MEMO# 31029

January 17, 2018

FINRA Publishes Its 2018 Regulatory and Examination Priority Letter

[31029]

January 17, 2018 TO: Broker/Dealer Advisory Committee
Chief Compliance Officer Committee
Compliance Advisory Committee
Principal Underwriters Working Group
Unit Investment Trust Committee RE: FINRA Publishes Its 2018 Regulatory and Examination Priority Letter

Last week, FINRA published its 2018 Regulatory and Examination Priority Letter.[1] FINRA's Letter included a cover letter from its President and CEO, Robert Cook. The cover letter noted that the areas discussed in FINRA's Letter are those that "member firms may wish to consider as they identify opportunities to improve their compliance, supervisory and risk management programs." The cover letter also "reflects briefly on how FINRA is working to become a more efficient and more effective self-regulatory organization."[2]

FINRA's Letter is organized into three sections: (1) the five areas that FINRA will focus on when it reviews members' operations over the coming year;[3] (2) "Report Cards;" and (3) new rules. While the letter's discussion under these heading is briefly summarized below, the areas of focus that may be of interest to mutual funds are:

- **Senior Investors** – under the headings of "Fraud" and "High-risk Firms and Brokers," FINRA's Letter discusses how exploitation of senior investors will be a focus of exams.
- **Unit Investment Trusts and Multi-Share Class Products** – As FINRA reviews the issue of suitability as a sales practice risk, "FINRA will review firms' handling of products where FINRA has observed firms experiencing problems implementing effective controls, such as firms' handling of Unit Investment Trusts (UITs) and multi-share class products as addressed in the Examination Findings Report . . .."[4]
- **Employer-sponsored Retirement Plans –** According to FINRA, this will "be an important area of focus for FINRA." As FINRA considers this issue, its focus will be on "the suitability of firms' and registered representatives' recommendations made to plan participants, including IRS rollover recommendations involving securities transactions." It will also look at how firms supervise these recommendations.
- **Moving Customers from Brokerage Accounts to Advisory Accounts –** FINRA plans to review the movement of customers among these different accounts where

the move "clearly disadvantages the customer, such as where the registered representative recommended the customer purchase a securities product subject to a front-end sales charge in a brokerage account and then shortly thereafter recommended that the account be transferred to a fee-based account."

The following is a summary of the contents of FINRA's Letter.

I. FINRA's Areas of Focus in Reviewing Members' Operations

As FINRA inspects its members this year, it will be focused on these areas:

- **Fraud:** FINRA's efforts in this area will focus on insider trading, microcap pump and dump schemes, issuer fraud, and Ponzi-type schemes.
- **High-Risk Firms and Brokers:** FINRA plans to continue to identify high-risk firms and brokers and mitigate their potential risks to investors.
- **Operational and Financial Risks:** FINRA's efforts in this area will focus on: BCP; customer protection and verification of assets and liabilities (*i.e.,* compliance with members' net capital and reserve requirements); technology governance; cybersecurity; AML; liquidity risks; and short sales.
- **Sales Practice Risks:** In addition to the UIT and multi-class product suitability issues discussed above, FINRA also intends to focus on: cryptocurrencies and their offerings; members' use of margin loans; and securities backed lines of credit.
- **Market Integrity:** Issues to be looked at under this topic include market manipulation, best execution, Regulation SHO, fixed income data integrity, options, market access, and alternative trading system surveillance.

II. Report Cards

FINRA's Letter explains that FINRA plans to launch "several new report cards to assist firms with their compliance efforts." It will also review how members are using FINRA's Report Cards. FINRA's new report cards are:

- **The Auto Execution Manipulation Report Card.** This report card will "highlight and assist" members with identifying "instances in which a market participant uses non-*bona fide* orders to move the NBBO." (*i.e.,* the National Best Bid or Offer).
- **The Alternative Trading System Cross Manipulation Report Card.** This report card will identify possible manipulation of the NBBO to modify a security's prevailing midpoint price on an alternative trading system crossing venue.
- **The Fixed Income Mark-up Report Card.** This report card will provide firms information "including median and mean percentage mark-ups for each firm, which firms will be able to display based on certain criteria such as investment rating, product (*e.g.,* corporate or agency) and length of time to maturity." FINRA will consider adding additional products in the future.

III. New Rules

FINRA also plans to review how members are implementing the following new regulatory requirements that will become effective in 2018:

- **New FINRA Rule 2165,** relating to financial exploitation of seniors and other vulnerable adults, which becomes effective February 5, 2018;
- **Revisions to FINRA Rule 4512** that require members to ask customers for information on a "trusted contact." This rule becomes effective on February 5, 2018;
- **FinCEN's Customer Due Diligence Rule.** FINRA wants to ensure that its members are complying with the four components of due diligence by May 11, 2018;[5]

- **Revisions to FINRA Rule 2232,** which governs members' disclosure of mark-ups and mark-downs on confirmations. These revisions are effective May 14, 2018;
- **Revisions in FINRA Rule 4210** to the margin requirements for covered agency transactions, which are effective June 25, 2018; and
- **FINRA's Consolidated Registration Rules** (*i.e.,* Rules 1210-1240), which are effective October 1, 2018. These rules significantly revise member's qualification and registration requirements.

Tamara K. Salmon
Associate General Counsel

endnotes

[1] *See 2018 Regulatory and Examination Priorities Letter,* FINRA (January 8, 2016) ("FINRA's Letter"), which is available at: http://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter. As you may know, the SEC's National Examination Program, too, annually publishes the priorities for the SEC's Office of Compliance Inspections and Examination. As of the date of this memo, the NEP has not yet published its priorities. We will let you know when they do.

[2] The issues Mr. Cook mentioned in his reflection include: FINRA360, which is FINRA's comprehensive self-evaluation and organizational improvement initiative; consolidating FINRA's enforcement function into a single unit; making FINRA's Advisory Committees more transparent; new retrospective rule reviews; establishing Innovation Outreach to foster an ongoing dialogue with the securities industry to help FINRA better understand technological innovations; implementing a risk-based examination framework; enhancing the training of examiners; making more tools and information available to members to help them with their compliance efforts; and publishing an Examination Findings Report to share information with members about FINRA's examination programs.

[3] These five areas are fraud, high-risk firms and brokers, operational and financial risks, sales practice risks, and market integrity.

[4] FINRA published an Examination Findings Report on "Product Suitability" in December 2017. This Report, which summarized issues relating to suitability that FINRA's examiners found when examining members, is available on FINRA's website at: http://www.finra.org/industry/2017-report-exam-findings/product-suitability. This Report included the following:

"FINRA identified instances in which customers were advised to roll their UIT investments over early, and firms did not have appropriate supervisory mechanisms in place to identify and review the suitability of the recommendation."

"Some firms FINRA reviewed failed to adequately identify short-term UIT trading activity as an area of potential abuse by registered representatives, and did not implement adequate internal controls to identify potentially problematic UIT trading activity."

"FINRA observed situations where firms: (1) recommended a higher-fee share class without a reasonable basis to believe that the recommendation was suitable or (2) recommended a complex product without a reasonable basis to believe the product was suitable in light of the customer's risk tolerance and investment time horizon. At one firm, for example, FINRA observed that, in a sample of short-term surrender variable annuity transactions, over 50 percent of customers had a long-term investment time horizon."

[5] The four areas of due diligence are: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information.
