rely largely on the ethical tone set by the firm owner coupled with required supervisory controls, especially those related to suitability, and the firm's compensation structure.

Although conflicts management frameworks may differ among firms, small and large firms alike often face some of the same basic conflicts. For example, a firm or its registered representatives may have an incentive to recommend one product over another. Conflicts may exist between an associated person's activities as a broker and their outside business activities. Firms may be tempted to hire an associated person in spite of a poor regulatory history, if they believe that the individual can boost firm profitability.

Effective Practices Summary: Comprehensive Conflicts Governance Framework

An effective practice FINRA observed at a number of firms is implementation of a comprehensive framework to identify and manage conflicts of interest across and within firms' business lines that is scaled to the size and complexity of their business. Without such a framework, firms are more likely to experience situations where conflicts cause harm to customers or the firm. Key features of a robust conflicts management framework that were observed include:

- a "tone from the top" that emphasizes the importance of ethical treatment of customers and the fair handling of conflicts of interest;
- articulated structures, policies and processes to identify and manage conflicts of interest that include:
  - a working description of conflicts of interest that enables employees to understand and identify conflicts of interest that may arise in a firm's business;
  - adoption of a best interests of the customer standard in a firm's code of conduct;
  - a delineation of employees' responsibilities with respect to identifying and managing conflicts of interest;
  - defined escalation procedures for handling potential conflict situations;

continued

- proactive and systematic identification of conflicts of interest in a firm's business on an ongoing and periodic basis;
    - transparency of material conflicts to executive management and the board; and
    - periodic testing of the firm's conflicts management framework;
- a willingness to avoid severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;
- effective disclosure to clients, taking into consideration the different needs of retail and institutional clients;
- hiring practices that rigorously review potential employees' ethical, financial and regulatory history;
- training that focuses on ethical treatment of customers and enables staff to identify and manage conflicts; and
- an information technology infrastructure that supports conflicts management in a comprehensive manner.

"Tone from the Top," Firm Culture and Conflicts of Interest

An effective practice for all firms is the establishment of a "tone from the top" that stresses the importance of ethical decision making and fair treatment of customers. This tone is set by a firm's executive management in their day-to-day actions and decisions. It is incumbent upon them to consistently communicate and demonstrate the values to which they expect their employees to adhere, and to monitor employees' behavior to ensure that it aligns with the firm's stated values.

Without the proper tone from the top, many of the measures discussed later in this report will be ineffective. Leadership that singlemindedly drives the distribution of proprietary products may undermine the effectiveness of new product review processes intended to protect customer interests. Conflict management frameworks cannot be expected to succeed without the strong support of a firm's leaders.

Boards can play an important role in setting the tone from the top. Providing the board with visibility on significant conflicts a firm faces, as well as the firm's overall approach to conflicts management, signals the importance the highest levels of the firm attach to addressing conflicts issues. Several firms report on conflicts issues to their boards, sometimes within the context of the firm's risk management reporting.

It is important to note, though, that reliance on the "tone from the top" and a good culture is a first line of defense. To protect customers and the firm from the potential negative consequences of conflicts of interest, supporting structures, policies, processes, controls and training are critical.

Conflicts Management Structures

A number of firms with which FINRA met manage conflicts at the enterprise level using either a distributed or centrally managed approach. Another group of firms neither defines conflicts management structures nor articulates the roles and responsibilities of senior management, firm committees and staff with respect to conflicts management.

An effective practice is for a firm to establish carefully designed and articulated structures to manage conflicts of interest that arise in its business. This includes clearly defining the roles and responsibilities of the individuals, committees and other bodies that play key roles in that structure. Both the distributed and centrally managed approaches may be appropriate for a firm depending on its specific circumstances. FINRA underscores that a firm's conflict management structure does not need to be complex, but it needs to be effective.

An approach where a firm simply relies on its existing structures to manage conflicts, without having considered their effectiveness for the task is likely to be ineffective. Put differently, simply adding conflicts management as one more task for the compliance or legal departments—without a clear delineation of expectations, roles and responsibilities—is insufficient.

Distributed Model

The most common approach to conflicts management is a distributed model where responsibility for identification and oversight is spread within a firm with no single office or department having overall ownership. In this model, the business lines typically bear front-line responsibility for identifying and managing conflicts. Various senior-level committees address conflicts specific to their scope of responsibilities and the control functions support both the business lines and the committees in varying degrees. Policy ownership for conflicts issues is diffused among these same functions. The complexity of this approach increases as a function of the complexity of a firm's business.

One benefit of this approach is that it places responsibility for identifying and managing conflicts with those individuals most directly familiar with the details of a firm's business and who are in a position to take measures to mitigate those conflicts. In addition, a firm does not need to create new structures or reporting lines which can be a challenging and time-consuming process.

One potential downside to the distributed approach is that individuals within a business line may be unaware of conflicts in their business that arise because of activities in other business lines. In addition, individual business lines may handle similar types of conflicts in different ways without a conscious decision that those differences are appropriate for the specific situation. Furthermore, firms' management teams may have difficulty remaining focused on conflicts issues among the myriad other issues competing for their time and attention. Finally, varying degrees of commitment to identifying and mitigating conflicts may exist across the firm.

Centralized Model

The second approach uses a centralized conflicts office to manage a firm's conflicts framework. Firms that take this approach emphasize that although they operate a centralized office, responsibility for identifying conflicts rests first and foremost with the business. FINRA observed this model in two versions. In one version, a dedicated conflicts office is part of firm management. The office has both a transactional and business practice focus. In the former role, the office oversees the firm's conflict management framework and works with business units to manage potentially significant conflicts within, and across, business units. In the latter role, the office works with business units to review and assess business practice conflicts on an ongoing basis, as well as to support presentation of thematic conflicts reviews to a senior firm management committee.

In the second version of the centralized approach, conflicts management is integrated into an existing, compliance-related group. This office is responsible for, among other things, the firm's Code of Ethics and certain other enterprise-level conflicts policies. The office coordinates line-of-business "conflicts officers" (discussed below) and works with business units to identify and manage unique conflict situations. The office maintains a log of non-standard conflicts, in part to help identify areas where training may be needed. In contrast to the dedicated conflicts office approach, the integrated conflicts office does not operate the firm's transactional review process.

Both centralized models use a network of "conflicts officers" in the business units to help address conflicts that may arise in the normal course of business. The "conflicts officers" act as a resource to the business unit in managing conflicts issues, are a point of contact for individuals who wish to raise potential conflicts concerns and can also escalate conflicts as warranted. These individuals may be part of either the risk or compliance functions.

There are several potential benefits of a centralized, enterprise-level approach to conflicts management. First, the office creates a platform to maintain a sustained, firm-wide focus on conflicts issues. A similar focus may be difficult to achieve when driven by multiple firm-level management committees. Second, creating a dedicated office sends a strong message to firm employees about the importance of conflicts issues to executive management. Third, if established at an appropriate level within a firm, the office provides visibility on conflicts issues to executive management and, as appropriate, the board. Fourth, a centralized office can help ensure a consistent approach to conflicts management across the enterprise.

The centralized model is not without potential downsides. First, it may diminish the sense of responsibility for conflicts in the business lines. Firms using the centralized model acknowledge that potential, but also emphasize that their approaches are designed to prevent this from happening. One firm explicitly places front-line responsibility for identifying conflicts with the business lines. Second, establishing a centralized model can be a significant undertaking. Firms will likely need to create new policies and processes and implement technology programs to support the operation of the conflicts office. In particular, the conflicts office may need a broad array of information about a firm's business activities to evaluate the conflicts the firm may face.

The centralized approach to conflicts management is relatively new, and its advantages and limitations may be more fully evaluated once the approach matures.

No Defined Structure

Several firms with which FINRA met did not define the structures, and related roles and responsibilities, for managing conflicts in the firm. Instead, these firms address specific conflicts in the business area in which they occur, but do so primarily in a compliance context. This makes it challenging to identify and manage conflicts that are not specifically addressed in statute or regulation, or that may arise as the firm's business model evolves over time—for example, through acquisitions or new business initiatives.

The lack of a comprehensive approach does not mean that firms were incapable of addressing potential conflicts of interest. Several of the firms had taken commendable steps to limit the distribution of more complex and risky products to retail customers. In some cases, disclosure of potential conflicts was particularly clear and concise.

Nevertheless, as a firm's scale and complexity increase, the lack of articulated structures, policies and processes to manage conflicts exposes a firm's customers (and the firm itself) to an increased risk of harm arising from conflicts of interest.

Committees and Other Ad Hoc Bodies

In addition to the conflicts review structures mentioned above, most firms also use various committees or ad hoc groups on an as-needed basis to address conflicts issues as they arise. These can include senior firm management committees, such as a reputational risk committee or similar body. One firm established a cross-divisional conflicts forum for compliance personnel. This group meets quarterly to share information about internal, external and regulatory developments, as well as business division specific items. The group provides a forum to share effective practices and lessons learned.

Conflicts Management Policies

An effective practice is for firms to articulate ethical standards to guide employees in managing conflicts of interest, as well as firm-wide policies on conflicts management, as appropriate to a firm's size and complexity. Firms generally establish enterprise-level conflicts of interest policies in two places: a firm-wide code of conduct or equivalent document (*e.g.*, a Code of Ethics), and, in some cases, a firm-wide conflicts policy.

Code of Conduct

Firms' codes of conduct typically establish the broad context within which employees make decisions about how to handle conflicts situations. The code of conduct generally contains a broad commitment to fair treatment of customers and requirements to avoid or manage conflict situations. One firm's code states that the firm "is committed to identifying and managing or avoiding potential conflicts of interest in its business" and is committed to "treating our clients fairly and with integrity." Another firm's code states "(i)n dealing with these potential conflicts, we require integrity and the use of good judgment and discretion exercised in a manner expected by this Code, our policies, and our values."

One dually registered broker-dealer and investment advisory firm's code states that the firm and covered staff "have an affirmative duty of care, honesty and good faith to act in the best interest of its clients." Covered staff, the code continues, "(s)hould avoid even the appearance of a conflict of interest and should fully disclose all material facts concerning any conflict that does arise with a client."

An effective practice is to add to a firm's code of conduct, or other appropriate documents, a best-interest-of-the-customer standard that applies to registered representatives' personalized recommendations to retail customers. Under this Code standard, a broker should make only those recommendations that are consistent with the customer's best interests.[10] A firm's code establishes an essential starting point—a yardstick against which the behavior of employees may be measured. Of course, to be meaningful, the rhetoric of a code should be supported by firm policies and procedures and implementation by firm leadership.

Enterprise-level Conflict Policy

In addition to the code of conduct, some firms use a dedicated, enterprise-level conflict of interest policy. Those policies typically contain the following elements:

- **A statement on objectives, policy or rationale:** These elements typically acknowledge that the firm operates in a business where it faces actual and potential conflicts of interest, and that a failure to manage these conflicts effectively may result in reputational damage to the firm.

- **A discussion of the types of conflicts a firm may face:** Firms' enterprise-level conflicts policies typically provide general guidance on the factors that can lead to a conflict of interest, in some cases supported by examples of specific conflicts relevant to a firm's business. (*See* Conflicts of Interest Examples from Firms' Enterprise-level Conflicts Policies, below, for a description and examples of common conflict categories some firms use.)
- **A description of roles and responsibilities:** Most firms' policies articulate the role of senior management and, in some cases, employees in managing conflicts. Firms with both a distributed and centralized approach to conflicts management use this section of the policy to place responsibility for identifying and addressing conflicts with the business lines. For example, the policy of one firm with a distributed approach to conflicts management states "(s)enior management of each Division is responsible for ensuring that Conflicts relating to its business are identified and addressed"; other firms have similar statements in their policies. Similarly, the policy of a firm with a centralized approach states, "(s)enior management of each Business Unit...is responsible for ensuring that Conflicts relating to its business are identified and addressed including escalating, as appropriate to the Franchise Committee process."
- **A description of conflict escalation procedures:** Most firms' policies describe an escalation process for handling those conflicts of interest that cannot be handled through other firm policies, including a description of individuals' roles and responsibilities and appropriate organizational contact points for escalation.

One firm takes a different approach to establishing an enterprise-level conflicts policy. It maintains enterprise-level content standards for conflicts policies and requires each line of business to create its own conflict of interest policy in line with the corporate standard. In essence, this creates a "policy on policies." Part of the rationale for this approach is to ensure firm-wide consistency of approach while allowing business lines to tailor their policies to their specific requirements.

Conflicts of Interest Examples From Firms' Enterprise-level Conflicts Policies

In their conflicts policies, some firms amplify general conflict categories with specific examples of conflicts that may arise in their business:

- **Firm vs. client conflicts**
  - The firm offers or recommends products for which the firm receives greater fees/compensation than other products, or that may not be suitable for certain clients.
  - The firm performs multiple roles with respect to a client or transaction (*e.g.*, advisor, underwriter, lender, principal counterparty, derivative counterparty).
  - The firm engages in business and trading activities for its own account or client accounts while other clients are active in relevant markets at the same time.
  - The firm may provide investment advice or discretionary portfolio management services to its clients, and the firm may also recommend or sell products that it or affiliated companies issue.
- **Client vs. client conflicts**
  - The firm is the discretionary portfolio manager for more than one client or fund, in particular with respect to issues related to allocation.
  - The firm has multiple clients interested in acquiring the same company or assets.
  - The firm charges clients in the same investment strategy or program different fees.
  - The firm may be in initial discussions with clients on both sides of a deal.

continued

- **Employee vs. client conflicts**
  - The compensation arrangements or incentives for the firm or its employees could affect whether employees recommend or offer a particular security or transaction to a client.
  - An employee is engaged in outside business activities with an issuer about which the employee may make a recommendation.
- **Employee vs. firm conflicts**
  - An employee may compete with the firm for the purchase or sale of property, assets, services or other interests.
  - An employee engages in personal trading or outside business activities (including board memberships/directorships) that could conflict with a client or with the firm.
- **Vendor vs. client conflicts**
  - A vendor may misuse, or inadequately protect, confidential customer information.
  - A vendor may fail adequately to protect confidential customer information after its relationship with the firm is terminated.

There is no consistent relationship between firms with centralized conflicts management structures and a centralized conflicts policy. Several of the firms with enterprise-level policies do not have enterprise-level conflicts offices and not all the firms with an enterprise-level conflicts office have an enterprise-level conflicts policy.

Business Activity and Other Policies

Some firms address conflicts management, including escalation procedures, in a variety of policies beyond those at the enterprise level. For example, firms maintain a wide variety of business line or topic-specific policies that focus either wholly or in part on specific conflicts issues. These include policies on outside business activities, products, confidentiality of information, information barriers, business selection and handling of customer trades.

Conflicts Management Processes

Two of the key processes firms identified that support their enterprise-level conflicts frameworks relate to conflicts escalation and conflicts inventories. In addition, several firms discussed the importance of monitoring and assessment processes through risk control self-assessments and internal audit reviews, to evaluate the effectiveness of a firm's overall conflicts framework. These latter processes are part of firms' risk management programs and fall outside the scope of this report, but their relationship to conflicts management is worth noting.

Escalation Procedures

Having clear and robust processes for escalating conflicts of interest is an effective practice. Many firms use a combination of topic or business activity-specific escalation procedures—for example, procedures for escalating conflicts that may arise in a firm's merger and acquisition advisory activities—coupled with an enterprise-level "catch-all" escalation process. This "catch-all" process is intended to capture conflicts that do not fit neatly into a firm's other, existing escalation procedures. Firms with enterprise-level conflicts policies typically articulate these "catch-all" processes in that policy. In one instance, a firm's policy provides a template/flowchart to help employees evaluate if and how they should escalate a conflict. Firms with more developed escalation procedures plainly articulate employees' roles and responsibilities as well as the circumstances and manner in which they should invoke the escalation processes.

The approaches firms take to their "catch-all" processes vary considerably. Firms with a centralized conflicts management office use the conflicts office, the related conflicts officer network (discussed below), and the legal and compliance departments as primary points of contact for employees who are unsure about whether an issue constitutes a conflict. From there, employees can raise issues to the central conflicts office or other offices, as appropriate.

