Alternative Investments and Complex Products
Wednesday, May 27
4:45 p.m. – 5:45 p.m.

Topics:

- Understand trends and developments with complex products and alternative investments.
- Summarize industry and regulatory perspectives from FINRA and the U.S. Securities and Exchange Commission (SEC) regarding complex products and alternative investments.
- Discuss expectations for firms in selling and supervising these products.

Speakers:

Erin Vocke *(moderator)*
Vice President and District Director
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Complex Products and Alternative Investments

FINRA Annual Conference
May 27, 2015 • Washington, DC

Financial Industry Regulatory Authority

Panelists

Moderator:

- Erin C. Vocke, Vice President and District Director, FINRA Dallas and New Orleans District Offices

Panelists:

- Donna Di Maria, Chief Executive Officer, Tessera Capital Partners, LLC
- Sara Grohl, Director, FINRA Emerging Regulatory Issues
- Brandon L. Klerk, Chief Compliance Officer, Incapital
- Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, SEC Division of Enforcement

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Agenda

- Introduction and polling questions
- Discussion of complex products and alternative investments
- SEC's Complex Financial Instruments Unit's approach to complex retail products.
- Industry and regulatory perspectives related to complex products
  - Due diligence
  - Onboarding
  - Suitability
  - Supervision
  - Training

Questions?

FINRA
Financial Industry Regulatory Authority

January 6, 2015

Introduction

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

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

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

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

Recurring Challenges

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

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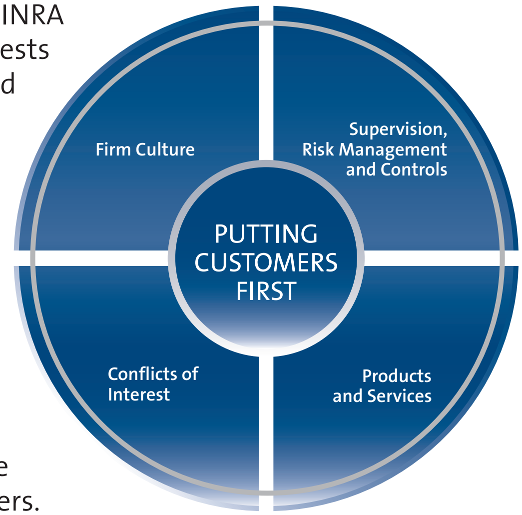

Putting customer interests first: A central failing FINRA has observed is firms not putting customers' interests first. The harm caused by this may be compounded when it involves vulnerable investors (*e.g.*, senior investors) or a major liquidity or wealth event in an investor's life (*e.g.*, an inheritance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

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

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

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

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

Areas of Focus in 2015

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

Sales Practice

Products

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

Interest Rate-Sensitive Fixed Income Securities

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

Variable Annuities

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

Alternative Mutual Funds

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

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

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

Non-Traded Real Estate Investment Trusts (REITs)

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

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

Exchange-Traded Products (ETPs) Tracking Alternatively Weighted Indices

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

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

Structured Retail Products (SRPs)

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

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

Floating-Rate Bank Loan Funds

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

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

Securities-Backed Lines of Credit (SBLOCs)

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

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

Supervision Rules

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

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

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

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

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

Excessive Trading and Concentration Controls

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

Private Placements

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

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

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

High-Risk and Recidivist Brokers

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

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

Sales Charge Discounts and Waivers

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

Senior Investors

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

Anti-Money Laundering (AML)

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

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

Municipal Advisors and Securities

Municipal Advisor Registration

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

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

Minimum Denomination Bonds

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

Financial and Operational Priorities

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

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

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

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

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

Cybersecurity

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

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

Outsourcing

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

Investor Protection Requires Timely Reporting of Disclosable Information

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

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

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

Market Integrity

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

Supervision and Governance Surrounding Trading Technology

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

Abusive Algorithms

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

Cross-Market and Cross-Product Manipulation

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

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

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

Order Routing Practices, Best Execution and Disclosure

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

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

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

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

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

Market Access

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

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

Audit Trail Integrity

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

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

Conclusion

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

Endnotes

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

2 Based on data from Morningstar.

3 *See* FINRA Rule 2210.

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

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

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

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

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

9 *See Regulatory Notice 13-45*.

10 *See Regulatory Notice 13-23*.

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

12 *See Regulatory Notice 13-31*.

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

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

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

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

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

18 MSRB Municipal Advisor Resources.

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

January 2, 2014

Each year, FINRA publishes its regulatory and examination priorities to highlight significant risks and issues that could adversely affect investors and market integrity in the coming year. These risks are primary drivers of our regulatory programs. Of course, markets and the economic environment are dynamic. As a result, FINRA updates its view on risks throughout the year, and adjusts our programs and allocation of resources to address changes in those perceived risks. We encourage firms to do so as well.

Business Conduct Priorities

The business conduct topics highlighted in this letter are broadly consistent with themes we raised in 2013. The drivers for these concerns include macro and micro economic factors, including interest rate policy; demographic trends; regulatory policy changes; and firm compensation structures and new product development trends.

Suitability

FINRA remains concerned about the suitability of recommendations to retail investors for complex products whose risk-return profiles, including their sensitivity to interest rate changes, underlying product or index volatility, fee structures or complexity may be challenging for investors to understand. These concerns are magnified when there is a strong incentive for the firm or registered representative to recommend the product because of its fee or compensation structure. Firms are urged to review *Regulatory Notice 13-31* for practices that may enhance the effectiveness of their suitability determinations.

In some cases, the challenge of understanding products may be exacerbated by disclosure practices that are ineffective. Given the proliferation of complex products recommended to retail investors, we intend to focus our examinations on the manner in which firms disclose material risks to investors and the policies and procedures surrounding those disclosures. FINRA urges firms to evaluate how to make disclosure more effective for retail investors through, at least, including a balanced discussion of the risks and potentially negative scenarios that might result in customer losses.

In the current investment environment, there are potential downside risks to interest rate sensitive fixed income products, and a possible adverse impact to equities markets, that could arise from an unanticipated, rapid or uncontrolled shift in the interest rate environment precipitated by changes in monetary policy. These risks raise suitability concerns. In 2014, our examiners will focus on concentrations in longer duration instruments, including bond funds with longer average durations, and high yield securities recommended to retail investors, especially if those investors have near-term liquidity needs or have a conservative or defensive investment profile. FINRA examiners will also focus on concentrations in speculative equities positions in retail accounts (see microcap discussion later in this document). Examinations will include a review of the training given to retail-facing brokers to determine whether they understand the products they recommend so they can have proactive conversations about product-specific risks with their customers.

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In discussing concerns about suitability, FINRA highlights a number of products due to heightened investor protection concerns. While we view these products as presenting specific types of risks, we are not providing investment advice and recognize that in some cases they may be part of a larger, well-constructed portfolio. Moreover, the fact that a particular product is not mentioned does not suggest that it is without risk or suitability and disclosure concerns. While this is not an exhaustive list, we intend to focus on the marketing, sale and suitability of:

- **Complex Structured Products—**These products represent a risk to retail investors who do not fully understand the credit risk exposure they are taking (*i.e.,* these are unsecured investments), the illiquidity of those investments, the derivative features that may be embedded in some products, and the uncertainty around the valuation of these products and their associated cash flows. The use of leverage in some products can potentially exacerbate exposure to loss and index tracking error; such is the case with leveraged exchange traded funds (ETF).
- **Private Real Estate Investment Trusts (REITs)—**These products do not trade on a national securities exchange and are generally illiquid—meaning that the early redemption of shares is often very limited. Fees associated with the sale of non-traded REITs can be high and erode total return. The periodic distributions that help make these products so appealing to income-seeking investors can, in some cases, be heavily subsidized by borrowed funds and include a return of investor principal. The valuation of non-traded REITs is complex, which also makes understanding the performance of the product difficult.
- **Frontier Funds—**These funds invest in what some fund managers believe to be the next emerging markets. Heightened risks associated with investing in foreign or emerging markets generally are magnified in frontier markets. Many frontier markets operate in politically unstable regions of the world and are subject to potentially serious geopolitical risks. In many cases, these markets have relatively few companies and investment opportunities, and the local securities market may not be fully developed. This could mean less liquidity and lower investor protection standards.
- **Interest Rate Sensitive Securities—**If interest rates rise, a wide range of interest rate sensitive securities could lose a substantial portion of their value, and have potentially significant knock-on effects. FINRA examiners will especially focus on accounts with concentrations in interest rate sensitive securities and the disclosures or omissions of material facts when these products are recommended. These include, for example:
  - **Mortgage-Backed Securities—**Significant upward pressure on long-term interest rates typically results in a significant decrease in the number of individual mortgage holders who exercise the prepayment option. This impacts the securities that these mortgages are bundled into, in that it extends the life of the average mortgage within the pool, at a rate that investors will find unattractive, putting downward pressure on price. Since these instruments are highly sensitive to rising interest rates, even small rate movements can have significant implications from a market value perspective, regardless of the credit quality of the underlying instrument. Investors with shorter term liquidity needs, or an inability to hold the instruments to maturity may experience unanticipated losses.
  - **Long Duration Bond Funds—**If long-term rates rise, significant bond fund redemptions may force fund managers to sell underlying bonds at less than advantageous rates. Given a potential lack of bid for longer duration instruments, fund managers may be forced to sell relatively lower duration instruments within their portfolio thereby increasing the weighted average duration of the overall portfolio and exacerbating downward pricing pressure.
  - **Long Duration Bond ETFs—**ETF bond funds are subject to the same pressures as bond mutual funds, albeit at a greater velocity. In addition, it is unclear what role authorized participants[1] will play in terms of retiring creation units if increasing velocity in redemptions impacts bid-ask balance or misaligns net asset value.

- **Long Duration Corporates (particularly zero coupon or bullet bonds[2])—**Regardless of credit quality, longer duration fixed income instruments could potentially suffer market losses associated with a rapid, uncontrolled increase in interest rates.
- **Emerging Market Debt—**Significant upward pressure on domestic interest rates and a corresponding widening of credit spreads could negatively impact the market price of emerging debt markets.
- **Municipal Securities—**Well-known examples of municipalities in significant financial distress including Detroit, Puerto Rico and others highlight instances where investors may face real harm from both a credit and market risk perspective. While many municipal bonds remain strong investments, the additional funding costs associated with a potentially rising interest rate environment pose a broader risk to the market. When long-term interest rates increase, municipalities may be forced to roll over retiring debt at higher rates. These incremental factors could exacerbate financial distress in municipalities already straining under the burden of falling tax receipts. Most at risk would be those issuers with significant debt maturing in the near- to mid-term, unrated issuers, and those with less capital and liquidity to absorb the additional expense.
- **Baby Bonds—**Although the market is in its infancy, FINRA is concerned that retail investors may not understand the liquidity risks they assume when gaining exposure to business development companies (BDCs) through baby bonds.[3] The secondary market for these instruments is thin and investors forced to sell prior to maturity may be harmed.

Focus on Recidivist Brokers

A small number of brokers have a pattern of complaints or disclosures for sales practice abuses and could harm investors as well as the reputation of the securities industry and financial markets. Early last year, FINRA launched the High Risk Broker initiative to identify such individuals and expedite investigations. In 2014, FINRA will expand the High Risk Broker program and create a dedicated Enforcement team to prosecute such cases. When FINRA examines a firm that hires these high risk brokers, examiners will review the firm's due diligence conducted in the hiring process, review for the adequacy of supervision of higher risk brokers—including whether the brokers have been placed under heightened supervision—based on the patterns of past conduct, and examiners will place particular focus on these brokers' clients' accounts in conducting reviews of sales practices.

