

## **FINRA Examination Findings and Priorities**

**Thursday, January 23, 2020**

**11:15 a.m. – 12:15 p.m.**

Panelists discuss the examination findings and priorities letters. FINRA staff will review effective practices and considerations worth highlighting due to their potential impact on investors and markets or the frequency with which they occur.

**Moderator:** Erin Vocke  
Vice President, Firm Group Examinations, Retail - New Orleans Office  
FINRA Member Supervision

**Speakers:** Grant Gibbons  
Examination Director, New Orleans Office  
FINRA Member Supervision

Elizabeth Mauro  
Examination Director, Boca Raton Office  
FINRA Member Supervision

Michael Pedlow  
Senior Vice President and Chief Compliance Officer  
Kestra Investment Services, LLC

## FINRA Examination Findings and Priorities Panelist Bios:

Moderator:

**Erin C. Vocke** is Vice President, Firm Group Examinations, Retail located in the New Orleans District Office. Ms. Vocke began her career in 1995 as an examiner in the New Orleans District Office. During this time, she conducted routine and cause examinations of member firms and focused examinations in the areas of variable products and mutual funds. Ms. Vocke became Supervisor of Examiners and relocated to the Florida District Office. She assumed responsibilities for supervising Continuing Membership Applications and financial surveillance of member firms, in addition to routine and cause examinations. Ms. Vocke was promoted to Associate District Director of the Dallas Office and assumed responsibility of overseeing the District cycle, cause, financial surveillance and Membership Application Programs. She served as the District Director of the Dallas District Office for approximately five years and the District Director for both the Dallas and New Orleans District Offices for approximately six years. In her new role, she will be responsible for examinations of Retail member firms across Member Supervision.

Speakers:

**Grant Gibbons** is Examination Director of the FINRA New Orleans Office. He began his career in 1997 as an Examiner in the New Orleans District Office. In March 2004, Mr. Gibbons was promoted to Supervisor of Examiners in the Dallas District Office. He oversaw a team of examiners responsible for the regulation of member firms relating to financial and operational matters, sales practice concerns, surveillance monitoring, customer complaints and termination for cause reviews. In March 2014, he assumed the role of Examination Manager in the New Orleans District Office. In this role, he managed a team of cycle examiners and helped form and successfully led the New Orleans Fixed Income team. In July 2016, he was promoted to the Associate District Director (n.k.a. Examination Director) of the New Orleans Office where he is responsible for the execution of the offices regulatory programs. Mr. Gibbons received a B.S. in Business Administration (Finance) from Auburn University in Auburn, Alabama.

**Elizabeth Mauro** is Examination Director at FINRA and is responsible for leading a team of managers and examiners that conduct Firm Examinations of member firms that fall within the Retail Firm Grouping. Ms. Mauro's knowledge of the securities industry has evolved from approximately 23 years of regulatory experience while working in various examination and surveillance roles at FINRA, the New York Stock Exchange and U. S. Securities and Exchange Commission. Her experience includes investigating and monitoring compliance and regulatory issues spanning a broad range of products and activities with expertise in broker-dealer risks associated with Sales Practice obligations to customers, Net Capital and Customer Segregation rules. Ms. Mauro received her Bachelor in Business Administration degree in Finance and Banking from Hofstra University, and is a Certified Anti-Money Laundering Specialist.

**Mike Pedlow** is Senior Vice President and Chief Compliance Officer at Kestra Financial. Mr. Pedlow directs all aspects of Compliance for Kestra Financial. He maintains company alignment with regulatory policies, while helping independent financial advisors meet the expectations of regulators as they conduct their day-to-day business. Working to balance the dual challenges of risk and business needs within the tightly regulated financial sector, Mr. Pedlow and his team actively seek to influence policy, rules and laws that may adversely impact advisors and their practice. He attributes this fresh, highly engaged approach in part to his time working as an independent financial advisor. Under his leadership, advisors experience a uniquely proactive, collaborative and supportive team of consultants within Advertising Compliance, Retirement Plan Compliance and Firm Policy. Mr. Pedlow also serves as the chief compliance officer for Kestra Private Wealth Services, a Kestra Financial affiliate. Previously, he held senior compliance positions as vice president of Investment Advisory Compliance at Kestra Financial and as RIA compliance officer at Raymond James Financial Services. Mr. Pedlow holds a Bachelor of Arts in economics from the University of South Florida and multiple industry licenses, including FINRA Series 7, 24 and 66.

# South Region Member Forum

January 23, 2020 | Hollywood, FL

## FINRA Examination Findings and Priorities

# Panelists

## ○ Moderator

- Erin Vocke, Vice President, Firm Group Examinations, Retail - New Orleans Office, FINRA Member Supervision

## ○ Panelists

- Grant Gibbons, Examination Director, New Orleans Office, FINRA Member Supervision
- Elizabeth Mauro, Examination Director, Boca Raton Office, FINRA Member Supervision
- Michael Pedlow, Senior Vice President and Chief Compliance Officer, Kestra Investment Services, LLC

# AGENDA

- 1 | Introductions
- 2 | Nuts and Bolts
- 3 | Topics for Discussion
- 4 | Questions



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# **2** | **Nuts and Bolts**



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# **3** | Topics for Discussion

# Topics for Discussion

- Variable Annuities
- Concentration
- BD/IA Issues
- Fixed Income markup/ mark-down disclosures
- Positions of Trust



# Topics of Discussion (Continued)

- Cybersecurity
- Private Placements/Retail Communications
- Trading Authorization
- Contractual Commitments



# 2019 Report on FINRA Examination Findings and Observations

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## INTRODUCTION

In both [2017](#) and [2018](#), FINRA issued Reports on Examination Findings in response to firms' requests that we make publicly available a summary of key findings from FINRA's examinations of member firms. Firms use this information, as well as effective practices observed by FINRA at certain firms, to anticipate potential areas of concern and improve their procedures and controls. (We subsequently refer to the two prior years' documents as the "2017 Report" and the "2018 Report.")