Firms with a distributed model take a variety of approaches. For example, one firm relies on employees escalating potential conflicts within the business line to the compliance department. Another firm encourages employees to escalate any issue that raises reputational risks, including conflicts, first to the business and, as warranted, to the risk management or legal departments.

In several firms, it was unclear what avenue an employee would take to escalate a conflict concern. Some firms' institutional compliance or trading personnel did not have effective escalation processes for potentially problematic market or trading practices. FINRA encourages firms to examine whether escalation processes for these practices should be more broadly incorporated into the firm's conflicts management infrastructure, particularly in light of recent enforcement matters related to trading practices (*e.g.*, research huddles, expert networks, research analyst practices, initial public offering practices/spinning and laddering).

Conflicts Inventory Reviews

FINRA believes that it is an effective practice to use both regular, ongoing processes and periodic reviews, to identify and create an inventory of conflicts in a firm's business. While we observed that some firms perform ongoing or periodic reviews—as well as some firms that do not perform reviews at all—none performed both. FINRA believes that the two types of reviews are complementary. The ongoing review helps firms identify conflicts in near real-time and allows firms to address them quickly. The periodic review permits firms to step back and consider conflicts issues in a structured, comprehensive way. That could be particularly valuable for firms that use a decentralized approach to conflicts management where there may be a less consistent focus on conflicts issues.

Firms that engage in conflicts reviews—on either a periodic or ongoing basis—stated that the process was extremely useful, both in identifying conflicts and in establishing or refining conflicts-related structures, policies and processes. Some firms conduct regular, periodic reviews of conflicts within their business, sometimes in the context of a broader annual risk assessment, and record this information in a conflicts register. Firms conduct these reviews annually or biennially. In another instance, a firm shifted from conducting periodic reviews to an ongoing conflicts review process. This firm finds the ongoing review process more effective than the periodic approach.

FINRA observed one firm that included, as part of its enterprise-level conflicts policy, a template of issues—*e.g.*, changes in business, organizational and informational structure and compensation/incentive structures—business lines should consider in conducting their conflicts review.

As part of effectively creating an inventory of conflicts, firms should consider whether conflicts can be categorized—or assigned attributes—that would facilitate future review and analysis. For example, a firm may sell complex products containing call features (*see* Structured and Complex Products and Embedded Conflict, page 21). These features may create potential conflicts between the interests of the issuer and investors. If a firm determined it could handle disclosure of the potential conflict in a way that was more effective, it could—with appropriate categorization—identify other products where a similar conflict might exist and assess the appropriateness of the improved disclosure practice to those other products.

Disclosure

The U.S. regulatory regime relies heavily on disclosure to customers as a tool to mitigate conflicts that may arise in the course of a firm's business. The specific nature of a firm's disclosure obligations depends on the facts and circumstances of a given situation, and these obligations are established in various places in statute, regulation and case law.[11] A broker-dealer's duty under the anti-fraud provisions of the federal securities laws to disclose material information depends upon the nature of its relationship with a customer.[12] When recommending a security, a broker-dealer may be liable if it does not "give honest and complete information" or does not disclose "material adverse facts of which it is aware".[13] Broker-dealers have also been found liable for failures to disclose conflicts, such as their role as a market maker; their trading in a principal capacity; the existence of multiple share classes of a recommended mutual fund; and their receipt of revenue sharing payments.[14] FINRA rules require extensive disclosure to customers in a number of circumstances (*see* Table 2: Examples of conflicts-related disclosure requirements and regulatory prohibitions, page 37).

State law also may impose disclosure obligations on broker-dealers. The Delaware Court of Chancery emphasized the importance of conflicts disclosure in mergers and acquisitions where a firm involved in advising and financing a transaction represents multiple clients, or has a proprietary interest in the transaction.[15]

FINRA believes that to make disclosure effective, firms should look beyond minimum disclosure obligations under statute, regulation and case law, to identify practices that are effective in helping customers make informed decisions. In selling new products, effective disclosure may help a customer understand the factors that may affect a product's financial outcome. To this end, firms should consider whether the use of scenarios and graphics could help customers achieve this level of understanding.

A test to evaluate the effectiveness of their disclosure is asking, in the event of a reasonably foreseeable adverse product outcome, could an investor legitimately say, "I did not realize that could happen" on the basis of information the firm provided apart from the prospectus. If the answer is "yes," the firm should reconsider how it presents information about that product to customers. In the context of an advised sale where the firm provided its own sales materials, it is not sufficient that the relevant risk information was contained solely in the product prospectus.[16]

A further effective practice is to require investors to attest to their understanding of more complex products before purchase. The process of going through this attestation may reinforce to customers the need to understand the products they purchase.

For firms representing multiple institutional clients, or with a proprietary interest in an advisory or financing transaction, the firm should make the customer aware of the multiple roles the firm plays and seek consent, preferably in writing, from the customer to the firm serving multiple parties' interests.

Hiring Practices

Employing ethical individuals is an integral part of maintaining a culture of compliance and integrity in which conflicts of interest are addressed fairly. Several firms identified conflicts in personnel processes that could undermine efforts to hire appropriately qualified individuals. First, the firm might seek to hire a candidate with a problematic financial or regulatory history because of the book of business she could bring to a firm. Second, firms may establish hiring targets, such as hiring three new registered representatives per month or filling a vacancy within 45 days. In order to mitigate the pressure to hire associated persons who may have problematic backgrounds, some firms give their compliance department veto rights over all hires. This is intended to mitigate incentives for hiring personnel to fill a position with a potentially ethically compromised individual in order to meet a hiring target.

As part of screening applicants for employment, an effective practice is to review those individuals' employment and regulatory history as well as their financial standing and credit history. This review includes whether the applicant was associated with disciplined firms, exhibited poor compliance behavior or engaged in sales practices that posed risks to customers. This type of review can help identify individuals who may be prone to engage in inappropriate activity.

In light of the negative impact individuals with poor ethical standards can have on a firm, FINRA remains concerned about the number of firms willing to hire associated persons with problematic disciplinary histories.[17] This creates risks for customers as well as reputational risk to firms. FINRA's concerns are heightened when we see firms hiring multiple individuals with these problematic backgrounds and FINRA reiterates firms' obligations to use hiring practices that may help mitigate conflicts of interest.

Hiring Associated Persons With a Problematic Disciplinary History

A firm hiring an associated person must affirmatively determine that the associated person satisfies FINRA's qualification requirements and is not subject to a "statutory disqualification" (whether or not that individual is required to be a registered person).[18] In addition to determining the eligibility of all potential associated persons, firms have a duty to investigate the character, business repute and experience of any person prior to submitting a Form U4 on behalf of the individual. There are a number of questions firms should consider before hiring an associated person.[19] In the case of registered representatives, firms should consider how that potential employee's book of business will fit with the firm's current business mix. Is the firm sufficiently familiar with all of the securities products the representative intends to offer? Does the representative engage in the sale of penny stocks and, if so, is the firm adequately equipped to supervise those transactions or recommendations? Is the firm comfortable that the products the representative intends to recommend to customers meet suitability requirements? Does the firm have the appropriate supervisory and compliance infrastructure (principals, licenses, operational personnel) to support any new business being brought on by the representative? Does the representative's financial background (*e.g.*, credit or bankruptcy history) raise concerns about the individual's financial probity and potential pressure to generate revenue through excessive trading or unsuitable recommendations?

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Firms should pay particular attention to, and exercise due care before hiring an individual with a problematic disciplinary history. If an individual has an employment history that includes items such as a large number of customer complaints, recent terminations for cause/permitted to resign, arbitration proceedings, disciplinary actions, frequent changes in employer, and a disproportionate number of disclosures of liens and judgments, firms should carefully assess the prudence of hiring such a person. In making this assessment, a firm should weigh its ability to appropriately supervise the individual with heightened procedures. In addition, firms should assess the likelihood of the individual repeating his or her past actions in the future, which could result in possible customer harm.[20] And, if a person is statutorily disqualified, firms must ensure that applications for association are completed that contain heightened supervisory plans and that the individual is appropriately supervised.

Hiring individuals who were previously associated with a "disciplined firm" can also have an adverse impact on a firm's compliance culture and supervisory systems. A disciplined firm is one that in connection with sales practices misconduct involving the offer, purchase or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer. When hiring registered representatives from a disciplined firm, the hiring firm should evaluate whether it must adopt and implement special supervisory requirements that include taping systems to monitor the actions of these associated persons.[21]

Training

Training on ethics and conflict of interest policies is an important practice for all firms. Training prepares staff, first, to recognize where a potential conflict situation exists and, second, to make appropriate decisions about handling the conflict consistent with a firm's policies, procedures and ethical standards.

The firms we met with broadly shared this view. For the firms, training is an important vehicle to communicate firm culture, specific requirements of a firm's code of conduct and its conflicts management framework. Several firms emphasized the value of linking conflict management and ethics training. The latter provides staff a broader context within which to frame their conflicts-related decision-making. At firms with a centralized conflicts management approach, the conflicts offices are involved in conflicts-related training.

Firms generally preferred face-to-face training where possible, but large firms by necessity relied primarily on computer-based training to reach their dispersed employees. In the context of conflicts, several firms highlighted the effectiveness of interactive, situation-based training to help guide employee decision-making.

One firm noted that the conflicts inventory, discussed earlier, is a useful tool in providing conflicts-related training across the organization. This firm found that training staff on how conflicts arise in other business units helped them understand better how conflicts arise in the firm's business as a whole as well as in their own business unit. In addition, the firm found that the inventory helped identify situations where the firm had failed effectively to manage conflicts in the past. These situations provided valuable training materials and learning opportunities.

In addition to broad conflicts management and ethics training, firms noted that they may provide targeted conflicts training to address conflicts issues that may arise in a particular business area, for example on a trading desk. Some firms also require registered representatives to complete specialized training on structured or complex products—including on the conflicts that may be associated with such products—before advising customers on these products.

Information Technology

For many firms, particularly larger more complex firms, a robust information technology infrastructure and associated governance mechanisms are essential components of an effective conflicts management framework. A number of processes that firms use to identify, track and manage conflicts—for example, the conflicts clearance process described below, the post product launch review discussed in the next section of this report, the delivery of conflicts training discussed above—all are critically dependent on technology. Indeed, virtually every firm that FINRA met with referred repeatedly to technology-dependent conflicts management processes.

Conflicts Clearance and Business Selection

An example of an area that a firm should consider carefully in developing its overall conflicts management framework is conflicts clearance and business selection. The conflicts that arise in this area present some of the more complex and nuanced conflicts FINRA observed during its review and illustrate the need for firms to tailor their conflicts management frameworks to the particular nature of their business.

In recent years, firms' decisions about how to manage conflicts arising from the roles they play in transactions have been repeatedly called into question. In some cases, these decisions have had serious adverse implications for the firms involved and the reputation of the industry as a whole. Below, we highlight some of the questions firms should consider in designing their conflicts clearance and business selection process and share approaches some firms are taking to address these challenges.

Structures

Firms use divergent structures for conflicts clearance and business selection. In most firms, the conflicts clearance function is part of and supports the business line, tracking potential transactions through their lifecycle (from business opportunity through execution) to identify potential conflicts. The conflicts clearance office typically also works closely with a firm's control room as well as the legal and compliance departments.

Depending on the firm, the conflicts group, the business line or the two working together decide how to address individual conflicts and also make the business selection decision. In situations that involve more significant conflicts or reputational risk—for example in a hostile takeover transaction—the business line may elevate the conflict to higher-level firm committees for review, such as a reputational risk committee.

A different approach combines conflicts clearance and business selection functions fully or partially outside the business line with a direct reporting line to enterprise-level executive management. FINRA observed this approach at some large firms that may compete for multiple facets of a potential transaction.

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Process

From a process perspective, each of the firms emphasized the importance of communication between the conflicts office and control room, clearly defined deal-logging policies and procedures as well as clear communications with potential customers throughout the transaction development process. Implicit in the discussion with firms was the need for the combination of the conflicts clearance and control room functions to have a comprehensive view of relevant firm activities, potentially across multiple legal, business and regional entities. Technology can be an essential tool in developing this view.

A key question firms should evaluate is which of their potentially many activities should be captured in the scope of their conflicts review processes. A firm's investment and merchant banking activities may give rise to potential conflicts, but the question may be less clear-cut in other cases. For example, if a firm acquires an entity, what element of the acquired entity's business activities should be included in the conflicts clearance process?

The activities to be covered through conflicts clearance can be nuanced. Some firms require their sales and trading staff to consider the intent of their customers and to report those customer trading activities the staff identifies as strategic, *i.e.*, reflecting a customer's interest in accumulating a position in an issuer's securities to become an activist shareholder or engage in a hostile takeover attempt. Thus, a transaction involving the acquisition of a 1 percent share in an issuer may be treated differently depending on whether the customer is an activist or passive hedge fund investor.

Given the variety of areas in a firm's business in which a conflict can arise, several firms emphasized the importance of the conflicts clearance office having multiple sources of information about firm activity and not simply relying on one source such as deal-logging. One firm's conflicts office reviews potentially relevant committee agendas and includes conflicts office staff on many transaction review committees to help ensure the conflicts clearance and business selection function does not miss key conflicts situations.

NEW BUSINESS AND NEW PRODUCT CONFLICTS REVIEW

Introduction

Financial services is a highly competitive industry in which new business initiatives, including new products and services launches, are important elements in many firms' business strategies. A firm must determine which products and services it offers, the markets in which it does so, the customers to whom the product or service is offered, and the terms and conditions that may apply. These decisions, which often involve conflicts of interest, can have far-reaching implications for firm customers. Unfortunately, the financial services industry has frequently shown limited ability effectively to manage conflicts of interest that may arise in the course of product innovation.

To be effective, identifying and managing conflicts of interest associated with new business initiatives should be a key component of firms' new business planning and implementation efforts. FINRA reviewed firms' approaches to two central conflicts management-related questions:

- How do firms identify and manage conflicts that may be present in a new business or product?
- How do firms resolve conflicts that may exist in their own review process?

FINRA evaluated firms' new business conflicts frameworks primarily through the lens of firms' new product assessments.[22] This product focus reflects FINRA's concerns about the increased sale of complex products to retail investors who may struggle to understand the features, risks and conflicts associated with these products. The firms with which FINRA met, manufacture, distribute, or both manufacture and distribute financial products. FINRA explored firms' new product reviews in each of these capacities.

Effective Practices Summary: New Product Conflicts Review

FINRA observed firms engaging in a number of effective practices to identify and manage conflicts of interest that may arise through the launch of a new product or service:[23]

- Firms' new product review committees include a mandate to identify and mitigate conflicts of interest that may be associated with a new product. This mandate is supported by a "tone from the top" and firm culture that encourages robust analysis and debate with the objective of protecting customer interests.
- Where a conflict of interest poses the potential for serious harm to customers, and the firm cannot effectively mitigate that conflict, firms decline to offer the product to customers.
- Firms differentiate product eligibility between institutional and retail clients. With respect to the latter, some firms restrict eligibility to purchase more complex products to customers whose accounts have been approved for options trading or establish other criteria that enable the firm to ascertain an individual's ability to understand and evaluate the risks associated with the product.[24]
- Product manufacturing firms implement strong KYD policies and processes to assess potential distributors' financial soundness, marketing and sales controls, sales practice and compliance mindset, quality of distribution network and technical capabilities before allowing them to sell a manufacturer's products.
- Firms conduct post-launch reviews to assess whether a product has performed as expected.

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- Firms evaluate registered representatives' ability to understand a product, provide training where it is necessary and limit registered representatives' access to products for which they cannot 1) demonstrate sufficient understanding to perform a suitability analysis and 2) effectively explain a product and its risks to customers.
- Firms disclose product risks to customers, including easily understandable explanations of the impact of adverse scenarios on a product's performance.
- Firms require written attestations that clients understand a product and its risks for certain potentially more complex products.

Manufacturing

Conflicts Reviews and New Product Review Committees

An effective practice for product manufacturers is to include as part of their new product review process a careful analysis of the conflicts of interest a product may raise and to establish measures to eliminate or mitigate those conflicts. The manufacturers with which FINRA spoke typically review new products in their firms' new business initiative review committees.