In addition, FINRA is concerned about the potential risks posed by brokers who formerly worked at one or more firms that have been severely disciplined by FINRA, and who may bring unethical or illegal practices to a firm. Using sophisticated analytics—known as the Broker Migration Model—FINRA identifies and monitors both brokers who move from a firm that has been expelled or otherwise has a serious disciplinary history to another FINRA-regulated firm, and the firms that hire such individuals. FINRA uses the model's risk scoring, among other means, to prioritize surveillance and to conduct focused or accelerated examinations and enforcement efforts.

Conflicts of Interest

In October, FINRA published its *Report on Conflicts of Interest*. The report highlights effective conflicts management practices and not necessarily regulatory requirements. In this regard, FINRA examiners will evaluate firms' conflicts management practices to help further inform our view on industry practices by focusing primarily on actions taken by firms and the impact on their clients. Examiners will explore topics addressed in the report including firms' approaches to identifying and managing conflicts as well as the participation of senior management in this process. Reviews will include firms' approaches to conducting new product reviews to identify and mitigate potential conflicts those products raise. They may also inquire about post-launch reviews to assess product performance. FINRA will also assess whether wealth management businesses make independent decisions about the products they offer without pressure to favor proprietary products or products for which the firm has revenue-sharing agreements. Firms' compensation structures and the mechanisms firms use to mitigate the conflicts those structures may create, for example, through supervision around compensation thresholds, will be a common focus during a conflicts review.

Cybersecurity

Cybersecurity remains a priority for FINRA in 2014 given the ongoing cybersecurity issues reported across the financial services industry. In recent years, many of the nation's largest financial institutions were targeted for disruptions through a range of different types of attacks. The frequency and sophistication of these attacks appears to be increasing. In light of this ongoing threat, FINRA continues to be concerned about the integrity of firms' infrastructure and the safety and security of sensitive customer data. Our primary focus is the integrity of firms' policies, procedures and controls to protect sensitive customer data. FINRA's evaluation of such controls may take the form of examinations and targeted investigations.

Qualified Plan Rollovers

Employees who retire or change jobs generally must make a decision regarding their accumulated savings and earnings in their employee-sponsored defined contribution plan (*e.g.*, a 401(k) plan). This is a moment of heightened importance and vulnerability as investors are making a financial decision regarding decades of savings that may be needed for retirement income for many years. Frequently these investors roll over their retirement savings into Individual Retirement Accounts (IRAs). According to an *Investment Company Institute study*, from 1996 to 2008, more than 90 percent of funds flowing into traditional IRAs came from retirement plan rollovers. In a report released last year, *401(k) Plans: Labor and IRS could improve the Rollover Process for Participants*, the U.S. Government Accountability Office (GAO) noted that the financial industry generally encourages employees to roll over their assets into IRAs without fully explaining the options that are available to these investors or making a valid determination that a rollover into an IRA is in the investor's best interest.

FINRA shares the GAO's concerns that investors may be misled about the benefits of rolling over assets from a 401(k) plan to an IRA. In *Regulatory Notice 13-23*, FINRA warned firms and associated persons not to make claims of "free IRAs" or "no-fee IRAs" where investors do pay costs associated with these accounts. In 2014, reviewing firm rollover practices will be an examination priority, and staff will examine firms' marketing materials and supervision in this area. FINRA will also evaluate securities recommendations made in rollover scenarios to determine whether they comply with suitability standards in FINRA Rule 2111.

Firms are urged to review *Regulatory Notice 13-45* regarding their responsibilities concerning IRA rollovers.

Initial Public Offering Market

After a long period of relative dormancy, the market for initial public offerings (IPOs) has increased recently. For firms that are entering the underwriting business or significantly expanding their activities in this area, it is important that firms adopt practices and controls to comply with all relevant rules and regulations for this activity. In May 2011, FINRA adopted Rule 5131 which, among other things, prohibits *quid pro quo* allocations and "spinning,"[4] and addresses the conduct of firms and associated persons in the areas of book-building, new issue pricing, penalty bids, trading and waivers of lock-up agreements. FINRA developed the rule to address past abuses seen in new issue distributions. Also, as with any hot economic sector, there is risk that bad actors will be drawn to the IPO market as has happened in the past.

For firms engaged in the public underwriting business, FINRA will review the firm's due diligence activities, monitor the completeness and accuracy of firms' filings regarding public underwritings with FINRA's Corporate Finance Department, and review compliance with rules concerning the sales and allocations of IPO securities, including whether firms are incenting associated persons to sell cold offerings to obtain client allocations of hot offerings.

General Solicitation and Advertising of Private Placements

FINRA has long been concerned about abuses in the sale and marketing of private placement securities and we regularly have identified this issue as an examination priority. Amendments to *Rule 506 of Regulation D*, which became effective September 23, 2013, permit general solicitation and advertising when offering private placements, provided that all purchasers of the offering are accredited investors. These amendments, prompted by the Jumpstart our Business Startups (JOBS) Act, are intended to facilitate capital formation and employment growth. General solicitation, which before the amendments had been permitted only in connection with public offerings registered with the SEC under the Securities Act of 1933, provides new challenges for firms to ensure advertisements and other marketing materials are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about securities acquired in a private placement.

Due Diligence and Suitability of Private Placements

FINRA will examine firms' private placement activity to ascertain whether firms are taking reasonable steps to validate that investors meet accredited investor standards. Also, the recent Regulation D amendments do not diminish a firm's responsibility to conduct adequate due diligence on its offerings to ensure any recommendations to purchase securities in a private placement are suitable.[5]

Offerings of Securities through Private Placements

FINRA Rules 5123 and 5122 require firms that participate in certain private placements to file information with FINRA through the Firm Gateway, including a copy of any offering documents used, within 15 days of first sale.[6] The rules generally apply to firms that sell to individual investors, while exempting those that sell only to institutions or that sell private placements that pose less risk due to the type of security (*e.g.*, offerings of investment grade debt securities). FINRA uses this information to enhance our risk-based supervision of private placement activities and to better identify and assess high-risk offerings. FINRA will verify that firms are making timely and accurate filings pursuant to these rules.

FINRA has found that a significant number of private placement filings made under Rule 5122, which applies to self-offerings by firms, and Rule 5123 are problematic. These filings have indicated that broker-dealers may not be performing their reasonable inquiry responsibilities as described in *Regulatory Notice 10-22*. Examples of specific problems uncovered during our reviews and subsequent investigations concern, for example: 1) contingency offerings with deficient escrow procedures; 2) private placements in which the issuer is in distressed financial condition or in default on its outstanding liabilities; and 3) raising proceeds in serial private placements to repay previous investors.

Anti-Money Laundering (AML)

In 2014, FINRA will focus on AML issues associated with institutional business. An emerging trend is the utilization of executing broker-dealers by certain DVP/RVP (Delivery versus Payment/ Receipt versus Payment) customers to liquidate large volumes of low-priced securities. Due to the nature of the DVP/RVP customer relationship with the executing broker, the source of the low-priced securities is often masked unless the executing broker makes reasonable inquiry. Depending on the volume of shares and specific securities liquidated as well as the customer engaging in the activity, this business can raise red flags for AML- and Section 5 of the Securities Act of 1933-related concerns. Executing brokers should consider this type of activity when establishing and implementing a program to detect and report suspicious activity.

We have also noted a misconception among some executing brokers that Customer Identification Program (CIP) requirements do not apply to DVP/RVP customers (who are not otherwise exempt[7]) or that the prime broker is responsible for CIP on those customers. DVP/RVP customers meet the definition of an "account" for CIP purposes,[8] and, absent a formal reliance agreement with the prime broker, the executing broker is responsible for implementing CIP for these customers. Depending on the nature of the account and the risks associated with it, firms may conduct additional due diligence on this type of account and obtain information on the individuals with authority or control over the account.[9] It is important that all firms, regardless of business model, develop a risk-based AML program designed to address the risk of money laundering specific to their firm. Firms that have high-risk customer bases should tailor their programs around the specific risks of those customers, including the types of customers, where its customers are located and the types of services they offer to those customers.

Municipal Advisors

In September 2013, the U.S. Securities and Exchange Commission (SEC) issued final rules regarding municipal advisors, including definitions of what constitutes municipal advisory activity requiring registration with the SEC.[10] The SEC also designated FINRA as the examination and enforcement authority for municipal advisors that are regulated by FINRA. The final rules become effective January 13, 2014. Accordingly, municipal advisory activity will be an area of focus in sales practice examinations in 2014.

Crowdfunding Portals

The JOBS Act became law in 2012. Among other things, the Act will allow retail investors to purchase unregistered securities offered through crowdfunding websites;[11] however, to maintain investor protections, the Act limits the amount they can invest in a 12-month period based on their income and net worth.[12] The SEC and FINRA proposed rules on October 23, 2013, and comments are due by February 3, 2014.[13] The objective of FINRA's proposed rules is to ensure that the capital-raising objectives of the JOBS Act are advanced in a manner consistent with investor protection. Pending adoption of the SEC's proposed rules, no JOBS Act crowdfunding is lawful.

Under the Act, a private company raising capital under the crowdfunding exemption will be required to use an intermediary that is either a registered broker-dealer or a newly-created category of intermediary, a funding portal, which must register with the SEC and FINRA. If the intermediary is a funding portal, its activities will be more limited than those permitted for broker-dealers. For example, a funding portal may not: solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; compensate promoters, finders or lead generators for providing information on individual investors; hold, manage or accept customers' funds or securities; or offer investment advice or recommendations.

FINRA proposed rules to streamline the registration and oversight of funding portals to reflect the limited scope of activity permitted by funding portals. The proposed rules address a number of topics, including the membership application process, fraud and manipulation, just and equitable principles of trade and more generally establishes requirements that funding portals be capable of complying with the JOBS Act, SEC and FINRA rules. The rules also contain provisions to ensure that bad actors do not enter the system. As the rules become effective, and funding portals become FINRA members, we will implement a regulatory program designed to protect investors while recognizing the distinctions between funding portals and broker-dealers.

Senior Investors

There are a large number of American investors who are approaching retirement and who control a substantial portion of investable assets. In 2014, FINRA examiners will continue to focus on how firms engage with these senior investors, especially with respect to suitability determinations as well as disclosures and communications. FINRA will also examine firms' policies and procedures to identify and address situations where issues of diminished capacity may be present.

The focus on senior investors builds on work we began in 2013. Last year, in a cooperative effort, the SEC and FINRA initiated an assessment of firms' policies and practices with respect to their senior investor client base. The assessment focused on suitability, disclosures, misrepresentation, advertising, pricing, compensation and supervision as they relate to products and services recommended, sold and provided to senior investors. In addition, the assessment reviewed firm's written supervisory procedures to determine whether firms have in place adequate controls to identify potential financial abuse of senior investors or individuals with diminished mental capacity. In our reviews, we have found, among other things, that age plays a role in many firms' supervisory processes. For example, some firms required their registered representatives to ascertain their customers' retirement status, their future prospects for employment, their healthcare needs and whether there was a durable power of attorney. Separately, we found that multiple firms have established product-specific suitability guidelines for senior investors purchasing products such as variable annuities, equity-indexed annuities, REITs and other high-yield alternative products. Upon completion of the review, we may issue a report with observations of firms' practices.