The name of this year's report—the "2019 Report on Examination Findings and Observations"—reflects FINRA's recent decision to distinguish more clearly between examination findings and observations. Findings constitute a determination that a firm or registered person has violated U.S. Securities and Exchange Commission (SEC), FINRA or other relevant rules. By contrast, observations (formerly known as recommendations) are suggestions to a firm about how it could improve its control environment in order to address perceived weaknesses that elevate risk, but do not typically rise to the level of a rule violation or cannot be tied to an existing rule, and are communicated to firms separately from the formal examination report. This report reflects key findings and observations identified in recent examinations, and contains effective practices, where noted, that could help firms improve their compliance and risk management programs. Where a matter is rule-based, the applicable regulatory sources ("Regulatory Obligations") are identified under the topic heading.

As a reminder, this report does not represent a complete inventory of findings, observations or effective practices. In fact, an individual firm may not have any deficiencies identified in this report, or may have other deficiencies that were not included. Similarly, we recognize that firms may employ effective practices that are not described in this report.

Further, this report does not create new legal or regulatory requirements or new interpretations of existing requirements. There should be no inference that FINRA requires firms to implement any specific effective practices described in this report or those that extend beyond the requirements of existing securities rules and regulations.

FINRA always welcomes feedback on how we can improve the content, structure, format or other elements of future reports on examination findings and observations. If you have suggestions, please contact Steven Polansky, Senior Director, Member Supervision, at (202) 728-8331 or by [email](#), or Elena Schlickemaier, Principal Research Analyst, Member Supervision, at (202) 728-6920 or by [email](#).

## SALES PRACTICE AND SUPERVISION

### Supervision

#### Regulatory Obligations

FINRA Rule [3110](#) (Supervision) requires firms to establish, maintain and enforce a system to supervise their activities and the activities of their associated persons that is reasonably designed to achieve compliance with federal securities laws and regulations, as well as FINRA rules. This includes updating supervisory processes and written supervisory procedures (WSPs) to address new or amended rules, as well as products and services.

Customer account and trading supervision includes complying with other obligations, such as FINRA Rule [4512](#) (Customer Account Information), which specifies the categories of customer account information firms must maintain. Further, FINRA Rule [2231](#) (Customer Account Statements) generally requires firms to send customers account statements containing their securities positions, money balances and account activity at least once each calendar quarter. Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (Exchange Act), as well as the FINRA Rule Series [4510](#) (Books and Records Requirements) prescribe recordkeeping obligations relating to customer account records, trading records and related documentation.

#### Noteworthy Examination Findings

FINRA noted the following issues relating to supervision and documentation requirements.

- ▶ **Insufficient WSPs for New or Amended Rules** – Some firms did not adequately address newly adopted or amended rules by developing controls to address the new requirements applicable to their business and updating their WSPs accordingly, for example: new fixed income mark-up disclosure requirements under FINRA Rule [2232](#) (Customer Confirmations); new trusted contact person information requirements pursuant to Rule [4512](#) (Customer Account Information); temporary holds, supervision and record retention requirements under new Rule [2165](#) (Financial Exploitation of Specified Adults) (if they intended to use the rule); and compliance with amended Rule [3310](#) (Anti-Money Laundering Compliance Program), which incorporates FinCen's new Customer Due Diligence (CDD) rule obligations. Firms are expected to evaluate which new and amended laws and regulations apply to their business, and review whether their supervisory systems, WSPs and training programs need to be amended to comply with any new or amended requirement(s).
- ▶ **Limited Supervision and Internal Inspections** – Some firms did not have reasonably designed branch supervision and inspection programs. In particular, some firms did not adequately understand the activities being conducted through their branch offices, including products and services that were offered only at certain branch locations, which could prevent such firms from effectively supervising and addressing the unique risks of each branch location. Many firms also did not conduct periodic inspections of non-branch locations as required by FINRA Rule [3110\(c\)](#) (Internal Inspections); did not determine relevant areas of review at branch offices or non-branch locations, taking into consideration the nature and complexity of the products and services offered or any indicators of irregularities or misconduct; failed to reduce the inspections and reviews to a written report; or did not follow through on corrective action determined to be necessary through their branch inspections.
- ▶ **Inadequate Supervision of Account Statements, Consolidated Account Reports and Other Forms** – FINRA found that some firms did not consistently maintain accurate information in account documents, which impacted their ability to reasonably supervise account activity.
  - *Consolidated Account Reports (CARs)*<sup>1</sup> – In certain instances, firms did not have supervisory systems to evaluate whether and when registered representatives used CARs, did not know

when CARs included manual entries by representatives or customers, and did not require review of relevant customer documents to confirm that CARs accurately represented customers' assets and values that were held outside the broker-dealer. FINRA notes that firms with stronger supervisory systems maintained comprehensive WSPs and training addressing the use and supervision of CARs; had strict limits on the use of CARs, including around manual entries; and determined whether they accurately reflected customer holdings outside of the broker-dealer.

- *Falsifying Documents* – Some firms did not have reasonable processes to detect or prevent various forms of forgeries, including “accommodation forgery,” where registered representatives and associated persons asked customers to sign blank, partial or incomplete documents. Some firms expanded risk-based reviews of associated persons' communications to cover requests for customer signatures or enhanced firm reviews of customer complaints for issues relating to forgery or falsification of documents. In addition, some firms did not follow their protocols relating to notarization and medallion stamp guarantees, or did not have any supervisory procedures for supervising the use of such stamps.
- ▶ **Insufficient Supervision for Specific Types of Accounts** – FINRA noted the following supervisory issues.
  - *Restricted and Insider Accounts* – Some firms failed to update timely their watch and restricted lists, or reasonably identify and restrict account activity susceptible to insider trading. Other firms did not have surveillance systems or procedures to review and approve restricted trading because they relied on clearing firms to conduct the review. Both introducing and correspondent firms are required to have supervisory systems reasonably designed to detect and prevent insider trading.
  - *Margin Accounts* – Some firms allowed customers to open margin accounts even though the customers did not meet the firms' standards for such accounts. FINRA also identified that some firms' systems of supervision were not reasonably designed to detect recommended margin account activity that appeared to be unsuitable and inconsistent with the cost and expense of margin use. Many firms' supervisory systems could not identify situations where the firm failed to accurately disclose their own—as well as their clearing firms'—fees, costs and charges relating to customers' use of margin.
  - *Options Accounts* – FINRA noted instances where some firms did not identify or prevent registered representatives from creating and canceling fictitious orders to circumvent sales limits; mismarking opening options transactions as “closing”; listing inaccurate receipt time, execution time and origin codes on tickets; failing to record purchases and time of order transmission for routed options orders in the firms' order management systems; and failing to show the terms or conditions of the order on tickets.