Although there are nuances across firms, from a definitional perspective, a "new" business initiative is viewed as encompassing a new business, new market, new product or new service, as well as the offering of an existing product or service in a new jurisdiction, through a new distribution channel or to a new customer segment. In at least one firm, the risk management department decides whether a business is "new" and when the new business review process should be invoked.

From a process and structural perspective, most manufacturing firms require the business unit initiating the new business to prepare a business case that includes an analysis of possible risks, including those arising from conflicts of interest, and mitigating measures for those risks. The firm's new business committee, and potentially sub-committees thereof, reviews these documents and may impose restrictions or conditions to address conflicts of interest or other concerns. A review committee may limit access to a product to distributors with stringent suitability frameworks, restrict the customers to whom a product may be sold, or prescribe minimum knowledge requirements for registered representatives who may recommend the product.

In part to reduce the conflict of interest that would exist if a business unit were responsible for vetting its own initiative, a new business initiative committee typically includes business, support and control functions, including information technology, operations, finance, legal, compliance and risk management. The participation of the latter functions is intended to provide a view independent from the proposing business unit on the new business initiative. The vetting process may involve various levels of seniority in the firm, depending on the perceived risk and complexity in the new product approval and can include senior firm executives.[25] In several firms, the risk management department has final sign-off authority on a product launch and in at least one instance, risk management is responsible for coordinating the review process.

Typically the new product review addresses two aspects of a new product launch: 1) Is the firm prepared to introduce the new business and 2) Will the new business adversely affect the firm's broader business and reputation? Each manufacturing firm emphasized the importance it attaches to identifying and thoroughly assessing conflicts that may be present in a product. One firm's new business review policy calls for escalating all proposals that involve conflicts of interest, reputational risk or suitability concerns. In addition, and as noted earlier, other firm committees may review a new business initiative and include conflicts within their scope of responsibility.

These approaches to mitigating potential conflicts in firms' internal processes are highly dependent for success on the culture of the firm and the specific committees involved. Reliance on the committees, and relevant control functions' nominal independence, to help mitigate conflicts of interest will be ineffective without a culture that encourages robust debate with the objective of protecting customer interests.

Expanding Product Availability

A key challenge for manufacturing firms in the context of their new product, or other new business, reviews is to monitor the conflicts of interest that may arise as they expand product availability, for example, when expanding the range of customers to which a product is offered, loosening controls that may exist around a product's distribution, or incrementally changing existing product features to make the product available to a broader range of investors.

To maintain effective control over conflicts when a firm changes its distribution channels from primarily institutional to also include a broader range of customers, the firm should evaluate the change process and whether it included an assessment of the appropriateness of retail distribution.

Reverse Inquiry

In addition to manufacturing firms that developing new products, a common practice (frequently referred to as "reverse inquiry") is for distributors to request the manufacture of a structured product designed to the distributor's specifications. Some manufacturers are developing sophisticated automated platforms to facilitate reverse inquiries, allowing select product types to be issued more quickly and in smaller notional amounts. A potential benefit of this product creation process is that it enables distribution firms to provide customers with a product customized to their needs and market outlook on economic terms that may be more favorable than otherwise obtainable. It is especially important for manufacturers supporting reverse inquiries to rigorously apply good KYD practices (discussed below) in the context of their reverse inquiry business.

Know-Your-Distributor Policies and Procedures

An effective practice is for firms that manufacture structured and complex products to implement strong KYD policies and processes to assess potential distributors for their products. These measures can help mitigate the incentive to maximize product revenue through the widest possible distribution of a product regardless of the capability of a distributor to perform effective due diligence and suitability analyses.

The following elements of a KYD process reflect effective practices:

- conducting background checks on the distributor and relevant employees (*e.g.*, through FINRA BrokerCheck®, compliance databases), including looking for complaints or litigations;
- reviewing the financial soundness of the distributor;
- requiring distributors to complete a detailed questionnaire to help the manufacturer assess a distributor's sales practices, marketing strategy, registered representative training, investor education, compliance culture, product classification, trade review and sign-off process and distribution strength;
- interviewing the distributor to develop an understanding of the firm's compliance culture; experience, particularly with more complex products; and capability and willingness effectively to discharge its suitability obligations;
- obtaining information about the composition and nature of the distributor's customer base (*e.g.*, age, retail/institutional percentage, experience with complex products);

- reviewing a distributor's relevant compliance manuals, written supervisory procedures and other relevant materials;
- reviewing and approving the distributor through a cross-functional committee that brings relevant perspectives to bear on the potential merits and limitation of the distributor;
- reviewing sub-distributors/sub-dealers annually; some firms require them to complete an abbreviated version of the on-boarding questionnaire annually; and
- requiring distributors/sub-distributors to sign an agreement, committing to ensure adherence to relevant rules and regulations (such as suitability and due diligence).

As an example of how some manufacturers' KYD processes work in practice, several manufacturers divide distributors into tiers—generally three levels—based on criteria such as a distributor's product expertise and experience, the quality of its control environment, and the strength of its sales practices. Firms that are rated more highly in these areas have access to a broader range of products, including more complex products, while firms with lower ratings have access to a narrower range of simpler or more "plain vanilla" products. One firm takes a binary view of its distributors, approving them to offer all or none of the products it manufactures.

Post-launch Product Reviews

An effective practice for product manufacturing firms is to implement post-launch reviews to identify potential issues with a product that may not have been apparent during the initial review process, which could lead to conflicts of interest or reputational risk. Such issues could include unexpected product performance, subsequent activity by the manufacturer that may specifically influence the performance of the product, use by investors for whom the product was not intended, or use that is inappropriate or unanticipated. Firms may want to consider how they would react to these potential issues, and what actions they may want to take—such as informing distributors. The frequency and timing of firms' post-launch reviews varies. One firm evaluates product performance within nine months of product launch and reviews existing products on a one-, two- or three-year cycle. Other firms use different approaches to identify products for review.

Embedded Conflicts

In addition to conflicts related to selling, FINRA is also concerned with how manufacturing firms handle conflicts of interest that may be inherent in a product. These conflicts arise where a manufacturer or its affiliates play multiple roles in determining a product's economic outcome and where firm and investor interests may diverge (*see* Structured and Complex Products and Embedded Conflicts, below). Each of the manufacturing firms addresses those conflicts through disclosure.

Structured and Complex Products and Embedded Conflicts

Embedded conflicts may arise in products for which the issuer or an affiliate makes a variety of critical, and potentially subjective, decisions that affect the value of a product and where those decisions may cause the economic interests of the issuer and investors to diverge. These decisions are frequently performed by entities referred to as "calculation agent" and "index calculation agent." (These can be separate entities with distinct roles; a product can have both a calculation agent affiliated with the issuer and an unaffiliated index calculation agent.)

continued

An index calculation agent may have discretion in how it calculates the value of an index it uses in a complex product, including, potentially, the authority to change the calculation methodology.

The calculation agent also performs a valuation function and may have broader authorities as well. Some products contain an "escape clause" relating to "hedging disruption events" that allows the calculation agent to call a product at any time if it believes the issuer or its affiliates may be unable to initiate, maintain or unwind hedges related to the product. It also may determine the value of the product to be returned to investors in the event of such a disruption, which may not be a transparent undertaking. In other instances, these escape clauses can be interpreted to effectively transfer to investors a significant portion of an issuer's operational risk. In other instances, a product issuer has the flexibility to extend the maturity of the product at its sole discretion. In each of these instances, the calculation agent, which is an affiliate of the issuer, also determines the value of the payout to investors.

Using an affiliated calculation agent is not necessarily problematic, particularly if the calculation is simple and based on readily accessible data. However, to be effective, disclosures should clearly articulate—in terms understandable to the target customer—the multiple conflicts of interest that may arise with an affiliated calculation agent and the roles that it plays. In addition, the disclosure should make clear if the agent will make its determinations using data not easily obtainable by the target customer. The disclosure should also include any subjective aspects of the agent's role, such as the degree of discretion the agent may exercise in determining how to calculate the index, payouts to customers or the declaration of a hedging disruption event. If the tenor of the product can be changed, the circumstances in which that could occur should be explained. As discussed elsewhere in this report, firms should consider the use of illustrative scenarios to help customers understand the situations that would trigger different possible financial outcomes from the product.

In addition, to mitigate conflicts, issuers with affiliated calculation agents should establish governance and supervisory review processes for those agents' decisions, particularly if the agent may exercise discretion in its decision-making. These processes should be transparent and provide for the balancing of investor and firm interests.

Other potential conflicts of interest associated with complex and structured products may arise in a variety of circumstances, including in the following cases.

The use of proprietary indices by structured retail products including notes and CDs

FINRA has noted concerns with structured products in the past, including complexity and potentially high or hidden costs. In general, the increased complexity of such debt products can favor issuers over investors, and this could become a more serious issue for a structured product the performance of which is linked to a proprietary index (created and maintained by the product issuer), as additional fees associated with the use of the index can be high and in some cases difficult to assess. Some proprietary indices reflect sophisticated or complicated trading algorithms or investment strategies, which may subject investors in products linked to these indices to fee structures that can be conditional or path dependent, require detailed analysis to understand and estimate, and be very costly under certain conditions. Moreover, some proprietary indices have limited histories, and so their behavior in different market environments—and the costs associated with the exposures they offer—may be harder to estimate.

continued

Debt issues with early or automatic termination features and notes linked to decaying assets

Over the last few years, debt issuance in the form of exchange-traded notes (ETNs) with longer maturities (*e.g.*, 10 or 30 years) has expanded investor access to non-traditional asset classes and more advanced investment strategies. Some ETNs can be reasonably viewed by investors as packaged investment strategies representing buy-and-hold, longer-term investments rather than shorter-term trading vehicles. A number of such ETNs have call provisions giving the issuers the ability to buy back these unsecured debt obligations at their discretion at prevailing market values. A conflict of interest could exist in the issuance of what is ostensibly a buy-and-hold investment strategy packaged in a callable debt wrapper: The issuer could terminate the notes prematurely at a significant discount to the principal amount, likely negatively and possibly unexpectedly impacting buy-and-hold investors. It is important that investors are clearly made aware of and understand the call risk associated with such investments, especially relative to competing products for which issuers would not appear to have such an incentive.

Distribution

One of the fundamental potential conflicts in the securities industry occurs in the distribution channel: the sale of products or services to generate revenue or profit without proper regard to suitability standards. This conflict affects both the registered representative and the firm. This conflict is magnified when a firm favors proprietary products or engages in revenue-sharing with third parties to the detriment of customer interests.

Conflicts Reviews and New Product Review Committees

As with product manufacturers, an effective practice for product distributors is to include as part of their new product review process a robust analysis of the conflicts of interest a product may raise and establish measures to eliminate or mitigate those conflicts. Distribution firms typically use new product vetting structures similar to those discussed above for manufacturers. (In the case of firms that engage in both product manufacturing and distribution, they typically use two, separate committees.) These committees include line of business representatives as well as support and control functions (*e.g.*, technology, finance, risk, compliance, legal). Some firms use a multi-layered committee review approach.

In the context of firms that engage in both product manufacturing and private wealth management businesses, FINRA underscores the importance for conflicts controls of the private wealth business operating with appropriate independence from other business lines within a firm. Firms should maintain effective safeguards, including through the use of new product review committees in the private wealth business, against pressure to prefer proprietary products to the detriment of customers' interests. This is particularly important as firms seek to leverage their brokerage and other platforms to cross-sell products and services. Equally important, firms with revenue sharing or other partnering arrangements with third-party product (or service) providers should exercise the necessary diligence and independent judgment to protect their customers' interests.

Some retail distribution firms use new product review departments separate from the business line. In one instance, a firm's research department makes recommendations about which products are brought onto the firm's distribution platform. Compensation for the research staff is at least partially based on how well the products they recommend perform. These recommendations are subject to further review by other firm committees. In another instance, a separate legal entity makes recommendations about mutual funds to be brought onto a firm's list of recommended mutual funds; this structure is intended to make these decisions independent of the firm's relationship with the fund providers. Several firms identified products they do not offer to customers because of suitability concerns, including leveraged exchange traded funds and structured products.

Some firms with a primarily institutional customer base are implementing technology systems in which they comprehensively catalogue customers and the products those customers are eligible to purchase. These systems may block the sale of a product for which a customer is not approved unless a manager or supervisor provides an override. In one firm, both the business line and compliance department must approve the products a customer is eligible to purchase. This broader review may mitigate the incentive for an individual registered representative to push a product that may be unsuitable for a customer.

Open Product Architecture and Revenue Sharing

Conflicts can arise when a firm distributes proprietary products or investment company products for which a firm receives revenue sharing payments.[26] The funds for which a firm receives revenue-sharing payments often will be placed on a "preferred" list of funds the firm offers. Proprietary products and revenue sharing arrangements may involve significant financial incentives for firms to favor these products over others. Although registered representatives do not share in the revenue sharing payments directly, they still may favor funds on preferred lists, because of training the issuer provides or because the mechanics of order processing are, in some cases, easier for funds on the preferred list. This can limit customer choice or may, in some cases, adversely affect the independence of a firm's new product review process or a registered representative's recommendations. Nevertheless, many firms disclose the arrangements, and their written disclosures related to revenue sharing were, in many cases, clear and direct.

FINRA is encouraged to see distributors shift towards open product architecture, *i.e.*, the distribution of both proprietary and non-proprietary products. FINRA observed some firms that engage in both manufacturing and distribution—or which have affiliated product providers, such as, mutual funds—include on their distribution platforms both proprietary and competing third party products. These firms offer competitors' products across a variety of product types—such as, mutual funds, structured products, and alternative investments—but not necessarily in every product type. (For example, a firm might not offer competitors' money market mutual funds, but include competitors' structured products and alternative investment vehicles on its platform.) Third party products make up a significant percentage of sales volumes in most cases.

In the context of a recommended transaction, an effective practice is for a registered representative to inform a customer if a recommended product is proprietary or from a preferred provider. As part of this practice, the registered representative should provide this information in advance of executing the transaction. Providing this type of disclosure will enable a customer to make a decision about whether to proceed with a transaction in the presence of a conflict relevant to that particular transaction. This disclosure supplements existing written disclosures that firms provide, frequently in account opening documents, but places the disclosure in the context of a specific customer decision.

Reverse Inquiry

The "reverse inquiry" process discussed earlier effectively integrates distributors in the product manufacturing process by allowing them to determine product features such as product structure, coupon rate, maturity and fees. While this integration is not inherently problematic, it raises potential conflicts concerns. The distributor basically acts as a "co-manufacturer" and may have incentives to incorporate features such as high selling concessions or potential higher returns at the cost of a riskier product structure.

An effective practice for distributors—and one in which many firms engage—is to put product requirements out for competitive bid across multiple firms. Factors that firms should consider in selecting a product manufacturer include competitiveness and pricing, service, innovation and credit diversification.

FINRA observed distributors taking different approaches to handling reverse inquiries with in-house manufacturing counterparts. Some firms provide the in-house supplier the opportunity to match the most competitive bid (in which case the in-house part of the firm wins the majority of the business while the competitive outside bid wins a minority portion of the product). Other firms do not provide such a second look.

COMPENSATION AND OVERSIGHT

Introduction

Financial compensation is a major source of conflicts of interest. The rewards firms offer associated persons may influence their behavior in ways that affect customer interests. In this section, FINRA focuses on four areas that may create, exacerbate or mitigate compensation-related conflicts of interest. These areas are:

- compensation for brokers;
- surveillance and supervision of registered representatives as they approach compensation thresholds;
- compensation for supervisory personnel; and
- deterrents to poor conflicts management.

The first three areas focus on firms' retail and private wealth activities; the discussion of deterrents encompasses a firm's business more broadly.

As an initial matter, the federal securities laws and FINRA rules require broker-dealer mark-ups, commissions and fees for services to be fair and reasonable.[27] The SEC and the courts have held that the antifraud provisions of the federal securities laws require broker-dealers to sell securities at prices reasonably related to the market price.[28]

Effective Practices Summary: Compensation and Oversight

In order to identify and manage compensation-related conflicts effectively, firms should take an integrated approach to designing and implementing their compensation, supervision and surveillance programs. The more significant a conflict a compensation structure may create, the more important it is for supervisory and surveillance programs to provide robust oversight. Supervisory and surveillance programs should enable firms to identify potential unsuitable activity arising from conflicts of interest across registered representatives and branch offices.