Of course, FINRA shifts its focus to enforcement options when it detects financial abuse, including abuse involving senior investors. Recently, FINRA barred two brokers from the securities industry for wrongfully converting approximately $300,000 from an elderly widow with diminished mental capacity, and for failing to fully cooperate with FINRA's investigation.[14]

Fraud Priorities

Microcap Fraud

Speculative microcap and low-priced over-the-counter (OTC) securities are an area of significant ongoing concern for FINRA. As FINRA noted in last year's letter, firms should review their policies and procedures to ensure that activities at the firm related to microcap and low-priced OTC securities are compliant with FINRA rules and federal securities laws. Examples of such policies and procedures remain consistent from year to year. Firms should perform heightened supervision of employees who maintain direct or indirect outside business activities associated with microcap and OTC companies, traders involved in trading microcap and low-priced OTC securities, and firm activities where an affiliate of the firm is the transfer agent for the microcap or low-priced OTC securities. In addition, firms should ensure that any research for microcap and low-priced OTC companies the firm produces is accurate and balanced, and appropriately discloses risks to investors. Firms should also monitor customer accounts liquidating microcap and low-priced OTC securities to ensure, among other things, that the firm is not facilitating, enabling or participating in an unregistered distribution. It is important for firms to implement AML responsibilities that require firms to monitor for suspicious activity and file Suspicious Activity Reports where warranted. Finally, firms should monitor broker solicitations of customers to trade microcap and low-priced OTC securities to ensure that any recommendations are balanced and the securities are suitable for the relevant customers.

Insider Trading

Insider trading continues to be a top regulatory priority for FINRA, the SEC and federal criminal law enforcement. In this area too, FINRA underscores the points made in last year's letter. Firms must be vigilant in safeguarding material, non-public information, and should periodically assess information barriers and risk controls to ensure they are adequate. There are a number of examples of such risk controls. For example, firms should routinely review electronic communications of personnel within business units that may come into possession of material, non-public information during the normal course of business, such as investment banking and research departments. Firms should also maintain appropriate information-barrier policies and procedures designed to limit or restrict the flow of material, non-public information within the firm to employees on a "need-to-know" basis. FINRA would expect firms to monitor employee trading activity both inside and outside the firm to identify suspicious activity and to conduct regular reviews of proprietary and customer trading in securities that are placed on a watch/restricted list. In addition, firms should conduct employee training with respect to the use and handling of material, non-public information.

Financial and Operational Priorities

Funding and Liquidity Risk

FINRA will remain focused on funding and liquidity risk in 2014. Over the past few years, we have incorporated reviews for this into our examinations and found widely varying practices in the way firms monitor and control their liquidity risk. We will undertake a more structured review of this area so that we can compare strengths and weaknesses across firms and identify effective practices.

In our 2014 examinations, we will ask many of our larger firms to perform a liquidity stress test that incorporates factors FINRA believes are important to understanding the resiliency of their liquidity position. The framework for this test will require stressing four basic areas of a firm's business: 1) stressed funding of proprietary positions (loss of counterparties, loss of funding for less liquid assets, widening of haircuts); 2) stressing of repo book (loss of counterparties, loss of internally generated liquidity, widening of haircuts); 3) stressing settlement payments and clearing deposits with clearing banks, central counterparties (CCPs) and clearing organizations; and 4) funding loss of customer balances or increases in obligations to lend to customers. We will look to see whether firms have incorporated these items into their framework and whether a funding gap exists that has not been adequately addressed within a firm's contingent funding plan.

FINRA is also concerned about the heightened potential for collateral squeezes and the adverse impact these may have on firms' ability to fund their operations. The increased use of CCPs and cleared swaps is boosting demand for high-quality collateral. Meeting this demand may prove challenging and may raise the cost of some traditional channels for obtaining such collateral, *e.g.*, through collateral upgrade trades.

In addition, FINRA expects firms to maintain adequate liquid capital cushions to weather counterparty credit risk exposures in the event that a material counterparty experiences financial distress or a liquidity squeeze driven by a shifting interest rate environment. FINRA will evaluate the rigor of firms' counterparty credit risk management programs.

Risk Control Documentation and Assessment

A recent amendment to Rule 17a-3 of the Securities Exchange Act of 1934 will require firms that hold more than $1 million in aggregate customer credits or $20 million in capital, including subordinated debt, to document their credit, market and liquidity risk management controls. This is the first time larger broker-dealers will be required to document their risk controls. FINRA will examine these risk controls in 2014 to understand whether such documentation is both reflective of the controls in place and whether they are reasonably designed to mitigate credit, market and liquidity risks. We will perform tests to determine whether the documented controls for these and other risks are in place and functioning as designed.

Accuracy of Firm's Financial Statements and Net Capital

Broker-dealers must be in a position to prepare accurate financial statements throughout the year, not just on their fiscal year-end date. Firms should review the manner in which they maintain their books and records, and ensure that the firm has the proper expertise (employee(s) or on- or off-site financial and operations principals) to maintain books and records that are accurate and prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Further, firms must ensure that they properly compute net capital and that the firm is aware of the interpretations to the Net Capital Rule which are applicable to their business model. Areas of continued concern include: (1) failure to apply Open Contractual Commitment Charges, haircuts, undue concentration or blockage charges; (2) failure to comply with the Net Capital Rule at all times and as a related item, failure to cease operations when a firm is under capital until the net capital deficiency is cured; (3) failure to prepare books and records on an accrual basis, or only making proper accruals at the end of a broker-dealer's fiscal year; and (4) netting transactions in the absence of authoritative accounting guidance which permits such netting.

Auditor Independence

FINRA has observed, and in a recent report the Public Company Accounting Oversight Board (PCAOB) has noted, a lack of independence by auditors of small broker-dealers. Broker-dealers may refer to the SEC's ***website*** for information on how the SEC defines auditor independence.

Market Regulation Priorities

Algorithmic Trading and Trading Systems

In recent years, there have been a number of algorithmic trading malfunctions that caused substantial market disruptions. These malfunctions raise concern about firms' ability to develop, implement and effectively supervise these systems. FINRA reiterates a number of comments from last year's letter that apply with equal relevance in 2014. FINRA will continue to assess whether firms' testing and controls related to high-frequency trading (HFT) and other algorithmic trading strategies and trading systems are adequate in light of the Market Access Rule and firms' other supervisory obligations. This assessment may take the form of examinations and targeted investigations.

Firms subject to review should be prepared to address whether they conduct separate, independent and robust pre-implementation testing of algorithms and trading systems and whether the firm's legal, compliance and operations staff are reviewing the design and development of the firm's algorithms and trading systems for compliance with legal requirements. FINRA staff will want to understand whether a firm actively monitors and surveils algorithms and trading systems once they are placed into production or after they have been changed, including procedures and controls to detect potential trading abuses such as wash sales, marking, layering and momentum ignition strategies, among others. Finally, firms should expect to explain their approach to firm-wide disconnect or "kill" switches, as well as procedures for responding to catastrophic system malfunctions.

High Frequency and Other Algorithmic Trading Abuses

The use of HFT strategies has grown substantially over the past years and drives a significant portion of activity on the U.S. markets. Although many HFT strategies are legitimate, some are not and may be used for manipulative purposes. Given the scale of the potential impact these practices may have, the surveillance of abusive algorithms remains a high priority for FINRA. FINRA reminds firms using HFT strategies and other trading algorithms of their obligation to be vigilant when testing these strategies pre- and post-launch to ensure that the strategies do not result in abusive trading. The following are more specific areas of concern that FINRA will continue to pursue in 2014.

FINRA continues to be concerned about the use of so-called "momentum ignition strategies" where a market participant attempts to induce others to trade at artificially high or low prices. Examples of this activity include layering and spoofing strategies where a market participant places a *non-bona fide* order on one side of the market (typically, but not always, above the offer or below the bid) in an attempt to bait other market participants to react to the *non-bona fide* order and trade with another order on the other side of the market. FINRA continues to observe variations of these strategies in terms of the number, price and size of the *non-bona fide* orders, including the use of wash sales as a component of the strategy, but the essential purpose behind these strategies remains the same, to bait others to trade at higher or lower prices.

Other examples of problematic HFT or algorithmic activity include momentum ignition and spoofing strategies related to the open or close of regular market hours that involve distorting disseminated market imbalance indicators through the entry of *non-bona fide* orders and/or aggressive trading activity near the open or close.

As in 2013, FINRA also will continue to focus on the entry of problematic HFT and algorithmic activity through sponsored participants who initiate their activity from outside of the United States. In this regard, FINRA reminds firms of their surveillance and control obligations under the SEC's Market Access Rule and *Notice to Members 04-66*, as well as potential issues related to treating such accounts as customer accounts, anti-money laundering and margin levels, as highlighted in *Regulatory Notice 10-18* and the SEC's Office of Compliance Inspections and Examination's National Exam Risk Alert dated September 29, 2011. FINRA also reminds firms of their obligations to perform appropriate due diligence when taking on new sponsored access customers, particularly those that previously accessed the markets through firms that have been the subject of regulatory action for Market Access Rule violations relating to manipulative trading schemes, so as to prevent the firm's facilitation of the entry of manipulative trading activity from such accounts to the marketplace.

FINRA's options program will continue to focus on cross-market, cross-product manipulation. Specifically, we will continue to focus on attempts to manipulate the price of underlying equities, typically through abusive trading algorithms, to either close out pre-existing options positions at favorable prices or establish new positions at advantageous prices.

Audit Trail Integrity

FINRA has observed significant, prolonged and wide-scale Large Options Positions Reporting (LOPR) deficiencies with some firms. FINRA will continue to pursue these cases and recommends that firms review their systems to make sure that they are filing accurate and complete LOPR reports. FINRA will work with the options exchanges to provide additional LOPR guidance in the Frequently Asked Questions that appear on The Options Clearing Corporation (OCC) website. In 2014, we anticipate focusing on in-concert reporting deficiencies, improper position deletions, non-reporting of positions, and the process that firms use to internally determine whether an over-the-counter position qualifies as a reportable options position.

Similar to LOPR Reports, FINRA has seen significant, prolonged and wide-spread deficiencies by some firms in properly marking the capacity of their options orders. Improper capacity codes compromise the audit trail and FINRA's and the options exchanges' reviews for trading ahead, best execution and proper execution priority. Firms should assess their supervisory controls from the front-end trading to the back-end clearance processes, factoring in client activity and any firms involved downstream during the life of an order.

Best Execution of Equities, Options and Fixed Income Securities

FINRA introduced new surveillance patterns to monitor best execution in equities and fixed income securities. For equities, FINRA introduced a surveillance scenario that more closely evaluates the execution prices market participants obtain for customers on exchange markets. FINRA will focus more closely on firms' practices to ensure compliance with their best execution obligations with respect to limit orders in equity securities. We are also introducing a new fixed income surveillance pattern to more closely assess the execution price a customer receives from a firm relative to other recently executed customer transactions on the same side of the market by the firm. With respect to options, we will review situations where a firm potentially ignores a favorable price on one options market and executes a trade on another market to the detriment of their customer. FINRA also reiterates that firms have a duty to conduct a regular and rigorous review of execution quality to assure that order flow is directed to markets providing the most beneficial terms for customers.

Conclusion

This letter addresses topics that FINRA has identified as concerns given the current environment. We encourage firms to use the information in this letter—and, of course, their own analysis to identify risk exposures in their business—to enhance their supervisory, compliance and risk management programs to protect investors and the integrity of the markets. As always, you may contact your firm's Regulatory Coordinator with specific questions or comments. In addition, if you have general comments regarding this letter or suggestions on how we can improve it, please send them to Daniel M. Sibears, Executive Vice President, at *dan.sibears@finra.org*.