### Additional Resources

- ▶ [Regulatory Notice 10-19](#) (FINRA Reminds Firms of Responsibilities When Providing Customers with Consolidated Financial Account Reports)
- ▶ [New Account Application Template](#)
- ▶ [Supervision Topic Page](#)
- ▶ [Books and Records Topic Page](#)
- ▶ [Broker-Dealer – Written Supervisory Procedures Checklist](#)
- ▶ Supervision category of the [Peer-2-Peer Compliance Library](#)
- ▶ Customer Information category of the [Peer-2-Peer Compliance Library](#)

## Suitability<sup>2</sup>

### Regulatory Obligations

Currently, FINRA's suitability rule establishes obligations that are central to promoting ethical sales practices and high standards of professional conduct. FINRA Rule [2111](#) (Suitability) establishes three primary obligations for firms and their associated persons: (1) reasonable-basis suitability, (2) customer-specific suitability and (3) quantitative suitability.<sup>3</sup>

### Noteworthy Examination Findings

Some firms did not have adequate systems of supervision to review that recommendations were suitable in light of a customer's individual financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs and other investment profile factors. This report shares some new suitability-related findings, as well as additional nuances on prior years' findings.

- ▶ **Inadequate Supervision of Product Exchanges** – Some firms did not maintain a supervisory system reasonably designed to assess the suitability of recommendations that customers exchange certain products, such as mutual funds, variable annuities or unit investment trusts (UITs). In particular, some firms did not maintain blotters or other processes to identify patterns of unsuitable recommendations of exchanges involving long-term products.<sup>4</sup> Additionally, some firms did not reasonably supervise exchanges because they could not verify the information provided by registered representatives in their rationales to justify a recommended exchange, such as inaccurate descriptions of product fees, costs and existing product values. In other instances, firm supervision did not detect that the source of funds for a purchase was misrepresented (*i.e.*, as “new” money), when other account information revealed another likely source of funds (*e.g.*, funds from a liquidation of another financial product at the firm).
- ▶ **Limited Supervision to Identify “Red Flags” for Suitability** – Some firms' supervisory systems were not reasonably designed or used to detect red flags of possible unsuitable transactions. For example, some firms did not identify or question patterns of similar recommendations by representatives or branch offices across many customers with different risk profiles, time horizons and investment objectives. In some instances, several customers of a representative or branch office appeared to have made “unsolicited” transactions in identical securities, which could raise questions around whether the transactions were actually “unsolicited.”
- ▶ **Inadequate Supervision of Changes to Customer Account Information** – As discussed further in the Supervision section of this report, FINRA noted instances where registered representatives unilaterally changed account information, such as customers' income, net worth or account objectives. In many instances, the changes preceded or were contemporaneous with one or more transactions that, but for the account change, would have been subject to heightened supervisory scrutiny, raised suitability concerns or would not have been approved.
- ▶ **Limited Supervision of Trading Activity for Excessive Trading or Churning** – FINRA identified a variety of situations where supervisors failed to recognize when a pattern of transactions rendered the series of recommendations unsuitable. FINRA also noted that some firms did not adequately train supervisors how to use exception reports to identify red flags indicative of excessive trading. In other cases, some firms did not appropriately respond to and address red flags indicating excessive trading identified through their exception reports.<sup>5</sup>

- ▶ **Unsuitable Options Strategy Recommendations** – FINRA identified registered representatives recommending complex options strategies to customers who did not have the sophistication to understand the features of an option or the associated strategy, or without adequately considering the customers’ individual financial situations and needs, as well as other investment profile factors. Further, some firms did not implement trade limits and controls to identify and prevent options trading that exceeded customer pre-approved investment levels.

#### **Additional Resources**

- ▶ [2017 Report – Product Suitability](#)
- ▶ [2018 Report – Suitability for Retail Customers](#)
- ▶ [Regulatory Notice 18-13](#) (FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111)
- ▶ [Supervision Topic Page](#)
- ▶ [Suitability Topic Page](#)
- ▶ Customer Information category of the [Peer-2-Peer Compliance Library](#)

## Digital Communication

### Regulatory Obligations

Exchange Act Rules 17a-3 and 17a-4, as well as FINRA Rule [3110\(b\)\(4\)](#) (Review of Correspondence and Internal Communications) and FINRA Rule Series [4510](#) (Books and Records Requirements) require a firm to, among other things, create and preserve, in an easily accessible place, originals of all communications received and sent relating to its “business as such.” If a firm permits its associated persons to use a particular application—for example, an app-based messaging service or a collaboration platform—the firm must preserve records of business-related communications and supervise the activities and communications of those persons on the application. Firms remain responsible for conducting due diligence to comply with the securities laws and FINRA rules and follow up on red flags of potentially violative activity and may, in some cases, use services provided by the relevant digital channel or third-party vendors.

### Noteworthy Examination Findings

FINRA has noted that some firms encountered challenges complying with supervision and recordkeeping requirements for various digital communications tools, technologies and services (collectively, “digital channels”).

- ▶ **Use of Prohibited Digital Channels** – In some instances, firms prohibited the use of texting, messaging, social media or collaboration applications (*e.g.*, WhatsApp, WeChat, Facebook, Slack or HipChat) for business-related communication with customers, but did not maintain a process to reasonably identify and respond to red flags that registered representatives were using impermissible personal digital channel communications in connection with firm business. Red flags could be detected through, for example, customer complaints, representatives’ email, outside business activity reviews or advertising reviews.
- ▶ **Prohibited Electronic Sales Seminars** – Some registered representatives conducted “electronic sales seminars” in a chatroom or on digital channels that were not permitted by their firms and were outside of supervision or recordkeeping programs.

### Effective Practices

Firms implemented a number of effective practices to manage registered representatives’ use of digital channels.