Effective practices include the following:

- **Compensation thresholds:** Firms avoid creating thresholds in their compensation structures that enable a registered representative to increase her compensation disproportionately through an incremental increase in sales.
- **Monitoring activity of representatives approaching compensation thresholds:** Firms' supervisory programs include specialized measures to assess whether a registered representative's recommendations may be influenced by thresholds in a firm's compensation structure. Some firms perform specialized surveillance as registered representatives approach thresholds that:
  - move the registered representative to a higher payout percentage in a firm's compensation grid;
  - qualify a representative to receive a back-end bonus; or
  - qualify a representative to participate in a recognition club, such as a President's Club.
- **Neutral grid:** Firms minimize incentives in their compensation structure for registered representatives to favor one type of product (*e.g.*, equities, mutual funds, variable annuities) over another.

continued

- **Fee-capping:** Firms reduce incentives for a registered representative to favor one mutual fund or variable annuity fund over another by capping the Gross Dealer Concession that will be credited to a representative's production.
- **Compensation for proprietary or preferred provider products:** For comparable products, firms refrain from providing higher compensation, or providing other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements.
- **Customer liquidity events and suitability monitoring:** Firms monitor the suitability of registered representatives' recommendations around key liquidity events in an investor's lifecycle where the impact of those recommendations may be particularly significant, for example, at the point where an investor rolls over his pension or 401(k).
- **Compensation penalties:** Firms adjust compensation for employees who do not properly manage conflicts of interest. Using red flag processes and clawbacks can support this objective.

Compensation Grids

At most firms with which FINRA met, compensation grids are a principal determinant of a registered representative's compensation. As such, they are critical in understanding the incentives, and possible conflicts of interest, that a registered representative may face. The structure and operation of grids varies significantly among firms; as a consequence, a representative generating a set amount of gross revenue may receive different compensation depending on the firm with which the registered representative is associated. Some structures are fairly straightforward, while others are more complex.

Structure and Mechanics

Typically, two factors drive a registered representative's grid-based compensation: the revenue that the registered representative generates, and the payout percentage the registered representative receives on that revenue. In some cases, firms use a grid structure where the type of product sold affects a registered representative's payout percentage. (Table 1, below, illustrates both types of grid; the former is frequently referred to as a "neutral grid.")

Table 1: Illustrative product neutral and non-neutral grid comparison

	Product Neutral Grid	Non-Neutral Grid		
Gross Commission/ Sales Charge *(figures in 000s)*	Payout %	Payout %: Equities, bonds, ETFs	Payout %: Options and futures	Payout %: Investment company products
$200-300	28%	28%	26%	30%
$300-400	35%	35%	33%	39%
$400-500	36%	36%	34%	42%
$500-650	38%	38%	35%	44%
$650-800	40%	40%	38%	46%
$800-1,000	42%	42%	40%	49%
$1,000-1,500	44%	45%	40%	49%
$1,500-2,500	45%	45%	41%	49%
$2,500 +	48%	45%	41%	50%

(The figures in this table are for illustrative purpose only and do not reflect any particular firm's grid structure.)

The payout percentage a registered representative receives typically increases as the broker's production rises. A $1 million producer will typically earn a higher percentage of gross revenue than a $500,000 producer with the same firm. FINRA observed a variety of payout ranges, from 28 – 47 percent at one firm to 25 – 43 percent at another and 22 – 48 percent at a third. These figures are representative for only some firms, others' payout rates may be higher. Firms with an independent contractor model may pay out a substantially higher percentage to registered representatives, but these firms also charge those representatives more for expenses associated with their business. In addition, one of the firms with which we met takes a notably different approach to its grid: This firm pays a flat 50 percent after the first $10,000 of monthly production.

The revenue tranches, or steps, within a grid are typically smaller at the low end of the grid and increase at the higher end. At some firms, an increase of $25,000 – $50,000 will move a representative from the lowest payout level to the next lowest. At the higher end, these tranches are larger and range into the millions, for example, from $1 – $2.5 million.

Firms described two basic approaches to handling payout percentages. Under one approach, the grid differentiates payout by product type—for example, equities, bonds, mutual funds and variable annuities. Under the other approach, commonly referred to as a "neutral grid," the grid provides a flat payout percentage in a given gross production band, regardless of product type sold. Table 1, above, provides an illustrative comparison of payout structures under a neutral and non-neutral grid.

Under both neutral and non-neutral grids, firms may calculate payout percentages in different ways. Firms may apply grid payout percentages on a prospective or retroactive basis. The time period over which production is calculated to determine the applicable payout percentage may vary as well. Frequently firms that apply the payout percentage prospectively calculate a broker's gross revenue on a trailing 12-month basis (T12). The firm applies the T12 production to its grid to determine the payout rate that applies to the broker's subsequent month's production (or longer periods depending on the firm's approach). A broker's payout rate for April 2013 would be determined by looking at total revenue generated from April 1, 2012, through March 31, 2013. If this total was $700,000, the grid for one firm establishes a 41 percent payout rate (40 percent in the product neutral portion of the example in Table 1). The broker's monthly grid compensation is determined on this rolling basis.

Some firms apply a broker's payout percentage on a retroactive basis. In these cases, many firms calculate gross revenue based on calendar year production, typically starting on January 1. Firms may start the registered representative off with $0 in revenue. The representative is paid at the lowest grid level until she reaches the next revenue tranche on the grid. Retroactive adjustments for revenue earned since January 1 may happen repeatedly through the year if a representative continues to move to revenue levels with higher payout percentages.

Other Approaches

Several firms with which FINRA met do not use a grid structure based on production. Some of these firms base payout percentages on a registered representative's years of service. Others use a non-grid-based formula to calculate registered representatives' compensation based on metrics such as employees' service and sales performance.

Compensation and Oversight Structures

An effective practice FINRA observed at firms is the establishment of compensation governance structures that include a mandate to identify and manage the conflicts that compensation structures may create. When firms identify such conflicts, firms adjust the compensation system to eliminate or reduce the conflict as well as establish oversight mechanisms appropriate to the scale of the conflict that may remain.

In the context of compensation grids, paying a registered representative a higher percentage of gross revenue may legitimately reward effective and hard workers and encourage higher productivity. A conflict is created, however, if a representative's desire to move to a higher payout level influences the number or type of recommendations he makes to customers. This conflict may be heightened when there is a relatively large increase in the percentage payout between revenue tranches; when there is a high probability that a few, incremental sales will move a registered representative to a new payout level; or where increased payout percentages are applied retroactively once a threshold is satisfied.

Neutral Grids

An effective practice FINRA observed was firms using "product neutral" compensation grids to reduce incentives for registered representatives to prefer one type of product over another. In identifying this as an effective practice, FINRA also notes that while the use of neutral grids eliminates the payout percentage as a factor that may influence registered representatives' product recommendations, the commission credit still significantly affects that individual's compensation. For example, on a given $10,000 purchase, a registered representative may receive more commission credit for a variable annuity sale than a mutual fund sale and more credit for a mutual fund sale than an equity transaction. Thus, a $10,000 customer purchase may result in different amounts credited to a representative's gross revenues, even though the percentage payout from the amount of the credit is the same.

In these cases, the broker's compensation is not product neutral. Therefore, the neutral grid should not be represented to customers as eliminating potential product biases in registered representatives' recommendations. Firms should structure their oversight programs to address and mitigate those biases that differences in compensation may create.

Commission-based vs. Fee-based Accounts

Conflicts also may arise in recommending the type of account that a customer should open with a firm. A firm that is dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer. Many variables, including a customer's desire for ongoing advice and portfolio management, may affect the decision. Depending on the circumstances, fee-based accounts may be preferable for customers with a fair amount of trading activity or the desire for active account monitoring and ongoing advice. Commission-based accounts may be more cost-effective or appropriate for customers with low trading activity.

Firms should examine their procedures to ensure that they are reasonably designed to monitor inappropriate behavior. A clear conflict would exist if a registered representative who is also registered as an investment adviser or advisory representative recommends that a customer purchase a mutual fund that is subject to a front-end sales load and, shortly thereafter, recommends that the customer move those mutual fund shares into an investment advisory account that is subject to an asset-based advisory fee. This behavior is an example of an inappropriate means by which a representative seeks to increase his compensation at the expense of his customer.[29]

Compensation for Proprietary or Preferred Provider Products

An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.

Fee-capping

In the context of mutual fund and variable annuity sales, an effective practice FINRA observed is firms' use of "fee-capping" to reduce incentives for a registered representative to favor one product family over another for comparable products. In a fee-capping arrangement, a firm caps the GDC that can be credited to a registered representative's grid. Any GDC in excess of the cap accrues to the firm. For example, a firm may cap at 4 percent the GDC for emerging market equity funds. This would eliminate incentives for a registered representative to favor a mutual fund that paid a higher GDC than the 4 percent. It would not, however, eliminate the potential incentive for the registered representative to recommend a fund with a 4 percent as opposed to a 2.5 percent GDC.

Supervision, Surveillance and Conflicts Management

Firms' supervisory and surveillance processes to monitor registered representatives' sales activities are key tools in a firm's overall conflicts management framework. In this section of the report, we focus on supervision in four areas. The first three relate to thresholds in firms' incentive structures: 1) step-up points in compensation grids, 2) milestones for admission to recognition clubs and 3) thresholds for back-end bonuses or other incentive compensation. These incentives may create a conflict of interest if a registered representative conducts, for example, excessive trading or recommends unsuitable or improper transactions in order to achieve a higher level of financial or other compensation. The fourth area relates to events in an investor's lifecycle—*e.g.*, a substantial liquidity event such as a pension rollover—that may significantly affect a registered representative's compensation as well as the investor's financial situation.

Supervision of Sales Activity Near Compensation Thresholds

Linking supervision and surveillance of registered representatives' recommendations to thresholds in a firm's compensation grid structure is one effective practice. This can enable firms to detect recommendations, or potential churning activities that may be motivated by a desire to move up in the grid structure and, thereby, receive a higher payout percentage. Unlike the two situations discussed below, FINRA is concerned that some firms' supervision and surveillance functions have limited ability to assess a representative's recommendations and representations in the context of grid compensation thresholds, despite the heightened conflicts that may exist as registered representatives approach those thresholds.

A second effective practice is to monitor registered representatives who are close to achieving the production level required for entry into recognition programs. In at least one firm with which FINRA met, this type of surveillance program is used to review the suitability of transactions that place registered representatives over the threshold to gain recognition in a firm's "President's Club" or similar recognition circle.

A third effective practice is to monitor registered representatives' recommendations and trading activity as they approach milestones for "back-end" recruitment bonus payments. Firms generally make these payments if the recruited registered representative achieves a certain level of production by an anniversary date of hiring. Several firms monitor the compensation trends of each registered representative who is within three months of a back-end bonus milestone date. Compliance analysts monitor production spikes or spikes in product sales for each of the three months before the award date or the expiration of the bonus milestone. Another firm reviews changes in the type of products the representatives sell and suitability assessments of the recommendations they make to customers.

Supervision of Sales Activity at Investor Lifecycle Milestone Events

An effective practice is for firms to monitor the suitability of registered representatives' recommendations around key liquidity events in an investor's life, for example, at the point when an investor rolls over her pension or 401(k). These events may heighten conflicts of interest because of the large sums of money that may be involved. When an individual changes jobs or retires, she must decide what to do with her 401(k) account—leave it in place, roll it over to a new employer's plan or roll it into an individual retirement account (IRA). Firms have a strong incentive to gather assets, and as a recent Government Accountability Office report noted, "(r)ollovers have become the largest source of contributions to IRAs."[30] It is not always clear, however, that rolling over a 401(k) to an IRA—as opposed to keeping money within the plan or rolling it over to a new employer's plan—is the best option for an investor. The recommendations a representative makes at these points in time may have profound implications for the investor and deserve thorough scrutiny and review.

Other Effective Supervisory Practices

In addition to the effective practices described above that are tied to specific compensation thresholds or events, FINRA also observed more general effective supervisory practices among firms. One firm developed a surveillance program to determine whether certain products or services for which a registered representative receives more compensation were being sold improperly. The surveillance program identifies spikes in an individual's production in these offerings from quarter to quarter. If the program flags a significant increase in production, the compliance department will review whether a particular product has caused the spike in revenue and then conduct a suitability analysis of the relevant recommended transactions. Another firm recently implemented a similar tool to assess revenue increases or shifts on a daily, weekly or monthly basis that leads to a deeper evaluation of a registered representative who is subject to production targets.

Compensation for Supervisory and Branch Management Staff

Financial incentives to registered representatives in firms' retail and private wealth businesses are one source of conflicts of interest; the financial incentives to their managers and supervisors are another. Financial incentives for these personnel could encourage them to, among other things, push registered representatives to achieve branch or broader business unit financial performance targets without proper regard for suitability, hire poorly qualified registered representatives to meet hiring targets or perform oversight tasks in a manner favoring productivity standards over quality of oversight.

Most firms' compensation structures for supervisory staff, branch office managers and their superiors are comprised of a base salary and discretionary bonus. The discretionary bonus may include elements that create potential conflicts of interest. Firms noted that they typically consider a variety of quantitative and qualitative factors in determining compensation for supervisors and managers. Examples of quantitative metrics include branch revenue and growth, profitability, net new assets and lending growth. Examples of the qualitative factors include an individual's development of staff and the quality of a manager's interaction with control functions.

Considering negative control issues—such as factoring in customer complaints or fines—in deciding bonuses for branch managers and their superiors is an effective practice. FINRA observed firms that could reduce or eliminate a branch manager's bonus if that individual did not perform his supervisory responsibilities effectively. In some cases, negative control concerns may also affect the compensation of the individual registered representative involved.

With respect to supervisory staff, in some cases firms noted that their personnel are not part of the business reporting line and are paid on a salary plus discretionary bonus basis, and that the bonus has no direct ties to the individuals or branches they supervise. In these instances, the firm typically awards a bonus on the basis of an individual's scope of responsibility, professional competency metrics and overall firm financial performance.

Deterrents to Poor Conflicts Management

Firms can mitigate the conflicts their financial incentives create through disincentives or deterrents in their compensation and performance evaluation systems. FINRA believes firms should consider imposing appropriate compensation adjustments on employees who do not properly manage conflicts of interest or otherwise engage in conduct detrimental to customers or the firm. Firms identified two effective tools they use in this regard: red flag programs and clawbacks. FINRA believes that a firm should consider employing both tools across its business, including retail and private wealth management (and to the extent permissible by state labor laws).

Red Flags

Firms use the compensation and performance evaluation processes to promote good conduct by their employees, including the appropriate handling of conflicts of interest. An effective practice for firms is to develop metrics for both good and bad behavior (red flags), assess employee performance against those metrics, and base compensation decisions on that performance. FINRA's focus here is on measures of behavior related to conflicts of interest, but clearly, firms may include a variety of metrics to incent favorable conduct more generally.

The firms with which FINRA met use processes with varying degrees of formality and structure to gather qualitative and quantitative data—or red flags—about employee behavior and apply that to their compensation and performance assessment programs.[31] On one end of this spectrum are firms that collect relatively little data, do not implement performance assessments, and whose registered representatives' compensation structure is mostly or entirely commission-driven with little or no non-formulaic variable compensation, *i.e.*, bonus. On the other end of the spectrum are firms that have highly formalized data collection, data review and performance assessment processes and whose employees receive a significant portion of variable compensation as a percentage of total compensation.

Firms with more formalized programs collect a broad range of information from multiple departments, including legal, compliance, human resources, risk management, sales supervision, operations and accounting. The types of information they accumulate includes registration and training lapses, trade input errors, suitability concerns, the frequency and severity of customer complaints, inappropriate or hostile behavior and other misconduct, excessive velocity, investment concentrations, mutual fund or annuity switching, audit or examination finding and credit limit violations. (Many of these measures do not relate directly to conflicts of interest concerns.) Depending on the firm, the human resources, compliance or risk management department may aggregate this information and then use it in performance evaluations as well as promotion and compensation decisions.