Endnotes

1. An "authorized participant" is an entity, typically a large financial institution that purchases the shares underlying an ETF. After purchasing the shares, the authorized participant transfers the underlying shares to the fund in return for ETF shares.
2. A bullet bond is an instrument in which the entire principal value is paid at the maturity of the bond.
3. BDCs are closed-end investment companies that are operated to make investments in small and emerging businesses and financially troubled businesses. The term "baby bonds" refers to bonds issued in small denominations.
4. "Spinning" refers to the practice in which an underwriter allocates "hot" IPO shares to directors and/or executives of potential investment banking clients in exchange for investment banking business.
5. *See* *Regulatory Notice 10-22*, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, April 2010.
6. FINRA Rule 5122 (Private Placements of Securities Issued by Members), which preceded Rule 5123 (Private Placements of Securities), contains similar filing requirements for Member Private Offerings.
7. *See* 31 CFR 1023.100(a)(2) and (d)(2).
8. *See* 31 CFR 1023.100(a).
9. *See* 31 CFR 1023.220(a)(2)(ii)(C).
10. *SEC Release 34-70462*
11. The Act creates a new safe harbor from registration for the sale of crowdfunded securities, provided the transactions meet a number of conditions.
12. For investors with an annual income and net worth of less than $100,000, the maximum annual investment in securities issued under the crowdfunding exemption over a 12-month period is capped at the greater of $2,000 or 5 percent of the investor's annual income or net worth. For investors with an annual income and net worth of greater than $100,000 the maximum annual investment is 10 percent of the annual income or net worth, whichever is greater, not to exceed $100,000.
13. *See* *Regulatory Notice 13-34*, FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms, October, 2013 and *http://www.sec.gov/rules/proposed/2013/33-9470*.
14. *See* Jimmy E. Caballero, FINRA Letter of Acceptance, Waiver and Consent, No. 20130372958 (December 2, 2013); and Fernando Arevalo, FINRA Letter of Acceptance, Waiver and Consent, No. 20130375318 (November 29, 2013).

Regulatory Notice 12-03

Complex Products

Heightened Supervision of Complex Products

Executive Summary

This *Notice* provides guidance to firms about the supervision of complex products, which may include a security or investment strategy with novel, complicated or intricate derivative-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities. These features may make it difficult for a retail investor to understand the essential characteristics of the product and its risks.

The *Notice* identifies characteristics that may render a product "complex" for purposes of determining whether the product should be subject to heightened supervisory and compliance procedures and provides examples of heightened procedures that may be appropriate.

Questions concerning this *Notice* should be directed to Tom Selman, Executive Vice President, Regulatory Policy, at (202) 728-6977.

Background

FINRA often has reminded firms of their obligation to assess the potential risks associated with products that raise specific investor protection concerns. In 2003, FINRA issued two *Notices* addressing the sale of hedge funds and non-conventional instruments to retail investors.[1] In 2005, FINRA issued *Notice to Members 05-26* (NASD Recommends Best Practices for Reviewing New Products), which recommends best practices for reviewing new products and describes some of the processes that firms use to assess products proposed for sale. Similarly, FINRA has issued *Notices* about equity-indexed annuities,[2] structured products,[3] leveraged and inverse exchange-traded funds,[4] principal protected notes,[5] reverse convertibles[6] and commodity futures-linked securities.[7] These *Notices* discuss the risks raised by each of these products, including the possibility that the product will not perform as many investors anticipate, or that it might be inappropriately sold on the basis of enhanced yield, principal protection or the tracking of an index or a reference asset. The *Notices* advise firms to adopt procedures for vetting the products and supervising the sale and marketing of the products to retail investors.

January 2012

Notice Type
- Guidance

Suggested Routing
- Advertising
- Compliance
- Legal
- Senior Management

Key Topics
- Complex Products
- Due Diligence
- Suitability
- Supervision
- Training

Referenced Rules and Notices
- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2111
- FINRA Rule 2360
- NASD Rule 2310
- NTM 03-07
- NTM 03-71
- NTM 05-26
- NTM 05-50
- NTM 05-59
- Regulatory Notice 09-31
- Regulatory Notice 09-73
- Regulatory Notice 10-09
- Regulatory Notice 10-22
- Regulatory Notice 10-51

FINRA
Financial Industry Regulatory Authority

A consistent theme in these *Notices* is that the complexity of a product often necessitates more scrutiny and supervision by a firm. For example, *Notice to Members 05-26* encourages firms to consider, during the vetting process, the complexity of a new product, whether the complexity would impair investor understanding of the product, and how complexity would affect the marketing and sale of the product. The *Notice* also encourages firms to consider whether less complex products could achieve the same objectives for investors. The *Notice* states that post-approval follow-up and review may be particularly important for complex products.[8] FINRA also has brought a number of enforcement actions involving complex products charging inadequate supervision, unsuitable recommendations and misleading sales practices.[9]

In 2010, FINRA issued *Regulatory Notice 10-22*, which discusses the obligations of broker-dealers that sell Regulation D offerings. The *Notice* reminds firms that FINRA's suitability rule requires that a broker-dealer conduct a reasonable investigation concerning any security that the broker-dealer recommends.[10] The *Notice* also explains that a broker-dealer has a duty to conduct a reasonable investigation about the security and the issuer's representations about it. The duty stems from the broker-dealer's "special relationship" to the customer, and from the fact that in recommending the security, the broker-dealer represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[11] Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.

The Securities and Exchange Commission (SEC) also has expressed concern about complex products[12] and has devoted more resources to the issues presented by complex products.[13] In recent years, the SEC has brought a number of enforcement cases involving complex products, addressing conduct such as the misrepresentation of complex investments as appropriate for retail investors seeking safe investments, fraud in collateralized debt obligation marketing materials, and misrepresentations about the extent to which an investment exposes the owner to the subprime real estate market.[14]

European and Asian regulators also have issued policy statements about the sale of complex products by financial firms within their jurisdictions. For example, the Danish Financial Supervisory Authority requires that all investment products sold to Danish retail investors carry one of three labels (green, yellow or red) indicating the risk of losing the initial investment amount and the difficulty in understanding that product.[15] The French Autorité des marchés financiers (AMF) has reminded firms of their marketing and disclosure obligations to investors when dealing with complex products and has established criteria to identify highly complex products.[16] The Financial Services Authority in the United Kingdom (FSA) recently published its new regulatory approach to product intervention, stating that it will place heightened focus on the design, development and management of products.[17] In addition, the FSA published for comment guidance to product providers regarding the sale of structured products.[18] The Financial Services and Markets Authority in Belgium has temporarily banned on a "voluntary" basis the distribution of any new "unnecessarily complex structured products" to retail investors.[19] The Securities and Futures Commission (SFC) in Hong Kong has adopted a package of measures to strengthen the regulatory regime governing the sale of unlisted structured products and other investments. The regime requires, for example, the issuance of "key fact statements" that summarize the essential features and risks of investment products and a "cooling off" or "unwind" period for investors in certain unlisted structured products.[20]

Discussion

The fact that a product is "complex" indicates that it presents an additional risk to retail investors because its complexity adds a further dimension to the investment decision process beyond the fundamentals of market forces. This may be the case even though the complexity of some products may arise from features that seek to reduce the probability of investment losses in particular situations. Regulators have expressed concern about complex products because the intricacy of these products can impair the ability of registered representatives or their customers to understand how the product will perform in a variety of time periods and market environments, and can lead to inappropriate recommendations and sales.

Although this *Notice* provides guidance about the characteristics of many complex products, it does not define a "complex product" or provide an exhaustive list of features that might render a product "complex." Moreover, some relatively simple products may also present significant risks to investors that warrant heightened scrutiny or supervision. Each firm is responsible for determining which products require enhanced compliance and supervisory procedures.

A. Characteristics of Complex Products

Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return.

Examples of complex products include the following:

- Asset-backed securities that are secured by a pool of collateral such as mortgages, payments from consumer credit cards or future royalty payments on popular music, may be difficult for retail investors to understand. With these securities, the creditworthiness of the underlying borrowers or the existence of prepayment risks, though critical to the evaluation of the product, may not be readily apparent to retail investors. Similarly, unlisted REITs may present liquidity and valuation issues for a retail investor.[21]

- Products that include an embedded derivative component that may be difficult to understand, such as those:
  - in which repayment of principal or payment of yield depends upon a reference asset, when information about the performance of the reference asset is not readily available to investors. An example is structured notes with an embedded derivative for which the reference asset is a constant maturity swap rate.
  - that provide for different stated returns throughout the lifetime of the product. For example, “steepener” notes typically offer a relatively high teaser coupon rate for the first year, after which they offer variable rates determined by the steepness of a yield curve. Similarly, some firms have offered structured notes with payoffs contingent on whether one or more reference asset performs within a certain range.
  - under which the investor might incur a capital loss as a result of the fall in the value of the reference asset without being able to participate in an increase in its value. So-called “reverse convertible notes” may fall into this category.
  - in which a change in the performance of the reference asset can have a disproportionate impact on the repayment of capital or on the payment of return. For example, “knock in” or “knock out” features associated with reverse convertible notes, in which a drop in the value of the reference asset to a pre-defined level, can affect determination of an investor’s gains or losses.
- Products with contingencies in gains or losses, particularly those that depend upon multiple mechanisms, such as the simultaneous occurrence of several conditions across different asset classes. An example is range accrual notes for which the return of principal can depend upon the value of two or more reference assets on certain pre-defined dates.
- Structured notes with “worst-of” features, which provide payoffs that depend upon the worst performing reference index in a pre-specified group. These notes can limit the return of principal at maturity if either the reference index falls by a stated percentage (*e.g.*, 30 percent) or if any of the reference indices decline in value since the date of issue.
- Investments tied to the performance of markets that may not be well understood by many investors. For example, some exchange-traded products offer retail investors exposure to stock market volatility. Some of these products also provide inverse or leveraged exposure. The investable form of volatility may be in the form of futures on the CBOE Volatility Index (VIX) that reflect the market’s expectation of volatility. Some investors may not understand that the product’s return may not be based on VIX fluctuations actually experienced on a given day, but on the market’s expectation of future volatility.

- Products with principal protection that is conditional or partial, or that can be withdrawn by the product sponsor upon the occurrence of certain events. Notes that can lose their principal protection based upon a stated event represent an example of a product with this feature.
- Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily. Leveraged or inverse exchange-traded funds exemplify this feature. Many leveraged and inverse ETFs "reset" daily, meaning that they are designed to achieve their stated leverage or inverse objectives on a daily basis. Their performance over longer periods of time can differ significantly from what might be expected based on their daily leverage or inverse factor.
- Products with complicated limits or formulas for the calculation of investor gains. For example, some structured notes have a payout structure that tracks the upside performance of a reference asset one-for-four, but if the reference asset's performance exceeds a specified threshold the payoff is reduced to a much lower, pre-set level, regardless of how it performs afterward.

The list above is not exhaustive. Moreover, many products that do not possess the characteristics described may nevertheless require heightened compliance and supervisory procedures due to the risks they present. However, the general characteristics should assist firms in establishing policies and procedures to identify products that are sufficiently complex to warrant enhanced oversight.

The fundamental point for firms is that if a product has similar features of complexity, such as embedded derivative-like features or a structure that produces different performance expectations according to price movements of other financial products or indices, then firms should err on the side of applying their procedures for enhanced oversight to the product.

B. Heightened Supervision

The following discussion of supervisory and compliance procedures may help firms assess the adequacy of controls with respect to complex products.