- ▶ **Establishing Comprehensive Governance** – Some firms maintained governance processes to manage firm decisions and develop compliance processes for each new digital channel, as well as new features of existing channels. Such firms worked closely with their marketing, compliance and information technology departments, as well as their third-party vendors, to monitor the rapidly evolving array of communication methods available to their associated persons and customers.
- ▶ **Defining and Controlling Permissible Digital Channels** – Firms with holistic supervision and record retention programs and policies clearly defined permissible (as well as prohibited) digital channels; blocked prohibited digital channels (or prohibited features of permitted channels); restricted the use of messaging and collaboration apps that limit the firm’s ability to comply with its recordkeeping requirements (such as apps with end-to-end encryption or self-destructing messages); established how permitted communications will be stored in a compliant manner; and implemented supervisory review procedures for communication and recordkeeping that are appropriate for the firm’s business model and tailored to each digital channel.



- ▶ **Managing Video Content** – Some firms implemented WSPs to manage the lifecycle of video content, which could include, for example, live-streamed public appearances, scripted commercials or video blogs.
- ▶ **Training** – Some firms implemented mandatory training programs prior to providing registered representatives access to firm-approved digital channels. The training clarified the firms' expectations for business and personal digital communications, and assisted personnel with using all permitted features of each channel in a compliant manner.
- ▶ **Disciplining Misuse of Digital Communications** – Some firms temporarily suspended or permanently blocked from certain digital channels those registered representatives who did not comply with the firm's digital channel policies and required additional digital communications training.

#### **Additional Resources**

- ▶ *Regulatory Notice [19-31](#)* (Disclosure Innovations in Advertising and Other Communications with the Public)
- ▶ *Regulatory Notice [17-18](#)* (Guidance on Social Networking Websites and Business Communications)
- ▶ [Broker-Dealer Books and Records: New and Amended Recordkeeping Requirements Checklist](#)
- ▶ [Social Media Topic Page](#)
- ▶ [Books and Records Topic Page](#)

## Anti-Money Laundering (AML)

### Regulatory Obligations

The Bank Secrecy Act (BSA) requires firms to monitor for, detect and report suspicious activity to the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN). Further, FINRA Rule [3310](#) (Anti-Money Laundering Compliance Program) requires that members develop and implement a written AML program reasonably designed to comply with the requirements of the BSA and regulations promulgated thereunder. FINRA also notes that FinCEN's CDD rule requires that firms identify beneficial owners of legal entity customers, understand the nature and purpose of customer accounts, conduct ongoing monitoring of customer accounts to identify and report suspicious transactions, and—on a risk basis—update customer information.<sup>6</sup>

### Noteworthy Examination Findings

FINRA identified the following issues relating to firms' AML programs, including challenges with transaction monitoring systems.

- ▶ **Inadequate AML Transaction Monitoring** – FINRA noted deficiencies in the design and implementation of systems and processes to detect and report suspicious activity:
  - Some firms did not tailor their transaction monitoring to address the risk(s) relating to the firms' business (for example, some firms did not adjust their AML programs for new sources of revenue or higher-risk customers with increased levels of activity, and other firms relied on FINRA's AML resources without tailoring them to the firms' business);<sup>7</sup>
  - Deficient transaction monitoring for suspicious trading and possible related money-laundering activity, which may have been due to an ongoing misconception that securities trading does not need to be monitored for suspicious activity reporting purposes, or inadequate delegation of duties to a group outside of the AML department (*e.g.*, the securities trading desk). As a result, some firms failed to detect red flags such as market dominance, prearranged trading or instances where groups of seemingly unrelated accounts were working in concert to manipulate stock prices; and
  - Transaction monitoring processes that were not reasonably designed to identify and investigate red flags associated with third-party wire transfers, where such red flags might include transfer requests that are out of the ordinary for the customer or appear designed to deter verification of the transfer instructions.
- ▶ **Overreliance on Clearing Firms** – FINRA found that some introducing firms continued to rely primarily or entirely on their clearing firm for transaction monitoring and suspicious activity reporting. While clearing firm inquiries about certain customers or activities can be triggers for further review by introducing firms, introducing firms are required to monitor for suspicious activity attempted or conducted through the firm.<sup>8</sup>

### Additional Resources

- ▶ *Regulatory Notice [19-18](#)* (Guidance Regarding Suspicious Activity Monitoring and Reporting Obligations)
- ▶ [2017 Report – Anti-Money Laundering \(AML\) Compliance Program](#)
- ▶ [2018 Report – Anti-Money Laundering](#)
- ▶ [Anti-Money Laundering \(AML\) Template for Small Firms](#)
- ▶ [Frequently Asked Questions \(FAQ\) Regarding Anti-Money Laundering \(AML\)](#)
- ▶ [Anti-Money Laundering \(AML\) Topic Page](#)

## Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) Accounts

### Regulatory Obligations

FINRA Rule [2090](#) (Know Your Customer) requires member firms and their associated persons to use reasonable diligence to determine the “essential facts” about every customer and “the authority of each person acting on behalf of such customer.” *Regulatory Notice [11-02](#)* (SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations) advised that firms verify the essential facts about a customer “at intervals reasonably calculated to prevent and detect any mishandling of a customer’s account that might result from the customer’s change in circumstances.”

### Noteworthy Examination Findings

Generally, when UTMA or UGMA accounts (UTMA/UGMA Accounts) are established, the beneficiary (a minor) becomes the owner of the property at the time of the gift; however, the custodian manages and invests the property on the beneficiary’s behalf until the beneficiary reaches the age of majority, at which point the custodian is required to transfer the custodial property to the beneficiary.

FINRA noted that some firms did not establish, maintain or enforce a supervisory system reasonably designed to achieve compliance with their continuing obligation to know the essential facts of their UTMA/UGMA Account customers. Specifically, the circumstances concerning the authority of a person acting on behalf of a customer will change in UTMA/UGMA Accounts when the account beneficiary reaches the age of majority.

FINRA found that many firms were aware of the need to transfer responsibility for the account at a future date because they had policies and procedures addressing this topic, such as noting the date of majority when setting up the account. However, even though they were aware of the need to transfer the account at a future date, some firms did not take any steps to track or monitor when beneficiaries would reach the age of majority, while other firms had procedures for their registered representatives to follow, but did not require any supervisory oversight. Further, in some instances, firms permitted custodians to effect transactions in, and withdraw, journal and transfer money from UTMA/UGMA Accounts months, or even years, after the beneficiaries reached the age of majority, and ignored red flags of such activity (e.g., customer complaints relating to such transactions).