Most firms evaluate these red flags in a committee process—which may include a combination of staff from firm and sales management, human resources, compliance, legal or risk departments—and when warranted recommend further action. This action may take several forms. With respect to compensation, the firm may reduce a registered representative's future grid payout rate and limit awards for referrals (or other items) for a period of time, *e.g.*, the next three to six months. It may also require the registered representative to share in the cost of the representative's trade input errors or customer settlements. The firm may also cap performance levels in an employee's performance appraisal or limit an employee's opportunities for promotion. Some firms also restrict access to employee achievement recognition programs, such as "President's Clubs." In some cases, firms noted that state labor laws may limit their ability to impose financial penalties on registered representatives.

One firm implements a particularly formalized red flags system, but it does not, as yet, cover customer-facing private wealth employees. The firm developed a series of indicators—or red flags—for behaviors that it would like to reduce. These include red flags for generic activities, such as overdue mandatory training and gifts and entertainment breaches—as well as for business specific activities, such as improper deal-logging and restricted list trading violations. This firm recently introduced red flags for supervisors. The more red flags a supervisor's subordinates have, the more red flags the supervisor may have. The firm reported that the introduction of this supervisory, or tone from the top, flag was followed by a noticeable drop in total red flags. The firm risk-weights the breaches based on severity or frequency. Ultimately, these red flags feed into the compensation process and the firm has established policies to reduce variable compensation by prescribed ranges based on an individual's red flags "score." This reduction is communicated to the employee as part of the annual compensation discussion. The red flags score is also used as part of discussions around employees' performance evaluation and promotions.

The firm identified several key lessons learned from implementing its red flags program. First, firm management should communicate clearly and consistently with employees about the program and its purpose. Second, the red flags themselves should be clearly aligned with an individual's behavior. Third, the red flags should be objective rather than subjective.

Clawbacks

In broad terms, clawbacks are viewed as a tool to address conflicts of interest that might arise between an employee's or management's short-term interests and the long-term interests of the firm and its stakeholders. "Clawback" generally refers to a contractual clause that allows a firm to revoke some or all of an employee's deferred compensation, in some cases including vested compensation.

Some firms apply clawback provisions only to a subset of a firm's employees, such as senior executives, while others apply them more broadly. To date, most firms have exercised clawbacks only rarely, mostly in connection with terminations for cause. FINRA believes that clawback programs are an effective conflicts management practice and firms should consider employing them throughout their businesses to all employees that receive deferred compensation. Moreover, where implemented, FINRA believes that clawbacks should not be reserved only for instances that result in termination for cause.

Scope and Content of Policies

Most firms surveyed employ a structure that includes a deferred variable compensation component coupled with the ability to claw back or forfeit that compensation under defined circumstances, as discussed further below. Some firms limit such compensation to executives or senior management, but other firms apply it to all of their registered representatives and investment bankers as part of a bonus or incentive plan. The deferred compensation most commonly takes the form of restricted cash or equity (or a combination) and typically has a vesting period of between three and five years, although at least one firm has some vesting periods of up to eight years. In addition, some firms require minimum holding periods for stock, even if the equity has vested. Firms use these deferred compensation arrangements to better align employee interests with the long-term interests of the firm and to manage risk to the firm and, in some cases, to the market and financial system. In light of these purposes, firms tend to prohibit employee hedging activity related to equity subject to vesting or holding periods.

Firms' compensation recoupment policies differ in scope, detail and processes, but have several common elements. The clawback and forfeiture policies usually apply only to unvested portions of deferred compensation. Firms indicated that they use other mechanisms to recoup or make adjustment for paid or vested compensation. Some firms reduce current year incentive compensation to redress circumstances or conduct that led to improper payment of unrestricted cash or equity payments in prior years. Two firms indicated they adjust the incentive compensation payout percentage for representatives that have, for example, excessive customer complaints, regulatory or ethical lapses, or significant trading errors.

Broadly speaking, there are three categories of clawbacks or forfeitures: performance-based, risk-based and behavior-based. Most of the surveyed firms include some combination of the three, with different points of emphasis. The clawback and forfeiture policies generally attach where the original compensation award is based on inaccurate financial or performance metrics or where there is a nexus between an employee's conduct and certain events with material impact on a firm's financial condition or reputation.

Performance-based

Performance-based clawbacks can be tied to the performance of the overall firm or business unit or the employee (and are not necessarily related to conflicts of interest). One common clawback trigger is a material restatement of financial results, as a consequence of error, not fraud. This may affect employee compensation in two ways. First, a firm may look to clawback compensation from an employee who materially contributes to the cause for a restatement. Second, firms may clawback or adjust for compensation that was tied to firm or division profitability and mistakenly awarded based on the inaccurate financial statements.

A related clawback allows for recovery of an award where a more specific performance measure is later determined to have been inaccurate. In this regard, one firm's policies provide for recovery of incentive compensation paid to an employee on the basis of materially inaccurate performance metrics, irrespective of whether the inaccuracy leads to a restatement and even if the inaccuracy is not attributable to the employee.

Other firms have policies that permit clawbacks based on performance shortfalls, rather than inaccurate measurements. One firm can claw back awards based on negative business performance according to specific pre-defined performance standards, while another requires clawbacks for an annual loss at the firm, division or business unit. A firm with a similar policy will cancel all deferred compensation set to vest in a year where a group or division fails to generate positive net income before income taxes. One firm's policies provide for flexibility to claw back awards for general poor performance of a team, business area or profit center unrelated to specific performance measures. Yet another firm can claw back an award if it was based on a deal or transaction that has a significant adverse effect on the firm. One firm may defer awards if the firm, line of business or product fails to remain profitable over the vesting period.

Risk-based

Many firms provide for clawbacks where an employee takes imprudent risk or violates risk policies. Most firms do not require that an actual loss result from that conduct to initiate a clawback review. One firm broadly applies its clawback policy to inappropriate consideration of risk that causes or has the potential to cause "material adverse impact on the firm, the employee's business unit or the broader financial system." Another firm similarly applies its policy to improper or gross negligence in identifying, raising or assessing risks or concerns with risks material to the firm. Other firms more narrowly tailor their risk-based clawback policy to apply only to material violations of firm risk limits or risk management policies.

Behavior-based

The broadest category of clawbacks and forfeitures involves employee misconduct. Most firms can recoup some or all of unvested deferred compensation in the event an employee engages in conduct that results in or could result in financial or reputational harm to the firm or violates securities laws, regulations or firm policies. Firms describe the offending conduct in a variety of ways—for example, "serious misconduct or ethical behavior" or "conduct detrimental to the firm"—yet most policies give the firm broad discretion to cancel some or all deferred compensation when an employee engages in bad acts or consequential conduct. While some firms require gross misconduct by the employee, other firms' policies provide that negligent conduct can trigger forfeiture if the specified harm or violation ensues. Most firms automatically cancel any unvested compensation in the event of termination for cause. Some firms make such termination a condition precedent to forfeiting that compensation, but some firms can also cancel unvested compensation for misconduct or a policy breach even if the sanctions fall short of termination.

A few firms' policies provide for claw back of vested deferred compensation. One firm can seek repayment of the value of awards already vested, but unpaid, if an employee was, or could have been, terminated for cause or engages in conduct that results in financial or reputational harm. Another firm can recoup vested compensation in the case of gross misconduct.

Review Processes

Firms employ different review processes to assess whether to impose a clawback or forfeiture. Many of the surveyed firms rely on the independent control functions—risk management, legal and compliance, human resources—to identify potential clawback situations or to conduct or provide input into a review to determine whether recoupment is appropriate. At some firms, a compensation committee makes clawback determinations and internal audit reviews the decision. One firm provides specific criteria to the review committee to consider in making its determination, such as the role and responsibility of the employee, the degree of involvement and the extent to which the individual raised concerns.

CONCLUSION

Conflicts of interest are present in many contexts in the financial services industry. There is no "one-size-fits-all" framework through which firms can manage conflicts. Firms need to assess what approach is most effective given their particular circumstances. As noted earlier, the conflicts management framework for a small firm almost certainly will be markedly different than that for a large firm; but some of the basic conflicts may be the same. All firms engaged in the distribution of securities should, for example, consider whether the incentives that stem from their compensation structures and product offering interfere with their suitability requirements. Do these structures create incentives for registered representatives to engage in unsuitable or excessive trading? If those incentives exist, how do firms structure their supervisory and other mechanisms to mitigate those incentives?

FINRA provides its observations in this report to stimulate firms' thinking and to offer examples of how some firms address conflicts. FINRA's expectation is that firms will use this information to, first, support a thoughtful analysis of the conflicts they face in their business and, second, implement an appropriate conflict management framework to identify, manage, or mitigate, or improve the mitigation of, those conflicts where necessary. As firms evaluate the measures appropriate for their circumstances, their reference points should include requirements in current statute and regulation, but also look beyond to encompass a broader ethical view that considers the impact of firm actions on customers. This will help firms avoid finding themselves out of step with evolving ethical norms and expectations.

The securities industry as a whole has played a tremendously valuable role in the development of the U.S. markets and economy. While they will continue to do so, the securities industry must strengthen the investing public's trust and confidence. Addressing conflicts of interest more effectively is one important step in that direction.

Looking forward, FINRA will continue to focus on conflicts issues through its regulatory programs and will evaluate the effectiveness of firms' conflicts management efforts. If firms make inadequate progress generally, FINRA will evaluate whether conflicts-focused rulemaking is necessary to enhance investor protection.

APPENDIX I—CONFLICTS REGULATION IN THE UNITED STATES AND SELECTED INTERNATIONAL JURISDICTIONS

United States

At the most general level, the Securities Exchange Act of 1934 (the Act) broadly prohibits misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. Section 15(c) of the Act prohibits a broker from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) states that a firm "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." In addition, FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) provides that no firm "shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

In addition to these broad obligations, FINRA and the SEC have implemented measures which mandate disclosures and outright prohibitions on certain activities.

Table 2: Examples of conflicts-related disclosure requirements and regulatory prohibitions

Mandated Disclosures	Prohibitions
Firm's Interest in the Security Recommended— Exchange Act Rules 15c1-5 and 15c1-6 generally require written disclosure to a customer if a broker-dealer has any control, affiliation, or interest in a security it is offering or in the issuer of the security.	**Restrictions on the Purchase and Sale of IPOs—** FINRA Rule 5130 generally prohibits firms and their associated persons from purchasing a new issue for any account in which the firm or an associated person has an interest, except in accordance with the rule's conditions.
Disclosure and Consent When Trading on a Net Basis With Customers—FINRA Rule 2124 requires transaction-by-transaction disclosure and written consent for net trades involving non-institutional customers. Net trades with institutional customers are subject to different consent requirements. For these purposes, a net trade is a principal transaction in which, for example, a market maker, after having received an order to buy a security, purchases the security from another broker-dealer or customer and then sells it to the customer at a different price.	**Prohibition on Certain Market Activities—**SEC Regulation M generally prohibits underwriters, broker-dealers, issuers and other persons participating in a distribution from bidding for or purchasing the offered security during a certain restricted period, or inducing another person to do so. Regulation M also regulates various market activities in connection with an offering and requires that firms notify FINRA or the market where certain bids are to be posted. FINRA Rule 5190 sets forth Regulation M notification requirements for firms.
Disclosure of Control Relationship with Issuer— If a firm controls, is controlled by, or under common control with an issuer of a security, FINRA Rule 2262 requires disclosure to the customer prior to commencing a transaction in the security.	**Trading Ahead of Research Reports—**FINRA Rule 5280 prohibits firms from using non-public advance knowledge of a research report to change its inventory position in a security or derivative of the security. *continued*

Mandated Disclosures	Prohibitions
Disclosure of Participation or Interest in Primary or Secondary Offering—FINRA Rule 2269 generally requires written disclosure to customers for trades in any security in which the firm is participating in the distribution or is otherwise financially interested.	**Research Analysts and Research Reports—**Among other things, NASD Rule 2711 and Incorporated NYSE Rule 472 restricts the activities of and the relationships between a firm's research analysts and its investment bankers and personal trading by research analysts in the stocks that they cover.
Disclosure of Financial Condition upon Customer Request—FINRA Rule 2261 requires disclosure of the information in its most recent balance sheet.	**Influencing or Rewarding Employees of Others—**FINRA Rule 3220 prohibits firms from giving anything worth more than $100 annually to employees of other firms where the payment is made because of the employer's business.
Public Offerings of Securities with Conflicts of Interest—FINRA Rule 5121 prohibits participation in an offering unless certain conditions are met, including prominent prospectus disclosure of the conflict.	**Brokerage Rewarding Fund Sales—**NASD Rule 2830(k) prohibits a firm from favoring the sale of a fund because of brokerage business that has been or may be directed to the firm
	Borrowing From or Lending to Customers—FINRA Rule 3240 prohibits these arrangements unless strict conditions are met.
	Trading Ahead of Customers—FINRA Rule 5320 generally prohibits firms from trading ahead of a customer order for the firm's own account.

International Organization of Securities Commissions

Concern about conflicts of interest is not confined to the United States. The International Organization of Securities Commissions (IOSCO)—a body of securities and commodity regulators from around the world—has developed policy recommendations and best practices related to conflicts of interest specific to various parts of the securities industry.[32]

Australia, Canada and the European Union

Regulators in Australia, Canada and the European Union have adopted measures that require financial services firms, not just broker-dealers, to address conflicts of interest holistically.

Best Interest of the Client Standard

Australia, Canada and the European Union have all implemented a "best interests of the client" standard with respect to how firms address conflicts of interest. In Europe, under the Markets in Financial Instruments Directive (MiFID) the "best interests of the client" standard governs all aspects of the investment firm-client relationship, including conflicts of interest. In Australia, the "best interest of the client" standard applies to the provision of personal advice by financial licensees to retail clients and the "best interests" standard for investment dealers in Canada applies specifically to the management of conflicts of interest.

Conflicts of Interest Policies and Procedures

All three jurisdictions require that firms put in place policies and procedures to manage all material conflicts of interest. Among other things, these policies and procedures must clearly identify all material potential conflicts of interest and specify how an investment firm intends to address each potential conflict (*e.g.*, by controlling, avoiding or disclosing these conflicts). Once the conflicts of interest policies, procedures and controls have been implemented, investment firms must put in place supervision and monitoring systems to ensure that they are properly implemented, maintained and updated. All three jurisdictions agree that the management of conflicts of interest cannot be achieved solely through disclosure, and that investment firms should seek first to avoid or control conflicts before relying on disclosure to resolve the conflict.

Disclosure of Conflicts of Interest

All three jurisdictions agree that when firms cannot avoid or control a conflict, they must disclose it. Canada requires that unless a firm avoids and controls a conflict in a way that "effectively ensures with reasonable confidence that the risk of loss to the customer has been eliminated," the firm must disclose it to the customer.[33] Once a firm determines that it must disclose a conflict, all three jurisdictions agree that the firm must disclose the conflict in a manner that provides sufficient information and time for the customer to take this information into account before making an investment decision.

Compensation-related Conflicts of Interest

Regulators in Europe and Australia have further determined that some conflicts of interest stemming from compensation practices cannot be disclosed away and have prohibited certain types of compensation, such as third party commissions or inducements to investment firms from product issuers and manufacturers. Starting January 1, 2013, the United Kingdom banned commissions from product manufacturers to investment firms that provide advice to retail customers and, in April 2013, banned payments from product manufacturers to platforms. The Financial Conduct Authority (FCA) believes that the potential for the commission to bias an advisor or platform towards products for which they receive a commission is such that disclosure of this commission to the client is not sufficient.

In Europe more generally, there is a proposal to amend MiFID that would prohibit investment firms that hold themselves out as independent from receiving fees, commissions or monetary benefit from any third party in relation to the advice or product recommended. The Australian government goes even further in its recent ban on "conflicted remuneration," which is any monetary or non-monetary benefit given to a financial licensee that might influence or distort advice provided to retail clients.

To address compensation-related biases by sales representatives and their supervisors, the FCA and the European Securities and Markets Authority (ESMA) have both introduced further guidance on how to manage these conflicts to comply with MiFID and Australia has banned performance benefits that may bias advice. These regulators found that in spite of requirements for firms to effectively manage conflicts of interest, remuneration policies and practices were leading advisors to neglect the clients' best interests, and to focus instead on selling products that generate the highest fees. Of particular concern were financial and non-financial benefits based on sales volume and financial incentives to sell proprietary products.