Approval of the Sale of Complex Products

Under FINRA's suitability rule, a firm or registered representative must perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security.[22] A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors (as opposed to the customer-specific suitability determination, which is made on an investor-by-investor basis). To discharge the reasonable basis suitability obligation, a firm or registered representative must perform reasonable diligence to understand the nature of the transaction or investment strategy, as well as the potential risks and rewards. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the familiarity of the firm or the registered representative with the security or investment strategy.[23]

Reasonable diligence must provide the firm or registered representative "with an understanding of the potential risks and rewards associated with the recommended security or strategy."[24] This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.[25] Firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. Those procedures should ensure that the right questions are answered before a complex product is recommended to retail investors.

These questions should include the following:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?
- Conversely, to whom should this product not be offered?
- What is the product's investment objective and is that investment objective reasonable in relation to the product's characteristics? How does the product add to or improve the firm's current offerings? Can less complex products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor's return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market, investment or credit risks?
- Does the product's complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements associated with the product?
- How liquid is the product? Is there an active secondary market for the product?[26]

Post-Approval Review

A well-designed system of internal controls should include a process to periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them. While a firm's procedures for approving specific complex products will help to ensure that the solicitation of investors is properly supervised, firms also should consider developing procedures to monitor how the products performed after the firm approved them. Every product presents risks that may cause the product to perform differently than anticipated, particularly when market conditions have changed. Some firms require that complex products be formally reviewed for a specific period of time so that the firm can assess their performance and determine whether product limitations are being met and whether market conditions have altered the risks associated with each product. Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.

Training of Registered Representatives

Registered representatives who recommend complex products must understand the features and risks associated with those products. For example, a registered representative who recommends a collateralized mortgage obligation should understand the various features of the instrument, including the prepayment, credit and liquidity risks associated with the collateral and the particular tranche being recommended. Registered representatives who recommend structured products with embedded options and derivatives should possess a sophisticated understanding of the payoff structure, any limit on upside potential and the risks to investors that the payoff structure presents.

Ideally, the registered representative should be competent to develop a payoff diagram of a structured product to facilitate his or her analysis of its embedded features and recognize that such a product typically can be decomposed into bond and derivative parts. For example, if a structured product promises a 100 percent return of capital at maturity plus 150 percent of any rise in an underlying index over the investment period, the registered representative should have a sufficiently sophisticated understanding of finance to appreciate that this product is similar to a bond that matures with 100 percent return of capital and an embedded call with 150 percent participation and a strike price of 100 percent.

Knowledge of the payoff structure is not equivalent to an understanding of the risks associated with a complex product. The registered representative also should understand such features as the characteristics of the reference asset, including its historic performance and volatility and its correlation with specific asset classes, any interrelationship between multiple reference assets, the likelihood that the complex product may be called by the issuer, and the extent and limitations of any principal protection. The registered representative should be adequately trained to understand not only the manner in which a complex product is expected to perform in normal market conditions, but the risks associated with the product.

Consideration of a Customer's Financial Sophistication

FINRA's suitability rule requires that a firm or registered representative determine that a recommendation to purchase a security is suitable for the particular customer involved. The rule requires that firms and their registered representatives consider, among other factors, a customer's "investment experience" and "risk tolerance" when recommending a securities transaction or investment strategy to the customer.[27] In recommending complex products, firms are encouraged to adopt the approach mandated for options trading accounts, which requires that a registered representative have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the" complex product.[28]

Some firms make approval of complex products contingent upon specific limitations or conditions, such as investment concentration limitations or limitations on the type of investors to whom the product may be sold. Some firms prequalify retail investors through specialized investor qualification agreements that may explain the product features and risk in plain English, and often include an attestation that the customer has read the materials provided, understands the risks and wants to invest in the product. The agreement cannot mitigate the responsibility of the firm and the registered representative to conduct a thorough, customer-specific suitability analysis.

Some complex products provide various forms of principal protection. Firms should take reasonable steps to ensure that registered representatives who recommend these products understand the limitations of this protection and the fact that the protection will not alone ensure that the product is suitable for all customers. For example, the existence of the principal protection may not render the product a "conservative investment" for an elderly retail investor for whom safety is an important consideration.

Firms also should consider prohibiting their sales force from recommending the purchase of some complex products to retail investors whose accounts have not been approved for options trading, particularly the recommendation of complex products with embedded options or derivatives. Firms should consider requiring some level of supervision by a specially qualified supervisor of these recommended transactions.

Firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable. These firms should be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts not approved for options trading. Of course, approving an account for the purchase of complex products is not a substitute for a thorough suitability analysis.

Discussions with the Customer

The registered representative who intends to recommend a complex product should discuss with the retail customer the features of the product, how it is expected to perform under different market conditions, the risks and the possible benefits, and the costs of the product. The registered representative also should discuss the scenarios in which the product may perform poorly. The registered representative should do so in a manner reasonably likely to facilitate the customer's understanding. The registered representative should consider whether, after this discussion, the retail customer seems to understand the basic features of the product, such as the fundamental payout structure and the nature of underlying collateral or a reference index or asset.

Consideration of Whether Less Complex or Costly Products Could Achieve the Same Objectives for the Customer

Registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers. For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product.

Conclusion

The decision to recommend complex products to retail investors is one that a firm should make only after the firm has implemented heightened supervisory and compliance procedures. Firms should rigorously monitor the extent to which these procedures address the various investor protection concerns raised by the recommendation of complex products to retail investors. Firms also should monitor the sale of these products in a manner that is reasonably designed to ensure that each product is recommended only to a customer who understands the essential features of the product and for whom the product is suitable.

Endnotes

1. *Notice to Members 03-07* (Feb. 2003) (NASD Reminds Members of Obligations When Selling Hedge Funds); *Notice to Members 03-71* (Nov. 2003) (NASD Reminds Members of Obligations When Selling Non-Conventional Investments).
2. *Notice to Members 05-50* (Aug. 2005) (Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities).
3. *Notice to Members 05-59* (Sept. 2005) (NASD Provides Guidance Concerning the Sale of Structured Products).
4. *Regulatory Notice 09-31* (June 2009) (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds).
5. *Regulatory Notice 09-73* (Dec. 2009) (FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes).
6. *Regulatory Notice 10-09* (Feb. 2010) (FINRA Reminds Firms of Their Sales Practice Obligations With Reverse Exchangeable Securities (Reverse Convertibles)).
7. *Regulatory Notice 10-51* (Oct. 2010) (Sales Practice Obligations for Commodity Futures-Linked Securities).
8. *See* generally, *Notice to Members 05-26* (April 2005) (NASD Recommends Best Practices for Reviewing New Products).
9. *See, e.g., Northern Trust Securities, Inc.* (CRD No. 7927) (June 2, 2011) (inadequate supervision of sales of collateralized mortgage obligations and certain high-volume securities trades); *Santander Securities Corporation* (BD No. 41791) (April 12, 2011) (deficiencies in structured product business and unsuitable reverse convertible sales); *UBS Financial Services, Inc.* (CRD No. 8174) (April 11, 2011) (misleading sales of principal-protected notes).
10. *Regulatory Notice 10-22* (April 2010) (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings).
11. *Id.* at 3 (citing Hanly v. SEC, 415 F.2d 589, 597 (2d. Cir. 1969)).
12. *See* Speech by SEC Chairman Mary Schapiro: Keynote Address at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar, May 6, 2010.
13. *See* Testimony on the President's FY 2012 Budget Request for the SEC by Chairman Mary Schapiro, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations, May 4, 2011.
14. *See* Speech by SEC Chairman Mary Schapiro, *supra* n.12.
15. *See* Danish Ministry of Economic and Business Affairs Executive Order No. 345 on Risk-Labeling of Investment Products (April 15, 2011).
16. *See* AMF Position No. 2010-05-15, Marketing of complex financial instruments, October 2010.
17. *See* FSA Discussion Paper DP 11/1, Product Intervention, January 2011. *See also* FSA Feedback Statement FS 11/3 (feedback on DP 11/1), June 2011.
18. *See* FSA Guidance Consultation, Retail Product Development and Governance - Structured Products Review, November 2011.
19. *See* Financial Services and Markets Authority Communication 2011_02, Moratorium on the Distribution of Unnecessarily Complex Structured Products, June 2011, updated September 2011.

20. *See* SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (Handbook), Section I: Overarching Principles, Chapter 6: Disclosure Requirements, Product Key Facts Statements, Sub-sections 6.5-6.8 and Handbook Part IV: Post-sale arrangements – cooling-off period, Chapter 8: Issuer to provide for cooling-off or unwind right, Sub-sections 8.1-8.6.
21. In *Regulatory Notice 11-44*, FINRA proposed amendments to NASD Rule 2340 to address how firms report the per share estimated values of unlisted Direct Participation Programs and unlisted REITs on customer account statements.
22. FINRA Rule 2111 takes effect on July 9, 2012. Pending effectiveness of that rule, NASD Rule 2310 governs the suitability obligations of a broker-dealer.
23. FINRA Rule 2111.05(a).
24. *Id.*
25. *Id.*
26. *See also Notice to Members 05-26* (April 2005).
27. FINRA Rule 2111(a).
28. FINRA Rule 2360(b)(19)(B).

Regulatory Notice 10-22

Regulation D Offerings

Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

April 2010

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics
- Communications With the Public
- Private Placements
- Suitability
- Supervision

Referenced Rules & Notices
- Regulation D
- Securities Act Section 17
- SEA Section 10(b)
- Rule 10b-5
- FINRA Rule 2010
- FINRA Rule 2020
- NASD Rule 2210
- NASD Rule 2310
- NASD Rule 3010
- NTM 03-71
- NTM 05-18
- NTM 05-48
- Regulatory Notice 09-05

Executive Summary

FINRA reminds broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the Securities and Exchange Commission's Regulation D under the Securities Act of 1933—also known as private placements.

Regulation D provides exemptions from the registration requirements of Section 5 under the Act. Regulation D transactions, however, are not exempt from the antifraud provisions of the federal securities laws. A broker-dealer has a duty—enforceable under federal securities laws and FINRA rules—to conduct a reasonable investigation of securities that it recommends, including those sold in a Regulation D offering.

Moreover, any broker-dealer that recommends securities offered under Regulation D must meet its suitability requirements under NASD Rule 2310 (Suitability), and must comply with the advertising and supervisory rules of FINRA and the SEC.

Questions regarding this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President Corporate Financing/Advertising, at (240) 386-4623;
- Paul Mathews, Director, Corporate Financing Department, at (240) 386-4639; or
- Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104.

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Background and Discussion

Part I of this *Notice* describes Regulation D. Part II describes broker-dealers' regulatory responsibilities to engage in a reasonable investigation of a Regulation D offering, enforceable under the antifraud provisions of the federal securities laws and FINRA rules. Part II also describes specific issues that pertain to a broker-dealer's (BD's) responsibilities and how the scope of a BD's responsibility to conduct a reasonable investigation will necessarily depend upon its affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail investors or more sophisticated institutional investors.[1]

Part III describes practices that some broker-dealers have adopted to help them discharge their reasonable investigation obligations. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act of 1934. BDs, however, may find that many of the practices are appropriate for other types of offerings.

I. Regulation D

The private placement market is an essential source of capital for American business, particularly small firms. According to one estimate, in 2008 companies intended to issue approximately $609 billion of securities in Regulation D offerings.[2] While the private placement market is an important source of capital for many U.S. companies, especially smaller issuers, FINRA has found significant problems in several recent examinations and investigations. These problems include fraud and sales practice abuses in Regulation D offerings. Recently, for example, broker-dealers were sanctioned for providing private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.[3]

Rule 504 under Regulation D provides an exemption from the registration provisions under Section 3(b) of the Securities Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed $1,000,000. Rule 505 provides an exemption under Section 3(b) of the Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed $5,000,000. Rule 505 permits an offering to an unlimited number of "accredited investors" and up to 35 non-accredited investors. Rule 501 defines "accredited investor" as any person who meets, or who the issuer reasonably believes meets, certain requirements, including natural persons with a net worth in excess of $1,000,000, or annual income in excess of $200,000 (or $300,000 jointly with a spouse).