### Effective Practices

Some firms implemented a number of effective practices for verifying the authority of custodians of UTMA/UGMA Accounts.

- ▶ **Age of Majority** – Some firms maintained supervisory systems and used automated tools to track when each UTMA/UGMA Account beneficiary reached the age of majority.
- ▶ **Notification to Custodians** – Some firms issued letters or provided notifications to custodians to advise them that beneficiaries were approaching the age of majority and informed them about upcoming transfers of custodial property in their UTMA/UGMA Accounts, as well as any restrictions to the custodians’ trading authority after the beneficiaries reached the age of majority.
- ▶ **Notification to Registered Representatives** – Some firms maintained systems to provide registered representatives with automated alerts when beneficiaries reached the age of majority and required them to communicate with the custodian about the transfer of custodial property.

## FIRM OPERATIONS

### Observations on Cybersecurity

While many firms have made significant improvements in their cybersecurity programs, cybersecurity attacks continue to increase in both number and level of sophistication. FINRA notes that such attacks often take advantage of and highlight weaknesses in a firm's cybersecurity program. The observations and effective practices we share below can help firms strengthen their cybersecurity programs and may support compliance with the SEC's Regulation S-P, which requires firms to have policies and procedures addressing the protection of customer records and information.<sup>9</sup>

We encourage firms to strengthen their cybersecurity programs by taking advantage of FINRA publications and other resources identified below. FINRA recognizes that there is no one-size-fits-all approach to cybersecurity, and reminds firms to evaluate each of the controls described in this report and other FINRA resources in the context of their business model and risk profile.

Highlighted below are effective practices some firms have implemented to strengthen their cybersecurity risk-management programs.

- ▶ **Branch Controls** – Firms maintained branch-level written cybersecurity policies to protect confidential data. In addition, they implemented procedures to verify that branch office controls were implemented and functioning adequately, either via automated monitoring tools or during in-person branch inspections.
- ▶ **Documented Policies on Vendor and Third-Party Management** – Firms using third-party vendors that provide critical firm services or handle sensitive client information adopted, implemented, and documented formal policies and procedures to manage the lifecycle of the firm's engagement with the vendor (*i.e.*, from onboarding, to ongoing monitoring, through off-boarding, including defining how vendors will dispose of sensitive client information).
- ▶ **Incident Response Planning** – Firms established and regularly tested written formal incident response plans that outlined procedures they would follow when responding to cybersecurity and information security incidents. Firms also developed procedures relating to incident response plans, which included a mechanism to appropriately identify, classify, prioritize, track and close cybersecurity-related incidents.
- ▶ **Data Protection Controls** – Firms encrypted all confidential data, including sensitive customer information and firm information, whether stored internally or at vendors' locations.
- ▶ **System Patching** – Firms adopted procedures to implement timely application of system security patches to critical firm resources (*e.g.*, servers, network routers, desktops, laptops and software systems) to protect sensitive client or firm information.
- ▶ **Access Controls** – Firms implemented or maintained policies and procedures to grant system and data access only when required (often referred to as "Policy of Least Privilege") and removed such access when it was no longer needed (such as when individuals departed or changed roles at the firm). In addition, firms tracked (and monitored the activities of) individuals granted administrator access to data or systems. Further, firms implemented multi-factor or two-factor authentication controls for registered representatives, employees, vendors and contractors accessing firm systems and data from outside the organization.
- ▶ **Management of Asset Inventory** – Some firms created and kept current an inventory of critical information technology assets—including hardware, software and data—in home and branch offices. These inventories also included legacy assets that vendors no longer supported, as well as corresponding cybersecurity controls to protect those assets.

- ▶ **Data Loss Prevention Controls** – Certain firms implemented data loss prevention controls to protect a broad range of sensitive customer information in addition to Social Security numbers, such as other account profile information (*e.g.*, account numbers, dates of birth, bank information and driver's license numbers).
- ▶ **Training and Awareness** – Firms provided robust cybersecurity training for registered representatives, personnel, third-party providers and consultants. This training addressed key topics relevant to individuals' roles and responsibilities (*e.g.*, training on the various types of phishing emails that might be directed towards registered representatives' associates or home office staff in the human resources or finance departments, or training on secure software development practices for developers). Some firms determined the appropriate frequency of such training based on the cybersecurity risk exposure associated with the firm, as well as individuals' roles and responsibilities.
- ▶ **Change Management Processes** – Some firms implemented change management procedures to document, review, prioritize, test, approve, and manage hardware and software changes in order to protect sensitive information and firm services.

### Additional Resources

- ▶ [Report on Cybersecurity Practices – 2015](#)
- ▶ [Report on Selected Cybersecurity Practices – 2018](#)
- ▶ [2017 Report – Cybersecurity](#)
- ▶ [Small Firm Cybersecurity Checklist](#)
- ▶ [Core Cybersecurity Controls for Small Firms](#)
- ▶ [Customer Information Protection Topic Page](#)
- ▶ [Cybersecurity Topic Page](#)
- ▶ Cybersecurity category of the [Peer-2-Peer Compliance Library](#)
- ▶ [Non-FINRA Cybersecurity Resources](#)

## Business Continuity Plans (BCPs)

### Regulatory Obligations

FINRA Rule [4370](#) (Business Continuity Plans and Emergency Contact Information) requires firms to create and maintain a written BCP with procedures that are reasonably designed to enable firms to meet their obligations to customers, counterparties and other broker-dealers during an emergency or significant business disruption.<sup>10</sup> The rule also requires firms to review and update their BCPs, if necessary, in light of changes to firms' operations, structure, business or location. Further, although most introducing firms rely, to some extent, on their clearing firms to allow customers to access their accounts and enter transactions, they are responsible for compliance with the BCP rule.

### Noteworthy Examination Findings

FINRA found some firms encountering challenges where their BCPs did not reflect certain market conditions, business models or other circumstances.