APPENDIX II—TEXT OF FINRA LETTER TO FIRMS ANNOUNCING CONFLICTS REVIEW

July 2012

Re: Conflicts of Interest

FINRA is reviewing how firms identify and manage conflicts of interest. As part of this review, we would like to meet with executive business and compliance staff of your firm to discuss the firm's approach to conflict identification and mitigation. At the meeting, we would like your firm to present on, among other conflicts related topics, the most significant conflicts your firm is currently managing and the processes in place to identify and assess whether business practices put your firm's—or your employee's—interests ahead of those of your customers.

This inquiry is not an indication that FINRA has determined that your firm has violated any rules or regulations. FINRA's goal in speaking with firms about their conflict identification and review process is to better understand industry practices and determine whether firms are taking reasonable steps to properly identify and manage conflicts that could affect their clients or the marketplace. Knowing what firms do to address conflicts and the challenges they face will help FINRA develop potential guidance for the industry and determine other steps FINRA could consider taking in this area.

In preparation for the referenced meeting, we request that your firm submit the following information to FINRA by September 14, 2012:

1. Summary of the most significant conflicts the firm is currently managing.
2. Names of departments and persons responsible for conducting conflicts reviews.
3. Summary of the types of reports or other documents prepared at the conclusion of a conflicts review.
4. Names of departments and persons who receive any final report or other documentation summarizing a conflicts review.
5. Available dates and times in the fourth quarter of 2012 that executive management of your firm can meet with FINRA staff for approximately three hours to discuss the firm's approach to conflicts of interest.

APPENDIX III—SUMMARY OF CONFLICTS IDENTIFIED BY FIRMS

As part of its targeted examination letter (*see* Appendix II), FINRA asked recipient firms to summarize the most significant conflicts they face in their business. This appendix summarizes firms' responses. There was considerable overlap in many cases between these activities. Most firms organized the conflicts they identified broadly around general and business line conflicts, and FINRA largely follows that approach here. FINRA notes that in some cases, and depending on the facts and circumstances, some of the conflicts described below may rise to the level of rule violations.

General Conflicts

Firms identified a number of conflicts that cut across firm activities or that were not related to specific business lines. These conflicts include:

- outside business interests: employees may engage in outside business activities which could create conflicts of interest with the firm or with a client;
- gifts and entertainment: offering or receiving a gift or entertainment could create a conflict of interest;
- political contributions: providing political contributions could create the perception that the company is seeking a *quid pro quo*;
- charitable donations: firm or employees charitable donations could create the perception that the company or employee is seeking a *quid pro quo*; and
- confidentiality: confidential information may be used inappropriately to benefit the firm, an employee, or a client.

Supervision and Compliance Conflicts

Some firms identified potential conflicts between a firm's supervision and compliance departments' oversight roles and responsibilities and a firm's or individual's revenue generation objectives:

- producing managers may spend more time on revenue generating activities than performing needed supervision; and
- supervisory and/or compliance staff could be subject to pressure from sales management to protect revenue generating financial advisors.

Research-related Conflicts

A number of firms identified various forms of research-related conflicts of interest. These conflicts include:

- timeliness of dissemination: research may be disseminated to clients at different times thereby potentially favoring one client over another, this could include internal clients, *e.g.*, sales and trading;
- pressure from investment bankers: research may be subject to pressure from investment bankers to issue reports, or change existing ratings, to help win or sustain investment banking business;
- pressure from issuers: issuers could pressure research to issue favorable reports in return for investment banking or other business;
- preferential access to research: a firm may provide preferential access to desk strategists' market commentary and trading ideas; and
- pressure from sales and trading: research may be biased to support the firm's sales and trading activities.

Banking and Capital Markets

Firms identified a number of conflicts that could arise in the investment banking and capital markets area, and these relate primarily to the multiple roles a firm may play in a single transaction. There are a number of scenarios in which this could occur, including:

- advising one bidder for a company while financing another;
- advising on both sides of the same deal;
- advising a seller while financing a buyer;
- financing multiple bidders; and
- advising on the buy or sell side where the firm has an interest in one or more involved parties.

Retail/Private Wealth

Firms identified potential conflicts related to their retail and private wealth business. At their foundation, though, these relate mostly to the pursuit of revenue by the firm or its registered representatives at a client's expense:

- firms offering, or preferencing, particular products or product providers because of their revenue or profit potential for the firm, such as through revenue sharing;
- registered representatives offering, or preferencing, particular products or services because of their income potential for the registered representative;
- registered representatives recommending transactions in order to generate revenue without due regard to suitability;
- firms offering sales incentive programs to employees; and
- firms or employees preferencing proprietary products.

ENDNOTES

1. *See, e.g.*, the Securities Act of 1933, the Securities Exchange Act of 1934, the Glass-Steagal Banking Act of 1933, the Investment Company Act of 1940 and the Investment Advisor Act of 1940.

2. As the SEC noted in a 2005 release, "[b]roker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder." *See* Securities Exchange Act Rel. No. 50980 (January 14, 2005).

3. FINRA rules also impose high ethical obligations on broker-dealers. *See, e.g.*, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and FINRA Rule 2111 (Suitability).

4. *See* Appendix II for a copy of FINRA's letter informing firms of the review and requesting that they provide certain information to FINRA.

5. *See* Appendix III for a summary of conflicts firms identified in their responses to FINRA.

6. All recommendations are, of course, subject to FINRA Rule 2111 (Suitability). This rule requires firms to, among other things, conduct both reasonable basis and customer-specific determinations before recommending a transaction or investment strategy involving a security. A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors. The customer-specific suitability determination must be performed on an investor-by-investor basis.

7. FINRA believes that the increasing "retailization" of complex products requires increased review of these products by the firms. The inherent conflicts in these products—*e.g.*, use of proprietary indices, certain call or extension features or use of affiliated calculation agents—and their typical complexity raise serious issues for a firm preparing to sell them to retail investors. Given these concerns, some firms impose heightened criteria for eligible customers before a complex product could be recommended. In the retail context, FINRA remains concerned that reliance on disclosure may be an inadequate antidote to conflicts, unless the firm is confident that the customer can effectively evaluate these disclosures and make sound judgments about their potential impact on an investment recommendation.

8. "Compensation grid" refers to the compensation schedule many firms use to pay brokers. Typically, the more commission revenue the registered representative generates, the larger the percentage of that revenue the representative may keep. Compensation grids are discussed in greater detail in the compensation section.

9. The federal securities laws and FINRA rules require broker-dealers to have comprehensive supervisory structures. Under Section 15(b) of the Securities Exchange Act, a firm and its supervisory personnel may be held liable for failing to supervise an individual who engages in bad behavior unless (i) the firm has established supervisory procedures and a system for applying the procedures, and (ii) individuals reasonably discharged their supervisory responsibilities. FINRA also requires comprehensive supervision. NASD Rule 3010 requires each firm, among other things, to establish, maintain and enforce a written supervisory system; designate supervisory personnel; and conduct an annual internal inspection. NASD Rule 3012 details the requirements for a firm's supervisory control system.

10. FINRA Rule 2111 (Suitability) *Frequently Asked Questions* 7.1., page 11.

11. In addition to the anti-fraud provisions discussed here, these also include rules under the Securities Exchange Act, *e.g.*, Rule 10b-10. This rule generally requires a broker-dealer to provide confirmation statements for transactions, which must note, among other information, the firm's compensation and whether it is acting as agent or principal. Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or in the issuer of the security.

12. As noted by the SEC staff, when a broker-dealer merely processes a customer's order, but does not recommend securities or solicit the customer, the broker-dealer's obligations are generally limited to information related to the consummation of the transaction. *See* January 2011 SEC Staff Study on Investment Advisers and Broker-Dealers, at 55 (SEC Staff Study).

13. *Id.*

14. *Id.*

15. *In re* El Paso Corp. Shareholder Litigation, 41 A.3d 432 (Del. Ch. 2012) and *In re* Del Monte Foods Co. Shareholder Litigation, 25 A.3d 813 (Del. Ch. 2011).

16. FINRA has stated on a number of occasions that firms must take care to present a fair and balanced picture of the risks, costs and benefits of investing in a product. In promoting the advantages of a product, firms must balance their promotional materials with disclosures concerning the attendant risks. Simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer. *See*, for example, *Regulatory Notice 09-31*, FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds, June 2009; *Regulatory Notice 08-81*, FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment, December 2008; *Notice to Members 04-30*, NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds, April 2004; and *Notice to Members 03-71*, Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments, November 2003.

17. See earlier guidance on this issue, for example, *Regulatory Notice 07-55*, Personnel Background Investigations: FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel, November, 2007; *Notice to Members 97-19*, NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations, April 1997; and, with respect to supervisory visits to office with personnel who have disciplinary records, *Notice to Members 98-38*, NASD Reminds Members Of Supervisory And Inspection Obligations, May 1998. *Notice to Members 99-45*, NASD Provides Guidance On Supervisory Responsibilities, June, 1999.

18. Firms need to determine whether a prospective employee is a statutorily "disqualified" person. The term disqualification is defined in Article III, Section 3 of the FINRA By-Laws, and among other things, renders FINRA member firms and their associated persons ineligible for membership, continued membership, association or continued association with FINRA.

19. *See* NASD Rule 3010(e).

20. *See* NASD Rule 3010(e) for greater specificity on the obligations of FINRA member firms and their hiring practices.

21. *See* NASD Rule 3010(b).

22. FINRA recognizes that in many firms a number of committees may review new business initiatives and that some of these may include conflict concerns as part of their remit. Here, FINRA focuses on the dedicated new business initiative review since firms identified this as the primary gateway for identifying and managing conflicts of interest in a new product launch.

23. In *Notice to Members 05-26*, New Products: NASD Recommends Best Practices for Reviewing New Products, April 2005, FINRA identifies a number of good practices that include, but also go beyond, conflicts of interest. In the current report, FINRA focuses on how firms address conflicts of interest in their new product review.

24. *See also Regulatory Notice 12-03*, Complex Products: Heightened Supervision of Complex Products, January 2012, and *Notice to Members 05-59*, Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products, September, 2005.

25. Large firms typically have a variety of committees outside the new business initiative committee where issues, including those related to conflicts, may arise. FINRA's focus in this section is on the new business initiative committee.

26. Revenue-sharing payments can take many different forms. For example, a fund company may pay a firm additional amounts at year end based on the amount a firm's customers currently hold in the offeror's funds, or based on the firm's total sales of the offeror's funds in the previous year. They can also take the form of other cash payments, such as an offeror helping to pay the costs of a firm's annual sales meeting. *See, e.g.,* Securities Act Release No. 8358 (Jan. 24, 2004), 69 FR 6438 (Feb. 10, 2004), at 6441 n.17.

27. There are a number of FINRA rules which address compensation, including: NASD Rule 2440 (Fair Price and Commissions), IM-2440-1 (Mark-Up Policy), IM–2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities), FINRA Rule 5110 (Underwriting Compensation), FINRA Rule 5250 (Payments for Market-Making), NASD Rule 2830 (Investment Company Securities), FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company) and 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements), and NASD Rule 2830 (Non-Cash Compensation).

28. The Commission has stated that undisclosed markups of more than 10 percent on an equity security are fraudulent, and that a markup of less than 10 percent may be fraudulent depending on the circumstances. Acceptable markups on debt securities are significantly lower.

29. *See* Timothy Edward Daly, FINRA Letter of Acceptance Waiver and Consent (April 27, 2012) for an example of inappropriate behavior with regard to commission-based vs. fee-based accounts.

30. U.S. Government Accountability Office, 401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants, GAO-13-30, March 7, 2013, p. 10.

31. Not all firms implement performance appraisals of their registered representatives. In addition, legal restrictions may limit firms' ability to reduce the non-discretionary salary portions of individuals' compensation.

32. *See*, for example, *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*, Report of the Board of IOSCO, December 2012; *Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries*, Report of the Emerging Markets Committee of IOSCO, November 2010; *Private Equity Conflicts of Interest*, Report of the Technical Committee of IOSCO, November 2010; *Market Intermediary Management of Conflicts that Arise in Securities Offerings - Final Report*, Report of the Technical Committee of IOSCO, November 2007; and *IOSCO Statement Of Principles For Addressing Sell-Side Securities Analyst Conflicts Of Interest*, Statement of the Technical Committee of IOSCO, September 2003.

33. Investment Industry Regulatory Organization of Canada, IIROC Rule 42.4 Guidance.

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13_0409.1 –10/13

AML Challenges and Effective Practices
Wednesday, September 11, 2019
12:30 p.m. –1:30 p.m.

During this session, FINRA staff and industry practitioners discuss common challenges institutional firms face in establishing and implementing AML compliance programs, as well as practical solutions to these challenges that FINRA staff and industry professionals have developed and observed.

Moderator: Jason Foye
Director
FINRA Anti-Money Laundering Investigative Unit (AMLIU)

Speakers: Katherine Johnson
Principal Examiner
FINRA Anti-Money Laundering Investigative Unit (AMLIU)

Joan Jones
Principal, Associate Compliance Director and the Global AML Officer
Piper Jaffray & Co.

Marianne Paoli
Head of Financial Crime Compliance for Global Banking and Markets
HSBC Securities (USA), Inc.

AML Challenges and Effective Practices Panelist Bios:

Moderator:

Jason Foye is Director of FINRA's AML Investigative Unit, a specialized team that conducts complex Anti-Money Laundering examinations, provides guidance to FINRA's examination and Enforcement staff in connection with AML-related matters, and provides education and training to FINRA staff and industry personnel throughout the country. Mr. Foye serves as an AML Regulatory Specialist within FINRA and is Certified Anti-Money Laundering Specialist and a Certified Fraud Examiner. Mr. Foye graduated from Florida State University with a Bachelor's degrees in Finance and Risk Management. Mr. Foye works from FINRA's Florida District Office, and has been with FINRA for 11 years.

Speakers:

Kate Johnson is Principal Examiner in FINRA's AML Investigative Unit, where she routinely works to address complex money laundering and fraud risks. After joining FINRA in 2013, Ms. Johnson worked on cycle examinations in the New York District Office as well as a specialized team focusing on the examinations of large broker-dealers. Ms. Johnson received her BA in Business from Franklin & Marshall College and is CAMS certified.

Joanie Jones is Principal, Associate Compliance Director and the Global AML Officer of Piper Jaffray. In this role, she is responsible for the implementation and management of the AML and anti-bribery programs for Piper Jaffray & Co., the US broker-dealer, and the affiliated broker-dealers in London and Hong Kong. Other areas of responsibility include sanctions compliance and managing the regulatory and registration functions within compliance. Ms. Jones began working in AML compliance in 2001 and was named Chief AML Officer for the US broker-dealer in 2006 and Global AML Officer in 2011. She joined Piper Jaffray in 1998 as a retail compliance officer. Prior to joining Piper Jaffray, she held various roles in operations, sales and sales supervision at a Minneapolis-based regional broker-dealer. Ms. Jones is a member of the SIFMA Anti-Money Laundering and Financial Crimes committee. She holds the series 7, 9, 10 and 24 licenses. Ms. Jones earned a Bachelor of Science degree in business administration from the University of North Dakota.

Marianne Paoli is the US Head of Financial Crime Compliance for Global Banking and Markets at HSBC. Prior to joining HSBC, Ms. Paoli was a Director in FINRA's Department of Enforcement where she supervised investigators and attorneys in conducting complex investigations and prosecutions, including matters involving AML and fraud. Before joining FINRA, Ms. Paoli was a prosecutor in the New York County District Attorney's office where she investigated and prosecuted white collar crimes, including those related to money laundering, bribery and corruption, and fraud.

2019 FINRA Institutional Conference

September 11, 2019 | New York, NY

AML Challenges and Effective Practices

Panelists

- **Moderator**
  - Jason Foye, Director, FINRA Anti-Money Laundering Investigative Unit (AMLIU)
- **Panelists**
  - Katherine Johnson, Principal Examiner, FINRA Anti-Money Laundering Investigative Unit (AMLIU)
  - Joan Jones, Principal, Associate Compliance Director and the Global AML Officer, Piper Jaffray & Co.
  - Marianne Paoli, Head of Financial Crime Compliance for Global Banking and Markets, HSBC Securities (USA), Inc.