Rule 506 provides a legal safe harbor for an exemption from registration under Section 4(2) of the Act for the sale of securities to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 506 (unlike Rule 505) does not limit the permissible size of the offering, but requires that non-accredited investors possess a degree of financial sophistication. Specifically, Rule 506 requires that each non-accredited investor, "either alone or with his purchaser representative(s)," have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," or the issuer must reasonably believe immediately prior to making any sale that the purchaser comes within this description.

Rule 505 and Rule 506 do not require that an issuer provide any specific written information concerning the offering to accredited investors, although issuers must provide specified information to a non-accredited investor who purchases in an offering. In practice, issuers often provide a private placement memorandum that describes the offering to all prospective purchasers, including accredited investors.[4]

II. BD Regulatory Requirements in Regulation D Offerings

A. Antifraud Provisions and FINRA Rules

The Securities and Exchange Commission (SEC) and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it.[5] This duty emanates from the BD's "special relationship" to the customer, and from the fact that in recommending the security, the BD represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[6] Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.[7] It also can constitute a violation of FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.[8]

Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer.[9] For example, the SEC and courts recognize that a more thorough investigation is required for "securities issued by smaller companies of recent origin,"[10] which could include many Regulation D issuers. While there are no "iron clad rules as to what a broker must do to meet his responsibility,"[11] the presence of any "red flags" also would alert the broker to the need for further inquiry.[12] Each BD must make a determination of the scope of its investigation based upon the facts and circumstances.

A BD that lacks essential information about an issuer or its securities when it makes a recommendation, including recommendations of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from its lack of information.[13] The degree to which a broker-dealer that relies on information supplied by the issuer may be found to have conducted a reasonable investigation as a basis for its recommendation will depend on the facts and circumstances. With respect to reporting companies under the Securities Exchange Act, in the absence of red flags, a BD that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company.

In general, however, a BD "may not rely blindly upon the issuer for information concerning a company,"[14] nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.[15] While BDs are not expected to have the same knowledge as an issuer or its management, firms are required to exercise a "high degree of care" in investigating and independently verifying an issuer's representations and claims.[16] Indeed, when an issuer seeks to finance a new speculative venture, BDs "must be particularly careful in verifying the issuer's obviously self-serving statements."[17]

The fact that a BD's customers may be sophisticated and knowledgeable does not obviate the duty to investigate.[18] Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions.[19]

B. FINRA Suitability Obligations

NASD Rule 2310 states that a BD must have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.[20] This analysis has two principal components. First, the "reasonable basis" suitability analysis requires the BD to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, the "customer specific suitability" analysis requires that the BD determine whether the security is suitable for the customer to whom it would be recommended.[21]

In the context of a Regulation D offering, Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors' knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis. The BD must make reasonable efforts to gather and analyze information about the customer's other holdings, financial situation and needs, tax status, investment objectives and such other information that would enable the firm to make its suitability determination. A BD also must be satisfied that the customer "fully understands the risks involved and is...able...to take those risks."[22]

In order to ensure that it has fulfilled its suitability responsibilities, a BD in a Regulation D offering should, at a minimum, conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made; and
- the intended use of proceeds of the offering.[23]

A BD must conduct a reasonable investigation in connection with each offering, notwithstanding that a subsequent offering may be for the same issuer.[24]

C. Specific Issues Related to a BD's Responsibilities

The scope of a BD's investigation will necessarily depend upon a number of factors, including the BD's affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors.

1. BD That Is Affiliated With the Issuer

A BD that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation.[25] The BD must resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation. Indeed, its affiliation with the issuer typically would raise expectations by its customers, particularly some retail customers, that the BD has special expertise concerning the issuer.[26]

2. BD That Prepares the Private Placement Memorandum

A BD that prepares the private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document.[27] In a recent enforcement action, FINRA found that a BD that prepared a private placement memorandum containing material misstatements and omissions about such matters as the amount and timing of distributions and the targeted return of principal to investors violated FINRA Rule 2010, which requires BDs to comply with just and equitable principles of trade.[28]

A BD that assists in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by that BD for purposes of NASD Rule 2210, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the BD that assisted in its preparation may be deemed to have violated NASD Rule 2210. Moreover, sales literature concerning a private placement that a BD distributes will generally be deemed to constitute a communication by that BD with the public, whether or not the BD assisted in its preparation.

3. The Presence of Red Flags

In the course of a reasonable investigation, a BD must note any information that it encounters that could be considered a "red flag" that would alert a prudent person to conduct further inquiry. Red flags might arise from information that is publicly available or information that is discovered during the course of the investigation. A BD's reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.[29]

When presented with red flags, the BD must do more than simply rely upon representations by issuer's management, the disclosure in an offering document or even a due diligence report of issuer's counsel. In *Kunz and Cline*, the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous "red flags" indicated that the financial statements were inaccurate.[30] The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances. The SEC also found that the broker acted contrary to just and equitable principles of trade when the private placement memorandum failed to disclose both the broker's consulting relationship with the issuer and the litigation history of the issuer's president and CEO.

An issuer's refusal to provide a broker-dealer with information that is necessary for the broker-dealer to meet its duty to investigate could itself constitute a red flag. If an issuer is not forthcoming with information requested by a broker-dealer (or provides information that is non-responsive or out-of-date), the broker-dealer must determine whether sufficient information is otherwise obtainable. While issuers are not required to provide accredited investors with a private placement memorandum in order to qualify for the exemptions in Rule 505 or Rule 506, these memoranda typically are used in Regulation D offerings and firms may need to consider whether the absence of a private placement memorandum itself might constitute a red flag.

4. Reliance on Counsel and Syndicate Managers

A BD may retain counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation. A BD must carefully review the qualifications and competency of counsel or experts retained to perform an investigation on its behalf[31] and must ensure that all gaps or omissions in the investigation by such counsel or experts are separately addressed by the BD. Moreover, the use of counsel or experts does not necessarily complete the BD's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues or concerns that require further investigation by the BD.

It may be appropriate in a Regulation D offering in which a BD is merely a member of a syndicate or selling group to rely upon a reasonable investigation by the syndicate manager, provided the BD has reason to believe that the syndicate manager has the expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has in fact performed such an inquiry with respect to the particular Regulation D offering. Any BD who intends to rely upon the efforts of a syndicate manager should meet with the manager, obtain a description of the manager's reasonable investigation efforts, and ask questions of the manager concerning the independence and thoroughness of the manager's exercise of its responsibilities. A BD that relies upon the efforts of the syndicate manager retains its own responsibilities, to the extent that they are not addressed by the syndicate manager's efforts. For example, if there is reason to believe that the syndicate manager has not addressed a particular issue, then each BD participating in the offering will be responsible to the extent that it implicates the BD's own suitability analysis.

D. Supervision

A firm that engages in Regulation D offerings must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel, including its registered representatives:

- engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
- perform the analysis required by NASD Rule 2310;
- qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and
- do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.

These procedures must be reasonably designed to ensure that each Regulation D offering is properly supervised before it is marketed to other firms or sold directly to customers.[32]

E. Documentation of Reasonable Investigation

To demonstrate that it has performed a reasonable investigation, a BD should retain records documenting both the process and results of its investigation. Such records may include descriptions of the meetings that were conducted in the course of the investigation, including meetings with the issuer or other parties, the tasks performed, the documents and other information reviewed, the results of such reviews, the date such events occurred, and the individuals who attended the meetings or conducted the reviews.

III. Reasonable Investigation Practices

A BD's reasonable investigation must be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. Accordingly, a single checklist of possible practices for a BD engaged in a Regulation D offering will not suffice for every offering, and mechanical reliance upon a single checklist may result in an inadequate investigation. Nevertheless, we are providing a list of practices that some firms have adopted to help them adequately discharge their responsibilities. Many of the practices described below are designed to satisfy BDs' regulatory requirements. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act.

Industry participants that we surveyed described the following as practices that help ensure they meet their reasonable investigation obligations.

A. Issuer and Management

Reasonable investigations of the issuer and its management concerning the issuer's history and management's background and qualifications to conduct the business might include:

- Examining the issuer's governing documents, including any charter, bylaws and partnership agreement, noting particularly the amount of its authorized stock and any restriction on its activities. If the issuer is a corporation, a BD might determine whether it has perpetual existence.
- Examining historical financial statements of the issuer and its affiliates, with particular focus, if available, on financial statements that have been audited by an independent certified public accountant and auditor letters to management.
- Looking for any trends indicated by the financial statements.
- Inquiring about the business of affiliates of the issuer and the extent to which any cash needs or other expectations for the affiliate might affect the business prospects of the issuer.
- Inquiring about internal audit controls of the issuer.
- Contacting customers and suppliers regarding their dealing with the issuer.
- Reviewing the issuer's contracts, leases, mortgages, financing arrangements, contractual arrangements between the issuer and its management, employment agreements and stock option plans.

- Inquiring about past securities offerings by the issuer and the degree of their success while keeping in mind that simply because a certain product or sponsor historically met obligations to investors, there are no guarantees that it will continue to do so, particularly if the issuer has been dependent on continuously raising new capital. This inquiry could be especially important for any blind pool or blank-check offering.
- Inquiring about pending litigation of the issuer or its affiliates.
- Inquiring about previous or potential regulatory or disciplinary problems of the issuer. A BD might make a credit check of the issuer.
- Making reasonable inquiries concerning the issuer's management. A BD might inquire about such issues as the expertise of management for the issuer's business and the extent to which management has changed or is expected to change. For example, a BD might inquire about any regulatory or disciplinary history on the part of management and any loans or other transactions between the issuer or its affiliates and members of management that might be inappropriate or might otherwise affect the issuer's business.
- Inquiring about the forms and amount of management compensation, who determines the compensation and the extent to which the forms of compensation could present serious conflicts of interest. A BD might make similar inquiries concerning the qualifications and integrity of any board of directors or similar body of the issuer.
- Inquiring about the length of time that the issuer has been in business and whether the focus of its business is expected to change.

B. Issuer's Business Prospects

Reasonable investigations of the issuer's business prospects, and the relationship of those prospects to the proposed price of the securities being offered, might include:

- Inquiring about the viability of any patent or other intellectual property rights held by the issuer.
- Inquiring about the industry in which the issuer conducts its business, the prospects for that industry, any existing or potential regulatory restrictions on that business and the competitive position of the issuer.
- Requesting any business plan, business model or other description of the business intentions of the issuer and its management and their expectations for the business, and analyzing management's assumptions upon which any business forecast is based. A BD might test models with information from representative assets to validate projected returns, break-even points and similar information provided to investors.

- Requesting financial models used to generate projections or targeted returns.
- Maintaining in the BD's files a summary of the analysis that was performed on financial models provided by the issuer that detail the results of any stress tests performed on the issuer's assumptions and projections.

C. Issuer's Assets

Reasonable investigations of the quality of the assets and facilities of the issuer might include:

- Visiting and inspecting a sample of the issuer's assets and facilities to determine whether the value of assets reflected in the financial statements is reasonable and that management's assertions concerning the condition of the issuer's physical plants and the adequacy of its equipment are accurate.
- Carefully examining any geological, land use, engineering or other reports by third-party experts that may raise red flags.
- Obtaining, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others are necessary as a basis for determining the suitability of the investment prior to recommending the security to investors.