- ▶ **Incomplete Mission-Critical Systems** – Some firms' BCPs did not identify all of their mission-critical systems. Omitted systems included those used for order management for trading desks, or vendor systems that processed and managed financing transactions, such as securities lending and repurchase agreements.
- ▶ **Insufficient Capacity** – Some larger firms did not have sufficient capacity to handle substantially increased call volumes and online activity during a business disruption, which affected customers' ability to access their accounts.
- ▶ **No Updates for Operational Changes** – Some firms did not update their BCPs after significant operational changes, such as outsourcing critical operational functions, relocating data centers or replacing other key systems, including trading desk order management systems or other systems that are critical to firms' business lines.
- ▶ **Outdated Contact Information** – Some firms' BCPs contained outdated emergency contact information and did not identify how customers could access their funds and securities during a business disruption.
- ▶ **Local Document Storage** – Some firms allowed employees to maintain critical working documents on their computers' local drives rather than requiring that they be stored on the firms' network. Firms should review their controls to test whether these files would be secure and readily accessible.
- ▶ **No Registered Principal Registrations** – Some senior management personnel, who were responsible for performing the annual BCP review, did not maintain the required registered principal registration.<sup>11</sup>

### Effective Practices

Firms implement a number of effective practices to fulfill their obligations under the rule, especially those relating to testing of their BCP plans.

- ▶ **Engaging in Annual Testing** – Firms tested their BCPs as part of their annual review to confirm that the BCP was updated, and to evaluate its effectiveness, especially with respect to the functioning of mission-critical systems and processes, availability of key personnel and access to physical contingency site location(s). As part of these tests, some firms assessed their remote access capabilities to such systems, as well as evaluated and documented their ability to failover from one server to another. Firms also included key vendors in their BCP tests and documented results from those tests.

- ▶ **Incorporating Test Results into Firm Training** – Firms found these tests can be a valuable tool, not only to identify weaknesses in their BCPs, but also to train staff on how to implement the program, should that become necessary.

#### **Additional Resources**

- ▶ *Regulatory Notice [19-06](#)* (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rule on Business Continuity Plans and Emergency Contact Information)
- ▶ *Regulatory Notice [19-15](#)* (FINRA Publishes Consolidated Criteria to Designate Firms for Mandatory Participation in FINRA’s Business Continuity/Disaster Recovery Testing)
- ▶ [Business Continuity Plan FAQs](#)
- ▶ [Small Firm Business Continuity Plan Template](#)
- ▶ [Business Continuity Planning Topic Page](#)

## Fixed Income Mark-up Disclosure

### Regulatory Obligations

FINRA's and the Municipal Securities Rulemaking Board's (MSRB) amendments to FINRA Rule [2232](#) (Customer Confirmations) and MSRB Rule [G-15](#) require firms to provide additional transaction-related pricing information to retail customers for certain trades in corporate, agency and municipal debt securities (other than municipal fund securities).<sup>12</sup>

### Noteworthy Examination Findings

FINRA identified many of the issues previously discussed in the [Fixed Income Mark-up Disclosure](#) section of the [2018](#) Report, as well as the following additional issues.

- ▶ **Excluding Charges from Mark-Up/Mark-Down Disclosure** – Some firms disclosed additional charges separately from disclosed mark-ups or mark-downs, even when such charges reflected firm compensation. Firm compensation should not be mischaracterized, for example, as miscellaneous or fixed transaction fees; it should instead be included in the reported price of the transaction and accounted for when calculating mark-ups and mark-downs, consistent with applicable rules and guidance.<sup>13</sup>
- ▶ **Unclear or Inaccurate Labels for Sales Credits or Concessions** – Some firms disclosed registered representatives' sales credits or concessions as separate line items on confirmations, in addition to the mark-up or mark-down, without clear and accurate labeling, creating confusion about the actual disclosed mark-up and therefore diminishing its utility.<sup>14</sup> Similarly, some firms inaccurately labeled only the sales credits or concessions portion as the total mark-up or mark-down.
- ▶ **Incorrect Prevailing Market Price (PMP) Determinations** – Some firms did not determine the PMP as set forth in FINRA Rule [2121.02\(b\)](#) (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities) for their fixed income transactions. Some firms' PMP determinations did not presumptively rely on the dealer's contemporaneous cost or proceeds, as required by Rule [2121](#). Other firms decided that their cost or proceeds were no longer "contemporaneous" without sufficient evidence as required by Rule [2121.02\(b\)\(4\)](#) and used other pricing information to determine the PMP.
- ▶ **Inaccurate Time of Execution** – Some firms disclosed times of execution on customer confirmations that did not match the times of execution disseminated by the Electronic Municipal Market Access system (EMMA) or Trade Reporting and Compliance Engine (TRACE).<sup>15</sup> The time of execution on confirmations must match the trade times disseminated by EMMA and TRACE to allow customers to identify their specific transactions, consistent with the intent of the disclosure requirement.

### Additional Resources

- ▶ [Regulatory Notice 17-24](#) (FINRA Issues Guidance on the Enhanced Confirmation Disclosure Requirements in Rule 2232 for Corporate and Agency Securities)
- ▶ [Report Center](#) – FINRA's MSRB Markup/Markdown Analysis Report
- ▶ [Report Center](#) – FINRA's TRACE Markup/Markdown Analysis Report
- ▶ [Fixed Income Confirmation Disclosure: Frequently Asked Questions \(FAQ\)](#)
- ▶ [Municipal Securities Topic Page](#)
- ▶ [Fixed Income Topic Page](#)



## MARKET INTEGRITY

### Best Execution

#### Regulatory Obligations

FINRA Rule [5310](#) (Best Execution and Interpositioning) requires firms to conduct a “regular and rigorous” review of the execution quality of customer orders if the firm does not conduct an order-by-order review.<sup>16</sup> Where “regular and rigorous” reviews are used instead of order-by-order reviews, the reviews must be performed at a minimum on a quarterly basis and on a security-by-security, type-of-order basis (e.g., limit order, market order and market on open order). If a firm identifies any material differences in execution quality among the markets that trade the securities under review, it must modify its routing arrangements or justify why it is not doing so.