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Regulatory Notice 19-18

Anti-Money Laundering (AML) Program

FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations

Summary

FINRA is issuing this *Notice* to provide guidance to member firms regarding suspicious activity monitoring and reporting obligations under FINRA Rule 3310 (Anti-Money Laundering Compliance Program).

Questions concerning this *Notice* should be directed to:

- Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104 or *victoria.crane@finra.org*; or
- Blake Snyder, Senior Director, Member Regulation, at (561) 443-8051 or *blake.snyder@finra.org*.

Background and Discussion

FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires each member firm to develop and implement a written anti-money laundering (AML) program reasonably designed to achieve and monitor the firm's compliance with the requirements of the Bank Secrecy Act (BSA),[1] and the implementing regulations promulgated thereunder by the Department of the Treasury (Treasury).

FINRA Rule 3310(a) requires firms to "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under [the BSA] and the implementing regulation thereunder." The BSA authorizes Treasury to require that financial institutions file suspicious activity reports (SARs).[2]

May 6, 2019

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Anti-Money Laundering
- Compliance Programs

Referenced Rules & Notices
- Bank Secrecy Act
- FINRA Rule 3310
- Notice to Members 02-21

Financial Industry Regulatory Authority

Under Treasury's SAR rule,[3] a broker-dealer must report a transaction to the Financial Crimes Enforcement Network (FinCEN) if it is conducted or attempted by, at or through a broker-dealer, it involves or aggregates funds or other assets of at least $5,000, and the broker-dealer knows, suspects or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):

- involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;
- is designed, whether through structuring or other means, to evade any regulations promulgated under the BSA;
- has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or
- involves use of the broker-dealer to facilitate criminal activity.[4]

Broker-dealers must report the suspicious activity by completing a SAR and filing it in accordance with the requirements of Treasury's SAR rule.[5] Broker-dealers must maintain a copy of any SAR filed and supporting documentation for a period of five years from the date of filing the SAR.[6] FinCEN has provided guidance[7] to the industry advising that if the activity that was the subject of a SAR filing continues, firms should review any continuing activity at least every 90 days to consider whether a continuing activity SAR filing is warranted, with the filing deadline being 120 days after the date of the previously related SAR filing.

In situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, broker-dealers must immediately notify by telephone an appropriate law enforcement authority in addition to filing timely a SAR. The firm may call FinCEN's Hotline at (866) 556-3974.

Money Laundering Red Flags

FINRA published a list of "money laundering red flags" in *Notice to Members 02-21* (NTM 02-21). Since NTM 02-21 was published, guidance detailing additional red flags that may be applicable to the securities industry have been published by a number of U.S. government agencies and international organizations.[8] FINRA is issuing this *Notice* to provide examples of these additional money laundering red flags for firms to consider incorporating into their AML programs, as may be appropriate in implementing a risk-based approach to BSA/AML compliance. This could include, as applicable, incorporation into policies and procedures relating to suspicious activity monitoring or suspicious activity investigation and SAR reporting. Upon detection of red flags through monitoring, firms should consider whether additional investigation, customer due diligence measures or a SAR filing may be warranted.

The following is not an exhaustive list and does not guarantee compliance with AML program requirements or provide a safe harbor from regulatory responsibility. Further, it is important to note that a red flag is not necessarily indicative of suspicious activity, and that not every item identified in this *Notice* will be relevant for every broker-dealer, every customer relationship or every business activity.

Firms should also be aware of emerging areas of risk, such as risks associated with activity in digital assets. Regardless of whether such assets are securities, BSA/AML requirements, including SAR filing requirements apply, and firms should thus consider the relevant risks, monitor for suspicious activity and, as applicable, report any such activity.

This *Notice* is intended to assist broker-dealers in complying with their existing obligations under BSA/AML requirements and does not create any new requirements or expectations. In addition, this *Notice* incorporates the red flags listed in NTM 02-21 so that firms can refer to this *Notice* only for examples of potential red flags.

I. Potential Red Flags in Customer Due Diligence and Interactions With Customers

1. The customer provides the firm with unusual or suspicious identification documents that cannot be readily verified or are inconsistent with other statements or documents that the customer has provided. Or, the customer provides information that is inconsistent with other available information about the customer. This indicator may apply to account openings and to interaction subsequent to account opening.
2. The customer is reluctant or refuses to provide the firm with complete customer due diligence information as required by the firm's procedures, which may include information regarding the nature and purpose of the customer's business, prior financial relationships, anticipated account activity, business location and, if applicable, the entity's officers and directors.
3. The customer refuses to identify a legitimate source of funds or information is false, misleading or substantially incorrect.
4. The customer is domiciled in, doing business in or regularly transacting with counterparties in a jurisdiction that is known as a bank secrecy haven, tax shelter, high-risk geographic location (*e.g.*, known as a narcotics producing jurisdiction, known to have ineffective AML/Combating the Financing of Terrorism systems) or conflict zone, including those with an established threat of terrorism.
5. The customer has difficulty describing the nature of his or her business or lacks general knowledge of his or her industry.
6. The customer has no discernable reason for using the firm's service or the firm's location (*e.g.*, the customer lacks roots to the local community or has gone out of his or her way to use the firm).

7. The customer has been rejected or has had its relationship terminated as a customer by other financial services firms.
8. The customer's legal or mailing address is associated with multiple other accounts or businesses that do not appear related.
9. The customer appears to be acting as an agent for an undisclosed principal, but is reluctant to provide information.
10. The customer is a trust, shell company or private investment company that is reluctant to provide information on controlling parties and underlying beneficiaries.
11. The customer is publicly known or known to the firm to have criminal, civil or regulatory proceedings against him or her for crime, corruption or misuse of public funds, or is known to associate with such persons. Sources for this information could include news items, the Internet or commercial database searches.
12. The customer's background is questionable or differs from expectations based on business activities.
13. The customer maintains multiple accounts, or maintains accounts in the names of family members or corporate entities, with no apparent business or other purpose.
14. An account is opened by a politically exposed person (PEP),[9] particularly in conjunction with one or more additional risk factors, such as the account being opened by a shell company[10] beneficially owned or controlled by the PEP, the PEP is from a country which has been identified by FATF as having strategic AML regime deficiencies, or the PEP is from a country known to have a high level of corruption.
15. An account is opened by a non-profit organization that provides services in geographic locations known to be at higher risk for being an active terrorist threat.[11]
16. An account is opened in the name of a legal entity that is involved in the activities of an association, organization or foundation whose aims are related to the claims or demands of a known terrorist entity.[12]
17. An account is opened for a purported stock loan company, which may hold the restricted securities of corporate insiders who have pledged the securities as collateral for, and then defaulted on, purported loans, after which the securities are sold on an unregistered basis.
18. An account is opened in the name of a foreign financial institution, such as an offshore bank or broker-dealer, that sells shares of stock on an unregistered basis on behalf of customers.
19. An account is opened for a foreign financial institution that is affiliated with a U.S. broker-dealer, bypassing its U.S. affiliate, for no apparent business purpose. An apparent business purpose could include access to products or services the U.S. affiliate does not provide.

II. Potential Red Flags in Deposits of Securities

1. A customer opens a new account and deposits physical certificates, or delivers in shares electronically, representing a large block of thinly traded or low-priced securities.
2. A customer has a pattern of depositing physical share certificates, or a pattern of delivering in shares electronically, immediately selling the shares and then wiring, or otherwise transferring out the proceeds of the sale(s).
3. A customer deposits into an account physical share certificates or electronically deposits or transfers shares that:
   - were recently issued or represent a large percentage of the float for the security;
   - reference a company or customer name that has been changed or that does not match the name on the account;
   - were issued by a shell company;
   - were issued by a company that has no apparent business, revenues or products;
   - were issued by a company whose SEC filings are not current, are incomplete, or nonexistent;
   - were issued by a company that has been through several recent name changes or business combinations or recapitalizations;
   - were issued by a company that has been the subject of a prior trading suspension; or
   - were issued by a company whose officers or insiders have a history of regulatory or criminal violations, or are associated with multiple low-priced stock issuers.
4. The lack of a restrictive legend on deposited shares seems inconsistent with the date the customer acquired the securities, the nature of the transaction in which the securities were acquired, the history of the stock or the volume of shares trading.
5. A customer with limited or no other assets at the firm receives an electronic transfer or journal transfer of large amounts of low-priced, non-exchange-listed securities.
6. The customer's explanation or documents purporting to evidence how the customer acquired the shares does not make sense or changes upon questioning by the firm or other parties. Such documents could include questionable legal opinions or securities purchase agreements.
7. The customer deposits physical securities or delivers in shares electronically, and within a short time-frame, requests to journal the shares into multiple accounts that do not appear to be related, or to sell or otherwise transfer ownership of the shares.
8. Seemingly unrelated clients open accounts on or at about the same time, deposit the same low-priced security and subsequently liquidate the security in a manner that suggests coordination.

III. Potential Red Flags in Securities Trading[13]

1. The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" stocks and bearer bonds, which although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.)
2. There is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.
3. The customer's activity represents a significant proportion of the daily trading volume in a thinly traded or low-priced security.
4. A customer buys and sells securities with no discernable purpose or circumstances that appear unusual.
5. Individuals known throughout the industry to be stock promoters sell securities through the broker-dealer.
6. A customer accumulates stock in small increments throughout the trading day to increase price.
7. A customer engages in pre-arranged or other non-competitive securities trading, including wash or cross trades, with no apparent business purpose.
8. A customer attempts to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market.
9. A customer engages in transactions suspected to be associated with cyber breaches of customer accounts, including potentially unauthorized disbursements of funds or trades.
10. A customer engages in a frequent pattern of placing orders on one side of the market, usually inside the existing National Best Bid or Offer (NBBO), followed by the customer entering orders on the other side of the market that execute against other market participants that joined the market at the improved NBBO (activity indicative of "spoofing").
11. A customer engages in a frequent pattern of placing multiple limit orders on one side of the market at various price levels, followed by the customer entering orders on the opposite side of the market that are executed and the customer cancelling the original limit orders (activity indicative of "layering").
12. Two or more unrelated customer accounts at the firm trade an illiquid or low-priced security suddenly and simultaneously.
13. The customer makes a large purchase or sale of a security, or option on a security, shortly before news or a significant announcement is issued that affects the price of the security.

14. The customer is known to have friends or family who work at or for the securities issuer, which may be a red flag for potential insider trading or unlawful sales of unregistered securities.
15. The customer's purchase of a security does not correspond to the customer's investment profile or history of transactions (*e.g.*, the customer may never have invested in equity securities or may have never invested in a given industry, but does so at an opportune time) and there is no reasonable explanation for the change.
16. The account is using a master/sub structure, which enables trading anonymity with respect to the sub-accounts' activity, and engages in trading activity that raises red flags, such as the liquidation of microcap issuers or potentially manipulative trading activity.
17. The firm receives regulatory inquiries or grand jury or other subpoenas concerning the firm's customers' trading.
18. The customer engages in a pattern of transactions in securities indicating the customer is using securities to engage in currency conversion. For example, the customer delivers in and subsequently liquidates American Depository Receipts (ADRs) or dual currency bonds for U.S. dollar proceeds, where the securities were originally purchased in a different currency.
19. The customer engages in mirror trades or transactions involving securities used for currency conversions, potentially through the use of offsetting trades.
20. The customer appears to buy or sell securities based on advanced knowledge of pending customer orders.

IV. Potential Red Flags in Money Movements

1. The customer attempts or makes frequent or large deposits of currency, insists on dealing only in cash equivalents, or asks for exemptions from the firm's policies and procedures relating to the deposit of cash and cash equivalents.
2. The customer "structures" deposits, withdrawals or purchases of monetary instruments below a certain amount to avoid reporting or recordkeeping requirements, and may state directly that they are trying to avoid triggering a reporting obligation or to evade taxing authorities.
3. The customer seemingly breaks funds transfers into smaller transfers to avoid raising attention to a larger funds transfer. The smaller funds transfers do not appear to be based on payroll cycles, retirement needs, or other legitimate regular deposit and withdrawal strategies.
4. The customer's account shows numerous currency, money order (particularly sequentially numbered money orders) or cashier's check transactions aggregating to significant sums without any apparent business or lawful purpose.

5. The customer frequently changes bank account details or information for redemption proceeds, in particular when followed by redemption requests.
6. The customer makes a funds deposit followed by an immediate request that the money be wired out or transferred to a third party, or to another firm, without any apparent business purpose.
7. Wire transfers are made in small amounts in an apparent effort to avoid triggering identification or reporting requirements.
8. Incoming payments are made by third-party checks or checks with multiple endorsements.
9. Outgoing checks to third parties coincide with, or are close in time to, incoming checks from other third parties.
10. Payments are made by third party check or money transfer from a source that has no apparent connection to the customer.
11. Wire transfers are made to or from financial secrecy havens, tax havens, high-risk geographic locations or conflict zones, including those with an established presence of terrorism.
12. Wire transfers originate from jurisdictions that have been highlighted in relation to black market peso exchange activities.
13. The customer engages in transactions involving foreign currency exchanges that are followed within a short time by wire transfers to locations of specific concern (*e.g.*, countries designated by national authorities, such as FATF, as non-cooperative countries and territories).
14. The parties to the transaction (*e.g.*, originator or beneficiary) are from countries that are known to support terrorist activities and organizations.
15. Wire transfers or payments are made to or from unrelated third parties (foreign or domestic), or where the name or account number of the beneficiary or remitter has not been supplied.
16. There is wire transfer activity that is unexplained, repetitive, unusually large, shows unusual patterns or has no apparent business purpose.
17. The securities account is used for payments or outgoing wire transfers with little or no securities activities (*i.e.*, account appears to be used as a depository account or a conduit for transfers, which may be purported to be for business operating needs).
18. Funds are transferred to financial or depository institutions other than those from which the funds were initially received, specifically when different countries are involved.

19. The customer engages in excessive journal entries of funds between related or unrelated accounts without any apparent business purpose.
20. The customer uses a personal/individual account for business purposes or vice versa.
21. A foreign import business with U.S. accounts receives payments from outside the area of its customer base.
22. There are frequent transactions involving round or whole dollar amounts purported to involve payments for goods or services.
23. Upon request, a customer is unable or unwilling to produce appropriate documentation (*e.g.*, invoices) to support a transaction, or documentation appears doctored or fake (*e.g.*, documents contain significant discrepancies between the descriptions on the transport document or bill of lading, the invoice, or other documents such as the certificate of origin or packing list).
24. The customer requests that certain payments be routed through nostro[14] or correspondent accounts held by the financial intermediary instead of its own accounts, for no apparent business purpose.
25. Funds are transferred into an account and are subsequently transferred out of the account in the same or nearly the same amounts, especially when the origin and destination locations are high-risk jurisdictions.
26. A dormant account suddenly becomes active without a plausible explanation (*e.g.*, large deposits that are suddenly wired out).
27. Nonprofit or charitable organizations engage in financial transactions for which there appears to be no logical economic purpose or in which there appears to be no link between the stated activity of the organization and the other parties in the transaction.
28. There is unusually frequent domestic and international automated teller machine (ATM) activity.
29. A person customarily uses the ATM to make several deposits into a brokerage account below a specified BSA/AML reporting threshold.
30. Many small, incoming wire transfers or deposits are made using checks and money orders that are almost immediately withdrawn or wired out in a manner inconsistent with the customer's business or history; the checks or money orders may reference in a memo section "investment" or "for purchase of stock." This may be an indicator of a Ponzi scheme or potential funneling activity.
31. Wire transfer activity, when viewed over a period of time, reveals suspicious or unusual patterns, which could include round dollar, repetitive transactions or circuitous money movements.

V. Potential Red Flags in Insurance Products

1. The customer cancels an insurance contract and directs that the funds be sent to a third party.
2. The customer deposits an insurance annuity check from a cancelled policy and immediately requests a withdrawal or transfer of funds.
3. The customer cancels an annuity product within the free-look period. This could be a red flag if accompanied with suspicious indicators, such as purchasing the annuity with several sequentially numbered money orders or having a history of cancelling annuity products during the free-look period.
4. The customer opens and closes accounts with one insurance company, then reopens a new account shortly thereafter with the same insurance company, each time with new ownership information.
5. The customer purchases an insurance product with no concern for the investment objective or performance.