Endnotes

1 As a general matter, any reference in this *Notice* to the obligations of a BD firm is also intended to cover the concomitant responsibilities of any registered representative who recommends a Regulation D offering to his/her customers and any registered principal who is charged by his/her firm with supervising this registered representative.

2 Office of the Inspector General, Securities and Exchange Commission, *Regulation D Exemption Process 2* (March 31, 2009).

3 *See, e.g.*, Provident Asset Management, LLC, FINRA Case No. 2009017497201 (2010); *Pacific Cornerstone Capital, Inc.* FINRA AWC No. 2007010591701 (2009).

4 A note to Rule 502(b)(1) states that when an issuer provides required information to any non-accredited investor, it should consider providing the information to accredited investors, too, "in view of the anti-fraud provisions of the federal securities laws."

5 *See Hanly v. SEC*, 415 F.2d 589, 595-96 (2d. Cir. 1969); *SEC v. Great Lake Equities Co.*, 1990 U.S. Dist. LEXIS 19819 at *16-17 (E.D. Mich. 1990); *SEC v. North American Research and Development Corp.*, 424 F.2d 63,84 (2d Cir. 1970). *See also SEC v. Current Financial Services, Inc.*, 100 F. Supp. 2d 1, 14-15 (D.D.C. 2000); *District Business Conduct Committee for District No. 4 v. Everest Securities, Inc., 1994 NASD Discip. Lexis 188* (Sept. 2, 1994), *aff'd*, 52 S.E.C.

Endnotes continued

958, 962-63 (Aug. 26, 1996), *aff'd*, 116 F. 3d 1235 (8th Cir. 1997); Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).

6 *Hanly, supra* note 5 at 597.

7 *See generally Hanly, supra* note 5.

8 *See Everest Securities, Inc*, supra note 5.

9 *See Hanly, supra* note 5. *See also University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976).

10 *Hanly, supra* note 5 at 597.

11 *University Hill Foundation, supra* note 9 at 898.

12 *See, e.g., SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS 16204 (S.D.N.Y. 2000), where the court held that the duty to independently investigate is greater "where promotional materials are in some ways questionable, for example by promising unusually high returns."

13 *See Hanly, supra* note 5 at 597 ("Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information"). *See also* Securities Act Release No. 4445, *supra* note 5; *Regulatory Notice 09-05* (Guidance to Member Firms Participating in Unregistered Resales of Restricted Securities) (January 2009).

14 *Hanly, supra* note 5 at 597. The duty of inquiry under the antifraud provisions is distinguished from the "reasonable investigation" that, under Section 11(b) of the Securities Act, permits an underwriter to escape liability for misrepresentations in a registration statement. Courts have compared the Section 11 reasonable investigation and the BD's general duty to investigate and concluded that "somewhat more is required of an underwriter than a broker to discharge its obligation to the investing public." *University Hill Foundation, supra* note 9 at 898-99. This is because "an underwriter's relationship to the issuer is more substantial" than a BD that is only recommending a security, and the underwriter "plays a more central role in the marketing process." *Id.*

15 *See Everest Securities, Inc.* v. US, supra note 5 at 1239 ("reliance on others does not excuse [the respondents] own lack of investigation").

16 *Everest Securities, Inc., supra* note 5 at 963.

17 *Everest Securities, Inc., supra* note 5 at 963.

18 *Hanly* at 596, *supra* note 5.

19 Note to Rule 502(b)(1).

20 FINRA has previously discussed the responsibilities of a BD to conduct a reasonable investigation of securities it is recommending. *See, e.g., Notice to Members 03-71* (concerning non-conventional investments)(November 2003); *Notice to Members 05-18* (concerning private placements of tenants-in-common interests) (March 2005).

21 *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168-69 (Dec. 13, 1989). *See also In the Matter of Michael Frederick Siegel*, Securities Exchange Act Release No. 58737 (October 6, 2008), 2008 SEC Lexis 2459, at *28.

22 *See James B. Chase*, 56 S.E.C. 149, 159 (2003).

23 BDs should analyze whether the investor's money is likely to be applied according to the stated use of proceeds, and whether the stated use of proceeds is reasonable in light of the issuer's business purpose and prospects. *See In Re Brian Prendergast*, 2001 SEC LEXIS 1533 (August 1, 2001); *Legend Merchant Group, Inc.*, NASD No. C10030058, summarized in NASD Disciplinary Actions (July 2004); *Shelman Securities, Inc.*, NASD No. C06030013, summarized in NASD Disciplinary Actions (February 2004).

Endnotes continued

24 *See, e.g., Shelman Securities, supra* note 23 (private placement memoranda contained material misrepresentations and omissions about use of proceeds in a previous offering).

25 *See In the Matter of C. Gilman Johnston*, 42 S.E.C. 217 (Aug. 14, 1964) (broker-dealer's control person prepared memorandum describing broker-dealer's own "highly speculative" securities without any reasonable basis for believing that the securities were suitable for some purchasers). *See generally Pacific Cornerstone Capital, supra* note 3 at 10 (person providing information for and reviewing and approving private placement memorandum and sales literature was BD's control person and issuer's founder). Regulation D generally prohibits a broker or other person that is affiliated with the issuer from serving as a purchaser representative to an investor. *See* Rule 501(h)(1)(definition of "purchaser representative").

26 *Cf.* FINRA Rule 5122 (requiring members to comply with certain requirements when engaging in private placement of securities issued by the member or a control entity).

27 *SEC v. Kunz and Cline Investment Management, Inc.* Admin. Proc. File No. 3-9960, *aff'd* 2003 U.S. App. LEXIS 6011 (10th Cir. 2003) (unpublished opinion).

28 *Pacific Cornerstone Capital, Inc., supra* note 3.

29 *Everest Securities, Inc. v. SEC, supra* note 5 at 1239 (finding "the investigation that was performed was itself insufficient," and even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading).

30 *Kunz and Cline*, supra note 27.

31 *See Notice to Members 05-48* (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers) (July 2005) (discussing a member's accountability and supervisory responsibility for outsourced functions).

32 *Pacific Cornerstone Capital, Inc., supra* note 3 at 9.

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Internal Audit

Legal and Compliance

Retail

Senior Management

KEY TOPICS

Best Practices

New Products

Non-Conventional Instruments

Rule 3010

Suitability

GUIDANCE

New Products

NASD Recommends Best Practices for Reviewing New Products

Executive Summary

NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

The purpose of this *Notice* is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

Questions/Further Information

Questions concerning these new reporting provisions can be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, at (202) 728-8275.

05-26

Background and Discussion

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including asset-backed securities, distressed debt, structured notes, and derivative products, are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

In 2003, NASD published *Notices to Members (NTMs)* addressing the sale of hedge funds and non-conventional instruments to retail customers.[1] More recently, we have proposed new rules tailored specifically to sales of deferred variable annuities, including new sales practice standards, supervisory approval and sales force training requirements,[2] and a new rule establishing pre-use advertising filing requirements for certain products not previously offered by the selling firm.[3] And, as discussed more fully below, we met with numerous firms during the past year to learn more about their practices for developing and vetting new products.

NASD continues to monitor new products carefully and will respond to specific products and problem areas as appropriate. However, we also urge firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

Written Procedures for Vetting New Products

As part of the supervisory responsibilities imposed by NASD Rule 3010, all firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory as well as a business perspective. At a minimum, those procedures should identify what constitutes a new product, and ensure that the right questions are asked and answered before a new product is offered for sale.

What Is a New Product?

As a threshold matter, a firm's written procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, including when a modification of an existing product is material enough to warrant the same level of review as a new product. Among the things to consider are:

- Is the product new to the marketplace or the firm?
- Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors? Will the product be offered by representatives who have not previously sold the product?
- Does the product involve material modifications to an existing product, whether risk to the customer, product structure, or fees and costs?
- Does the product require material operational or system changes?
- Is the product an existing product that is being offered in a new geographic region, in a new currency, or to a new type of customer?
- Would the product involve a new or significant change in sales practices?
- Does the product raise conflicts that have not previously been identified and addressed?

This list is not necessarily exhaustive of all factors that determine whether a product is new. Firms should not simply assume that if something is "like" a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary. NASD believes that when firms are unsure as to whether something warrants new product review, the best practice is to err on the side of caution, and subject any material modification to an existing product (whether the existing product is sold by the firm or not) to the same level of review as a new product. It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

Ask the Right Questions

The fundamental goal of every vetting process should be to ensure that the right questions are asked during the review period. Consequently, a firm's policies and procedures addressing new products should be designed to answer these questions. While the right questions will depend in part on the nature of the product, NASD believes that, at a minimum, every firm should ask and answer the following questions before a new product is offered for sale:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should this product NOT be offered?
- What is the product's investment objective? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.
- Does the product present any novel legal, tax, market investment, or credit risks?
- What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.

- What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications comport with the expertise necessary to reach sound conclusions?
- Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
- Will this product be sold only by the firm, or by third parties? How liquid is the product? Is there a secondary market for the product?
- Do the firm's current systems support the product, or will new systems be required? If promises will be made to customers (such as volume-based discounts), can current systems deliver on those promises?
- Does the structure or a feature of the new product, including the proposed sales plan, implicate any additional regulations (*i.e.*, NASD Rule 2860 or NASD Rule 2720)?

Asking the right questions is critical not only to determine if the product should be offered at all (is it suitable for targeted investors, does it present insurmountable conflicts between the firm and its customers), but also to identify important features of the product that should be highlighted for the sales and marketing staff, and to plan for appropriate training and supervision.

Survey of Best Practices

To help firms determine whether their current procedures for vetting new products are appropriate, NASD has surveyed a number of firms that manufacture proprietary products and/or distribute third-party products and has conferred with certain of its committees, including the NASD Consultative Committees. The remainder of this *Notice* highlights practices employed by some firms that NASD believes others should consider. These practices can make it easier for firms to comply with their various suitability obligations, avoid conflicts, and plan for appropriate training and supervision. This *Notice* is not intended to be a comprehensive roadmap for compliance and supervision with respect to vetting new products, but rather highlights measures that some firms are using to ensure better compliance. Firms should consider the information in this section of the *Notice* in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While firms must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have policies and procedures concerning new products reasonably designed to achieve compliance with NASD rules and the federal securities laws because of the limitation of its size, structure, or operations. Using the information in this *Notice* may be helpful, but it is not designed as a safe harbor as circumstances may dictate different practices, processes, and procedures.

While the procedures used by the firms we surveyed vary slightly depending on their own business model and culture, they tended to share the following components:

- A mandatory, standardized process that requires a written "new product" proposal and thorough accompanying documentation, that:
  - assigns clear "ownership" of the product or concept to a particular business unit, product group, or department;
  - is clearly communicated to, and has a high profile within, the firm; and
  - is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity;
- A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management; and
- If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

Initial Product Review

Whatever the specifics of a firm's review process, the most successful processes require review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval.

A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage. Some firms do this by having compliance and legal personnel attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise. Others include compliance and legal personnel in the initial product assessment, as well as in the detailed review. However it is done, firms that include these perspectives early in the development process report that their business units are likely to view compliance personnel as a positive "part of the team," rather than as a stumbling block. The opposite can also be true. When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.[4]

The firms we surveyed also reported that it is extremely helpful to have operations, sales, and supervisory personnel participate in the product review process, rather than waiting until after a product has been approved to determine what training, controls, or operational enhancements are necessary. Many important questions are best answered by those personnel. For example, they may be in the best position to determine whether current systems support the product, including delivering on promises such as volume-based discounts. If additional training is required, firms should plan in advance how that training will be administered, and how the firm will ensure that only brokers who have had the required training are allowed to offer the product to customers. Firms also should plan to ensure that the necessary training is available as long as the product is offered. Consideration also should be given to whether offering the product will require any additional licensing for sales personnel.