#### Noteworthy Examination Findings

FINRA continued to identify issues with some firms’ execution quality reviews, as well as conflicts of interest and related disclosures.

- ▶ **No Execution Quality Assessment of Competing Markets** – Some firms did not compare the quality of the execution of their existing order routing and execution arrangements against the quality of executions that the firm could have obtained from competing venues.
- ▶ **No Review of Certain Order Types** – In some instances, firms did not conduct adequate reviews on a type-of-order basis, including, for example, on market, marketable limit or non-marketable limit orders.
- ▶ **No Evaluation of Required Factors** – Some firms did not consider factors set forth in FINRA Rule [5310](#) (Best Execution and Interpositioning) when conducting their execution quality reviews, including, among other things, the speed of execution, price improvement opportunities and the likelihood of execution of limit orders.
- ▶ **Conflicts of Interest** – Some firms did not adequately consider and address potential conflicts of interest relating to their routing of orders to affiliated alternative trading systems (ATSS) or market centers that provide payment for order flow or other routing inducements. In addition, some firms continue to route significant portions of their order flow to such venues without conducting an adequate “regular and rigorous” review to support such routing decisions.
- ▶ **Inadequate SEC Rule 606 Disclosures** – Some firms did not provide adequate information in the material disclosures section of their order routing reports required by Rule 606 of Regulation NMS. For example, certain firms did not disclose, when required, the specific, material aspects of the non-directed order flow routed to their own trading desk, including that the firm stands to share in 100 percent of the profits generated by the firm’s trading as principal with its customers’ orders.<sup>17</sup> Other firms did not disclose material aspects of their relationships with each of the significant venues identified on their reports, including descriptions and terms of all arrangements for payment for order flow (including the amounts of payment for order flow on a per share or per order basis)<sup>18</sup> and profit-sharing relationships that may have influenced the firms’ order routing decisions.

#### Additional Resources

- ▶ [2017 Report – Best Execution](#)
- ▶ [2018 Report – Best Execution](#)
- ▶ [Regulatory Notice 15-46](#) (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets)
- ▶ [Report Center, Equity Report Cards](#) section – FINRA’s Best Execution Outside-of-the-Inside Report Card

## Direct Market Access Controls

### Regulatory Obligations

Compliance with Exchange Act Rule 15c3-5 (Market Access Rule) requires firms that provide access to trading in securities on an exchange or ATS to incorporate appropriate controls to mitigate key risks. The Market Access Rule is particularly important with the continued increase in automated and high-speed trading.

### Noteworthy Examination Findings

FINRA continued to find many of the same issues identified in the Market Access Controls sections of the [2017](#) and [2018](#) Reports, as well as additional challenges with certain other market access controls, especially those related to fixed income transactions.

- ▶ **Insufficient Controls and WSPs** – Some firms’ risk management controls and WSPs did not include pre-trade order limits, pre-set capital thresholds and duplicative and erroneous order controls for accessing ATSs, especially for fixed income transactions.
- ▶ **Inadequate Financial Risk Management Controls** – In some instances, firms with market access, or those that provide it, did not establish appropriate capital thresholds for trading desks, aggregate daily limits, or credit limits on institutional customers and counterparties. In some instances, firms with market access, or those that provide it, did not have reasonably designed risk-management controls or WSPs to manage the financial, regulatory or other risks associated with this business activity. Firms should regularly assess the appropriateness of their capital thresholds and pre-set credit limits for each customer.
- ▶ **Inadequate Basis for CEO Certification** – Some firms did not maintain reasonably designed risk-management controls that could support the CEO’s certification pursuant to the requirements of Exchange Act Rule 15c3-5(e)(2).
- ▶ **Inaccurate Intra-day (Ad Hoc) Adjustments** – FINRA identified weaknesses in some firms’ processes for requesting, approving, reviewing and documenting ad hoc credit threshold increases. For example, institutional clients requested ad hoc (daily) adjustments to financial limits in anticipation of increased order activity related to events such as an index rebalancing or a public offering, but once the event concluded (typically the next trading day), firms did not return the limits to their original values. Some firms maintained a manual process for reverting limits to their original values or did not revert the elevated credit limits in a timely fashion, which exposed clients and firms to elevated levels of financial risk.
- ▶ **Ineffective Erroneous Trading Controls** – Some firms failed to implement adequate controls relating to duplicative and erroneous orders. For example, some firms set controls to prevent the routing of a market order based on impact (Average Daily Volume Control) at unreasonable levels, preventing such firms from blocking erroneous trades. These controls can be effective tools (particularly in thinly traded securities) when set at reasonably high levels, and firms should calibrate them to reflect, among other things, the characteristics of the relevant securities, the business of the firm, and market conditions.
- ▶ **Insufficient Post-Trade Controls and Surveillance** – Some firms that provide direct market access via multiple systems, including sponsored access arrangements, did not employ reasonable controls to confirm that those systems’ records were aggregated and integrated in a timely manner. As a result, those firms were not able to successfully conduct holistic post-trade and supervisory reviews for, among other things, potential manipulative trading patterns.

### Additional Resources

- ▶ *Regulatory Notice [15-09](#)* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)
- ▶ *Regulatory Notice [16-21](#)* (SEC Approves Rule to Require Registration of Associated Persons Involved in the Design, Development or Significant Modification of Algorithmic Trading Strategies)
- ▶ [Algorithmic Trading Topic Page](#)
- ▶ [Market Access Topic Page](#)

## Short Sales

### Regulatory Obligations

Regulation SHO Rules 200 to 204 require firms to address risks relating to market manipulation, market liquidity and investor confidence by regulating excessive and “naked” short sales so that purchasers of securities from short sellers receive their securities positions in a timely manner. Regulation SHO requires firms to appropriately mark their securities orders; confirm that they have deliverable securities to complete short sale transactions; and have a process to close-out fails to deliver within the required timeframes.

### Noteworthy Examination Findings

In addition to the findings FINRA shared in the [Regulation SHO](#) section of the [2017](#) Report, we found some firms were not able to satisfy the Continuous Net Settlement (CNS) System fail-to-deliver close-out requirements pursuant to Rule 204 because they did not implement a sufficient process to age fails, resulting in fails not being closed out timely. In other instances, firms did not accurately allocate CNS fails to correspondents. For example, some firms faced challenges relating to both inaccurate calculation of pre-fail credits prior to allocating fails to the correspondent, and used inconsistent methods when allocating fails to the correspondents where the share quantities exceeded the CNS fails.