VI. Other Potential Red Flags

1. The customer is reluctant to provide information needed to file reports to proceed with the transaction.
2. The customer exhibits unusual concern with the firm's compliance with government reporting requirements and the firm's AML policies.
3. The customer tries to persuade an employee not to file required reports or not to maintain the required records.
4. Notifications received from the broker-dealer's clearing firm that the clearing firm had identified potentially suspicious activity in customer accounts. Such notifications can take the form of alerts or other concern regarding negative news, money movements or activity involving certain securities.
5. Law enforcement has issued subpoenas or freeze letters regarding a customer or account at the securities firm.
6. The customer makes high-value transactions not commensurate with the customer's known income or financial resources.
7. The customer wishes to engage in transactions that lack business sense or an apparent investment strategy, or are inconsistent with the customer's stated business strategy.
8. The stated business, occupation or financial resources of the customer are not commensurate with the type or level of activity of the customer.
9. The customer engages in transactions that show the customer is acting on behalf of third parties with no apparent business or lawful purpose.

10. The customer engages in transactions that show a sudden change inconsistent with normal activities of the customer.
11. Securities transactions are unwound before maturity, absent volatile market conditions or other logical or apparent reason.
12. The customer does not exhibit a concern with the cost of the transaction or fees (*e.g.*, surrender fees, or higher than necessary commissions).
13. A borrower defaults on a cash-secured loan or any loan that is secured by assets that are readily convertible into currency.
14. There is an unusual use of trust funds in business transactions or other financial activity.

Endnotes

1. 31 U.S.C. 5311, et seq.

2. See 31 U.S.C. 5318(g).

3. See 31 CFR 1023.320.

4. See 31 CFR 1023.320(a)(2).

5. See 31 CFR 1023.320.

6. See 31 CFR 1023.320(d).

7. See FinCEN SAR Activity Review Issue 21 (May 2012).

8. See, e.g, Financial Action Task Force (FATF), Guidance for a Risk-Based Approach for the Securities Sector, October 2018; FATF, Money Laundering and Terrorist Financing in the Securities Sector, October 2009; FATF, Guidance for Financial Institutions in Detecting Terrorist Financing, April 2002; FATF Report, Laundering the Proceeds of Corruption, July 2011; FATF Report, Risk of Terrorist Abuse in Non-Profit Organisations, June 2014; FinCEN Advisory FIN-2010-A001: Advisory to Financial Institutions on Filing Suspicious Activity Reports regarding Trade Based Money Laundering, February 2010; U.S. Department of State, Money Laundering Methods, Trends and Typologies, March 2004; Securities and Exchange Commission (SEC) National Exam Risk Alert on Master/Sub-accounts, September 2011; SEC National Exam Risk Alert on Broker-Dealer Controls Regarding Customer Sales of Microcap Securities, October 2014; and SEC Responses to Frequently Asked Questions about a Broker-Dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders, October 2014. See also Regulatory Notices 09-05 (January 2009) and 10-18 (April 2010); and Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering, Money Laundering and Terrorist Financing "Red Flags."

9. A "Politically Exposed Person" is defined by FATF as an individual who is or has been entrusted with a prominent public function, for example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, or important political party officials. See FATF Guidance, Politically Exposed Persons, June 2013.

10. A "shell company" is an issuer of securities for which a registration statement has been filed with the SEC that has: (1) no or nominal operations; and (2) either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. See 17 CFR 230.504.

11. The FATF Report on Risk of Terrorist Abuse in Non-Profit Organisations (FATF Report), June 2014, defines "terrorist threat" as: A person or group of people, object or activity, with the potential to cause harm. Threat is contingent on actors that possess both the capability and intent to do harm.

12. The FATF Report defines "terrorist entity" as a terrorist and/or terrorist organization identified as a supporter of terrorism by national or international sanctions lists, or assessed by a jurisdiction as active in terrorist activity. See id.

13. These red flags could also be indicative of securities law violations.

14. Nostro accounts are accounts that a financial institution holds in a foreign currency in another bank, typically in order to facilitate foreign exchange transactions.

Common Examination Findings for Institutional Firms
Wednesday, September 11, 2019
1:45 p.m. – 2:45 p.m.

Join FINRA staff as they discuss the most common deficiencies noted during FINRA cycle examinations of institutional firms. Industry practitioners describe taking corrective action and updating compliance procedures and practices based on lessons learned from common examination findings pertaining to fixed income and equity sales, and trading business lines.

Moderator: Scott Gilbert
Vice President and District Director, Sales Practice
FINRA New York District Office

Speakers: Gary Distell
Chief Compliance Officer and Senior Regulatory Counsel
Guggenheim Securities, LLC

Eric Field
Director of Capital Markets Compliance
Robert W. Baird & Co.

Rajesh Mirchandani
Senior Director, Trading and Financial Compliance Examinations (TFCE)
FINRA Market Regulation

Common Examination Findings for Institutional Firms Panelist Bios:

Moderator:

Scott M. Gilbert is a FINRA Vice President and New York District Director, responsible for the District's examination and risk monitoring programs. From 2013 to 2019, he was a FINRA Senior Director with responsibility for the New York District's large firm examination and cause examination programs. From 2004 through 2013, Mr. Gilbert was employed at UBS Financial Services Inc. in various roles including Executive Director and Head of Compliance for the Wealth Management Advisor Group of UBS, with responsibility for compliance matters and policies relating to the broker-dealer's financial advisors. From 2006 through 2010, he was Senior Associate General Counsel and head of the group responsible for internal investigations and disciplinary recommendations at UBS. In that role, he advised the firm's management in all aspects of issues related to employee compliance with firm policies and industry rules, regulations and laws. From 2000 to 2004, Mr. Gilbert was Vice President and Senior Counsel with Merrill Lynch & Co., where he was responsible for global regulatory matters and internal investigations. Before that, he was a trial counsel with the Division of Enforcement of the New York Stock Exchange, responsible for enforcing the rules of that self-regulatory organization, investigating customer complaints and prosecuting disciplinary actions. Mr. Gilbert was at the NYSE from 1995 to 2000. He also was a litigation attorney in private practice from 1990 to 1995, with a focus on complex commercial litigation and securities class actions. Mr. Gilbert is a graduate of Columbia University and New York University School of Law.

Speakers:

Gary Distell has more than 25 years of experience in the financial compliance and legal fields. He started his career at the NASD and now serves as the Chief Compliance Officer, Senior Managing Director and Senior Regulatory Counsel for Guggenheim Securities. Mr. Distell first served as a Senior Consultant and in September 2015 joined the company as a Managing Director and Regulatory Counsel for Guggenheim Partners, where he advised the Global Head of Compliance on a variety of compliance issues arising in the broker-dealer and investment advisory divisions. Prior to Guggenheim Partners, he served as the Global Head of Compliance, Managing Director and Senior Counsel for Cantor Fitzgerald where he coordinated and implemented policies globally for all of Cantor Fitzgerald's compliance departments and oversaw many aspects of the Americas legal department, including fixed income and equity. From July 2008 to January 2010, Mr. Distell was a partner for Katten Muchin Rosenman LLP, a full-service law firm where he focused on Financial Services law. Mr. Distell was also previously a Senior Managing Director for Bear, Stearns & Co. where he was the head equity attorney and head of their regulatory group from 1996 to 2008. Prior to Bear, Sterns & Co., Mr. Distell served as an investigator for the National Association of Securities Dealers (Now FINRA) until 1996. Mr. Distell is Series 7, 24, 57, 63, 79 and 99 licensed and holds a B.S. in Finance from Penn State University, a J.D. from George Washington University Law School and the LL.M. from Georgetown University Law Center.

Eric Field has been with Robert W. Baird & Co. Inc. since 2010, first as Director of Equity Capital Markets Compliance, then as Director of Capital Markets Compliance in 2011, which includes responsibility for all equities and fixed income compliance. He is currently Baird's Municipal Advisor CCO. From 2003-2010, Mr. Field worked at a mid-size broker dealer near Washington, DC and was responsible for a variety of compliance areas including equities, fixed income, options, public communications, and registrations. Prior to that he worked from 2000-2003 as a TMMS examiner with then NASD, where he conducted examinations of member firms trading desks. Mr. Field has his Masters of Science Degree in Finance from Johns Hopkins University and his B.S. in Finance from West Virginia University. He currently serves on the MSRB Series 50/54 exam writing committee.

Rajesh Mirchandani is Senior Director in the Trading and Financial Compliance Examinations (TFCE) examination program within FINRA's Market Regulation Department. TFCE was formerly known as Trading and Market Making Surveillance (TMMS). Mr. Mirchandani's team regulates FINRA and various Exchange members for compliance with REG SHO Compliance, Confirmation disclosures, Order Execution and Order Routing information disclosures, OATS Reporting, Trade Reporting/Order Entry, Record-keeping, Market Access, and other trading rules. Mr. Mirchandani is responsible for planning, coordination, and execution of the annual TFCE examination cycle. Mr. Mirchandani has been with FINRA since July 1996, where he started with Member Supervision as a Sales Practice examiner. He received his B.S. degree in Industrial Engineering from State University at Buffalo in 1991, and an MBA in Finance and Investments from Baruch College in 1996.

Common Examination Findings for Institutional Firms

Panelists

- **Moderator**
  - Scott Gilbert, Vice President and District Director, Sales Practice, FINRA New York District Office
- **Panelists**
  - Gary Distell, Chief Compliance Officer and Senior Regulatory Counsel, Guggenheim Securities, LLC
  - Eric Field, Director of Capital Markets Compliance, Robert W. Baird & Co.
  - Rajesh Mirchandani, Senior Director, Trading and Financial Compliance Examinations (TFCE), FINRA Market Regulation

To Access Polling

- Under the “Schedule” icon on the home screen,
- Select the day,
- Choose the Common Examination Findings for Institutional Firms session,
- Click on the polling icon: 

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Polling Question 1

1. **Do you have a process for monitoring vendors from a compliance perspective?**
   a. Yes
   b. No
   c. I don't know

Common Examination Findings for Institutional Firms
Wednesday, September 11, 2019
1:45 p.m. – 2:45 p.m.

Resources

CAT Clock Synchronization

- CAT FAQs

  www.catnmsplan.com/faq/index.html

- FINRA *Regulatory Notice 17-09, Consolidated Audit Trail (CAT), The National Securities Exchanges and FINRA Issue Joint Guidance on Clock Synchronization and Certification Requirements Under the CAT NMS Plan* (March 2017)

  www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-09.pdf

- FINRA *Regulatory Notice 16-23, Clock Synchronization, SEC Approves Rule Change to Reduce the Clock Synchronization Tolerance for Computer Clocks Used to Record Events in NMS Securities and OTC Equity Securities* (July 2016)

  www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-23.pdf

OATS Reporting

- FAQ Regarding Order Audit Trail System (OATS) Compliance

  www.finra.org/filing-reporting/market-transparency-reporting/oats/faq/compliance

- OATS Technical Specifications

  www.finra.org/filing-reporting/oats/oats-technical-specifications

Registration

- Web CRD, Individual Form Filing: Form U4

  www.finra.org/sites/default/files/web-crd-form-u4.pdf

TRACE Resources

- Frequently Asked Questions (FAQ) about the Trade Reporting and Compliance Engine (TRACE)

  www.finra.org/filing-reporting/trace/faq

- FINRA *Trade Reporting Notice, FINRA Reminds Firms of Their Obligations Regarding TRACE Reporting* (July 2019)

  Webpage: *www.finra.org/rules-guidance/notices/trade-reporting-notice-071919*
  PDF: *www.finra.org/sites/default/files/2019-07/Trade-Reporting-Notice-071919.pdf*

2019 FINRA Institutional Conference

September 11 | New York, NY

Ask FINRA Senior Staff
Wednesday, September 11, 2019
3:00 p.m. – 4:00 p.m.

FINRA senior leaders and industry experts discuss the regulatory environment and a range of topics affecting institutional firms.

Moderator: William St. Louis
Senior Vice President and Regional Director, Sales Practice
FINRA Northeast Region

Speakers: Ornella Bergeron
Senior Vice President, Unit Leader ROOR
FINRA Office of Risk Oversight and Operational Regulation

Gene DeMaio
Executive Vice President, Options Regulation and Trading and Financial Compliance Examinations (TFCE)
FINRA Market Regulation

John Edmonds
Examination Manager, Sales Practice
FINRA New York District Office

Scott Gilbert
Vice President and District Director, Sales Practice
FINRA New York District Office

Ask FINRA Senior Staff Panelist Bios:

Moderator:

William St. Louis is Regional Director for FINRA's Northeast region and has responsibility for the sales practice examination and surveillance programs in FINRA's New York, Boston, Philadelphia, and New Jersey District offices. He also oversees FINRA's Membership Application Program (MAP). Prior to assuming the Regional Director role in March 2019, he was the District Director of FINRA's New York office. Before joining FINRA's examination program, Mr. St. Louis held senior roles in FINRA's Enforcement Department including serving as the Regional Chief Counsel for FINRA's North Region. Mr. St. Louis earned a B.A. from Baruch College and a law degree from New York University School of Law. Immediately after law school, Mr. St. Louis clerked for a New York state trial judge, and prior to law school he worked for several years in the Compliance Department of a NY-based broker-dealer.

Speakers:

Ornella Bergeron has been with FINRA since its inception in 2007. In her role as Senior Vice President in the Risk Oversight and Operational Regulation group of Member Supervision, she leads a group of 90 professionals who supervise and examine approximately 200 of FINRA's largest members for financial and operational soundness, risk assessment adequacy and business conduct compliance. Prior to joining FINRA, Ms. Bergeron spent 19 years at the New York Stock Exchange in similar roles. Ms. Bergeron holds a BBA in Finance from Iona College.

Gene DeMaio is Executive Vice President in FINRA's Market Regulation Department where he manages the Options Regulation and Trading and Financial Compliance Examinations programs. Prior to joining FINRA, Mr. DeMaio was an Options Market Maker at the American Stock Exchange, and earlier worked as an attorney at the law firm of Kord Lagemann where he represented complainants in securities arbitration disputes. Mr. DeMaio is a graduate of Fordham Law and earned his LL.M at New York University.

John Edmonds is currently Examination Manager for the FINRA New York Municipal Examination Team. The team was created in 2013 to conduct Municipal examinations of Firms in New York City that engage in Primary Municipal Market activities, and/or Firms that conduct significant Secondary Market trading of Municipal Securities. Mr. Edmonds began his career with NASD, (now FINRA) as an Examiner in 1997. He has been an Examination Manger in the New York District Office since 2000.

Scott M. Gilbert is a FINRA Vice President and New York District Director, responsible for the District's examination and risk monitoring programs. From 2013 to 2019, he was a FINRA Senior Director with responsibility for the New York District's large firm examination and cause examination programs. From 2004 through 2013, Mr. Gilbert was employed at UBS Financial Services Inc. in various roles including Executive Director and Head of Compliance for the Wealth Management Advisor Group of UBS, with responsibility for compliance matters and policies relating to the broker-dealer's financial advisors. From 2006 through 2010, he was Senior Associate General Counsel and head of the group responsible for internal investigations and disciplinary recommendations at UBS. In that role, he advised the firm's management in all aspects of issues related to employee compliance with firm policies and industry rules, regulations and laws. From 2000 to 2004, Mr. Gilbert was Vice President and Senior Counsel with Merrill Lynch & Co., where he was responsible for global regulatory matters and internal investigations. Before that, he was a trial counsel with the Division of Enforcement of the New York Stock Exchange, responsible for enforcing the rules of that self-regulatory organization, investigating customer complaints and prosecuting disciplinary actions. Mr. Gilbert was at the NYSE from 1995 to 2000. He also was a litigation attorney in private practice from 1990 to 1995, with a focus on complex commercial litigation and securities class actions. Mr. Gilbert is a graduate of Columbia University and New York University School of Law.

Ask FINRA Senior Staff

Panelists

- **Moderator**
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  - John Edmonds, Examination Manager, Sales Practice, FINRA New York District Office
  - Scott Gilbert, Vice President and District Director, Sales Practice, FINRA New York District Office