Firms manage the initial review process differently, with many utilizing Web-based applications to streamline and document the process. While some firms rely on the proposing business unit to shepherd a product through the process, at least one firm has established an independent new products group that is responsible for managing the process and ensuring that all relevant departments have reviewed and signed off on the proposed product before it is submitted for formal approval. The new products group also formally notifies all relevant departments about product modifications that it deems do not warrant full review in a process of negative consent; if any department disagrees with the new product group's initial assessment, the product is submitted for full review.

Formal Approval

After the appropriate initial review has been completed, most of the firms we surveyed require formal approval by a committee consisting of representatives from senior management before a product can be offered, which enhances a firm's ability to apply consistent standards and ensures accountability. The committee may base its decision on a written proposal supported by detailed documentation, an oral presentation, or, as in most cases, both. A number of firms reported that approval of complex or unusual products will often be made contingent of specific limitations or conditions, including to whom the product can be sold, what kind of training must be required, or what kind of market conditions must exist for the approval to remain effective. For example, the product may be approved on the condition that it is offered only to customers whose investment objectives are coded "speculative," who have a certain minimum risk tolerance level, or who have a minimum net wealth. (While these limitations may be helpful, NASD cautions that there is no substitute for a suitability analysis, and "accredited" status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth.) Other conditions of approval might include that no more than a set percentage of a customer's net worth be invested in the same or a similar product. In such cases, it is important to determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

Post-Approval Review

Some firms require that complex products, those approved on a contingent or limited basis, or those based on critical market assumptions, be formally reviewed for a specific period of time, often six months or a year. This allows the firm to assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product. Firms also should ensure that they:

- track and monitor customer complaints and grievances relating to new products;
- reassess the firm's training needs regarding a product on a continuing basis;
- establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- periodically reassess the suitability of the product; and
- review any product before lifting any restrictions or conditions on the sale of the product.

Conclusion

NASD urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. At a minimum, firms should have in place written procedures for determining what is a new product, and for making sure that the right questions are asked and answered before a new product is offered for sale. In addition, while NASD recognizes that what specific procedures are appropriate will vary depending on firm size and structure, we believe that the best practices identified above can help firms avoid conflicts, unsuitable recommendations, and other problems before violations occur. Finally, NASD notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

Endnotes

1 NASD Reminds Members of Obligations When Selling Hedge Funds, *NTM 03-07* (February 2003), and Non-Conventional Investments, *NTM 03-71* (November 2003).

2 Proposed New Rule 2821 Regarding Transactions in Deferred Variable Annuities, SR-NASD-2004-183 (December 2004).

3 *See NTM 05-25* (April 2005) (NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; Comment Period Expires May 20, 2005).

4 Nothing in this *Notice* is intended to imply that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.

NOVEMBER 2003

SUGGESTED ROUTING

Legal/Compliance
Retail
Senior Management
Internal Audit

KEY TOPICS

Advertising and Sales Literature
Due Diligence
Non-Conventional Investments
Suitability

INFORMATIONAL

Non-Conventional Investments

NASD Reminds Members of Obligations When Selling Non-Conventional Investments

Executive Summary

In the aftermath of the recent downturn in the equity markets, NASD reviewed the services and products offered by members and observed that retail investors were being offered an array of different investments as alternatives to conventional equity and fixed-income investments. These alternative investments do not fall under a common category; the staff review indicates that brokers and retail investors have shown increased interest in products such as asset-backed securities, distressed debt, and derivative products (for ease of reference these products are collectively refered to as non-conventional investments or "NCIs"). NCIs often have complex terms and features that are not easily understood. NASD staff reminds members that the fact that an investment is an NCI does not in any way diminish a member's responsibility to ensure that such a product is offered and sold in a manner consistent with the member's general sales conduct obligations. This *Notice to Members* reminds members offering NCIs of their obligations to: (1) conduct adequate due diligence to understand the features of the product; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis in connection with any recommended transactions; (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors; (5) implement appropriate internal controls; and (6) train registered persons regarding the features, risks, and suitability of these products.

03-71

Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8104; or Janene Marasciullo, Senior Attorney, Regulatory Policy and Oversight, NASD, at (202) 974-2978.

Background and Discussion

As a result of the recent downturn in the equity markets and historically low interest rates, brokers and retail investors have been turning to alternative investment vehicles in search of a better return or yield on investments. A review of members indicated that there is an increased interest in a variety of NCIs that have a wide array of terms, conditions, risks, and rewards.[1] Some of these NCIs are marketed as offering greater security or a "guaranteed" return on investments. Other products seek to maximize the potential return on investments. Some of these products have unique features relating to risk and reward that may not be readily understood, especially by retail investors.

For example, certain asset-backed securities and corporate bonds are secured by a range of collateral such as mobile homes, future royalty payments on popular music, payments from consumer credit cards or other consumer goods. The credit risks associated with these myriad forms of collateral are varied and for many non-institutional parties may be difficult to understand and assess. Other NCIs, such as distressed corporate bonds and certain derivative contracts, may be offered to retail investors in an attempt to maximize the return on investment, but they correspondingly may involve greater degrees of risk. These products also tend to have less market liquidity, less transparency as to their pricing and value and may entail significant credit risks that are difficult to understand and assess.

In sum, recent trends indicate that brokers and investors may be turning to NCIs in search of increased yield or return. Although these products may have attractive qualities, it is crucial that members understand the distinct features, and risks and rewards, of any product they sell. Thus, whenever members recommend NCIs to investors, they must take special care to ensure that all registered persons understand the features of the product in order to be in a position to perform the required suitability analysis before executing a transaction. Likewise, members have an obligation to ensure that all marketing materials used by the member provide an accurate and balanced description of the risks and rewards.

NASD is issuing this *Notice to Members* to remind members of their sales conduct obligations.[2] Given the complex nature of NCIs and the potential for customer harm or confusion, members are cautioned to ensure that their sales conduct procedures fully and accurately address any of the special circumstances presented by the sale of NCIs. Additionally, NASD is concerned that investors, particularly retail investors, may not fully understand the risks associated with these products. Accordingly, NASD reminds members that the sale of NCIs, like more traditional investments, requires them to:

(1) conduct appropriate due diligence with respect to these products; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis for recommended transactions; (4) ensure that promotional materials used by the member are fair, accurate, and balanced; (5) implement appropriate internal controls; and (6) provide appropriate training to registered representatives that sell these products. Given the complex and, at times, difficult-to-understand nature of NCIs, members should take particular care to assure that they are fulfilling these obligations.

Due Diligence/Reasonable-Basis Suitability

As NASD noted most recently in *Notice to Members 03-07* (pertaining to hedge fund sales to customers), performing appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis.[3] A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination, discussed below, which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI only to institutional investors does not relieve the member of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

The type of due diligence investigation that is appropriate will vary from product to product. However, there are some common features that members must understand about products before registered representatives can perform the appropriate suitability analysis. These features include, but are not limited to:

- The liquidity of the product
- The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions
- The creditworthiness of the issuer
- The creditworthiness and value of any underlying collateral
- Where applicable, the creditworthiness of the counterparties
- Principal, return, and/or interest rate risks and the factors that determine those risks
- The tax consequences of the product
- The costs and fees associated with purchasing and selling the product

Members should examine these and other appropriate factors when conducting due diligence. A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes. In such case, the member must seek additional information about the NCI or conclude that the product is not appropriate for sale to the public. In addition, members should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits.

Customer-Specific Suitability

Members and their associated persons must reasonably believe that the product is a suitable investment prior to making a recommendation to a particular customer. To ensure that a particular investment is suitable for a specific customer, members and their registered persons must examine: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. [4]

NASD cautions members against relying too heavily upon a customer's financial status as the basis for recommending NCIs. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor. Given the unique nature of NCIs, these products may present challenges when it comes to a member's duty to dispense its suitability obligation; however, the difficulty in meeting such challenges cannot be considered as a mitigating factor in determining whether members have met their suitability obligations. NCIs with particular risks may be suitable for recommendation to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

Promotional Materials

Sales materials and oral presentations regarding NCIs must present a fair and balanced picture regarding both the risks and benefits of investing in these products. For example, members may not claim that certain NCI products, such as asset-backed securities, distressed debt, derivative contracts, or other products, offer protection against declining markets or protection of invested capital unless these statements are fair and accurate. Moreover, when promoting the advantages of NCIs, it is critical that members balance their promotional materials with disclosures of the corresponding risks and limitations of the product discussed above in the "Due Diligence/Reasonable Basis Suitability" section of this *Notice*.

Additionally, if applicable, members should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. NASD reminds members, however, that simply providing a prospectus or offering memoranda does not cure unfair or unbalanced sales or promotional materials, whether prepared by the member, sponsor, or issuer.[5]

Internal Controls

Members must establish sufficient internal controls, including supervision and training requirements, that are reasonably designed to ensure that sales of NCIs comply with all applicable NASD and SEC rules. Members must ensure that their written procedures for supervisory and compliance personnel require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; (3) all promotional materials are accurate and balanced; and (4) all NASD and SEC rules are followed. In addition to establishing written procedures, members also must document the steps they have taken to ensure adherence to these procedures.

Training

Members must train registered persons about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors. Likewise, members should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. Members' focus on training should not be limited to representatives selling such products; members also should provide appropriate training to supervisors of registered persons selling NCIs.

For a variety of reasons, the need for adequate training is heightened when registered persons sell NCIs. First, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to provide a full and balanced disclosure regarding both the risks and the rewards of these products.

Educational brochures, videos, lectures, explanatory memoranda, and Web-based seminars are all appropriate ways of delivering training. The particular training methods will vary based upon the products themselves, as well as the size and customer base of the firm. NASD encourages firms that offer NCIs to offer training about these products as part of the Firm Element of their Continuing Education Program.

Conclusion

NCIs can be unusual and complex investment vehicles that may appear increasingly attractive to investors during periods in which traditional equity and fixed income investments come into disfavor. However, the unique and complex features of some NCIs may be difficult to understand and may obscure the risks. Accordingly, members must conduct appropriate due diligence/reasonable-basis suitability before offering any product to the public. Likewise, members must conduct a customer-specific suitability analysis prior to making any recommendations to a customer. Members also must ensure that all promotional materials are fair, accurate, and balanced. Finally, in connection with the recommendation and sale of NCIs, members must ensure that they implement appropriate supervisory internal control and appropriate training to all registered persons who sell such products to customers.

Endnotes

1 Approximately 35% of the firms reviewed sold NCIs in denominations that raise the possibility of sales to retail investors. The list of NCIs being offered is broad and includes asset-backed securities, index-linked notes, non-traded REITS, equity-linked notes, multi-callable step up notes, redeemable secured notes, auction rate preferred securities, principal protected index-linked CDs, distressed debt, derivative products, and emerging market debt securities.

2 Members also are reminded of the application of IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products), which emphasizes members' obligations for fair dealing with customers when making recommendations or accepting orders for new financial products.

3 NASD's use of the term "due diligence" is not intended to equate the responsibilities of a member for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176.

4 NASD Conduct Rule 2310(b).

5 *See* NASD Letter of Acceptance, Waiver and Consent, Altegris Invs., Inc., and Robert Amedeo, No. CAF030015 (April 15, 2003).