In addition, firms may consider as an effective practice to periodically review their policies relating to rates charged for borrowing, sourcing or locating securities in connection with short sales, including monitoring the aging of short positions and determining whether the rates assigned at the onset of those positions are still appropriate.

## FINANCIAL MANAGEMENT

### Observations on Liquidity and Credit Risk Management

Effective liquidity and credit risk management controls are critical elements in a broker-dealer's risk management framework, and should be documented in a firm's books and records.<sup>19</sup> FINRA routinely reviews firms' practices in these areas, and in *Regulatory Notice 15-33* (Guidance on Liquidity Risk Management Practices) shared observations on liquidity management practices.

FINRA shares the following practices that some firms used to strengthen their liquidity management programs.

- ▶ **Liquidity Contingency Plans** – Small clearing and introducing firms developed contingency plans for operating in a stressed environment and outlined specific steps to address certain stress conditions. Further, firms' contingency plans identified the firm staff responsible for enacting the plan, the process for accessing liquidity during a stress event or standards to determine how liquidity funding would be used.
- ▶ **Liquidity Risk Management Updates** – Firms updated their liquidity risk management practices to take into account their current business activities.
- ▶ **Stress Tests** – Firms conducted stress tests in a manner and frequency that was appropriate for their business model. In addition, such stress tests evaluated the potential impact of off-balance sheet items on liquidity. Some firms that relied on a shared funding source with affiliated entities for their liquidity stress test and their shared Master Credit Agreement confirmed that source would be ring-fenced for them during a stress event.
- ▶ **Credit Risk Management** – Firms maintained a robust internal control framework to capture, measure, aggregate, manage and report credit risk.<sup>20</sup> In particular, firms evaluated their risk management and control processes to review whether they were accurately capturing their exposure to credit risk; maintained approval and documentation processes for increases or other changes to assigned credit limits; and monitored exposure to their affiliated counterparties.

### Additional Resources

- ▶ [2018 Report – Liquidity](#)
- ▶ [Regulatory Notice 10-57](#) (Funding and Liquidity Risk Management Practices)
- ▶ [Funding and Liquidity Topic Page](#)

## Segregation of Client Assets

### Regulatory Obligations

Exchange Act Rule 15c3-3 (Customer Protection Rule) requires firms that maintain custody of customer securities and safeguard customer cash to segregate these assets from the firm's proprietary business.

### Noteworthy Examination Findings

FINRA has continued to identify many of the same concerns noted in the [Segregation of Client Assets](#) section of the [2018](#) Report, including challenges with check-forwarding and possession or control.

- ▶ **Omitted or Inaccurate Blotter Information** – Some firms' blotters lacked sufficient information to demonstrate that checks were forwarded in a timely manner or contained inaccurate information with respect to the status of checks.
- ▶ **Inadequate Possession or Control Processes** – FINRA noted the following deficiencies:
  - Failure to obtain documentation (no lien letters) from custodians and issuers to show that all securities in a good control location were free of liens that could be exercised by a third party on the firm;
  - Inability to identify deficits in fully paid and excess margin securities when certain firms did not correctly age the deficits due to errors in their formulas;
  - Failure to confirm that fully paid securities were correctly segregated at custodian banks (FINRA notes that firms should consider verifying whether they have sufficient securities positions that exceed possession or control requirements prior to transferring such excess securities from a custodial account); and
  - Failure to combine balances and positions in related customer securities accounts and accounts with the same Taxpayer Identification Numbers in order to determine the extent to which the market value of securities carried for the customer's account exceeded 140 percent of the customer's debit balance.
- ▶ **Inaccurate Reserve Formula Calculations** – Some firms did not exclude concentrated margin debit balances<sup>21</sup> because they did not have a process to identify accounts under common control or related customer accounts.
- ▶ **Coding Errors** – FINRA noted joint customer and firm officer accounts miscoded as "non-customer" rather than "customer." Some firms also coded foreign bank accounts as "PAB" without obtaining a written agreement acknowledging that the accounts are proprietary transactions of the foreign bank.<sup>22</sup>

### Additional Resources

- ▶ [Interpretations of Financial and Operational Rules](#)
- ▶ [Customer Protection – Reserves and Custody of Securities \(SEA Rule 15c3-3\)](#)

## Net Capital Calculations

### Regulatory Obligations

Exchange Act Rule 15c3-1 (Net Capital Rule) requires firms to maintain net capital at specific levels to protect customers and creditors from monetary losses that can occur when firms fail.

### Noteworthy Examination Findings

FINRA has continued to identify some of the same concerns noted in the [Net Capital and Credit Risk Assessments](#) section of the [2017](#) Report and [Accuracy of Net Capital Calculations](#) section of the [2018](#) Report, as well as the following additional issues.

- ▶ **Incorrect Inventory Haircuts** – Some firms did not apply correct haircut charges when computing net capital because they did not adequately assess and monitor the creditworthiness of fixed income securities, such as corporate debt and collateralized mortgage obligations (CMOs), to determine whether these products have a “minimal amount of creditworthiness” pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(I).<sup>23</sup>
- ▶ **Incorrect Capital Charges for Underwriting Commitments** – Some firms did not maintain an adequate process to assess moment-to-moment and open contractual commitment capital charges on underwriting commitments and did not understand their role as it pertained to the underwriting (*i.e.*, best efforts or firm commitment).<sup>24</sup>
- ▶ **Inaccurate Classification of Receivables, Liabilities and Revenue** – In some instances, firms inaccurately classified receivables, liabilities and revenues, which resulted in inaccurate reporting of a firm’s financial position and, in some instances, a capital deficiency. In addition, upon settlement of a customer claim, some firms understated their liability by recognizing the monies due to the customer based on a payment schedule instead of recognizing the full amount owed at the time of settlement.
- ▶ **Recognition of Insurance Claims** – Some firms did not recognize on their books and records receivables due from insurance carriers and the corresponding liabilities owed to customers. Other firms did not obtain an opinion of counsel with respect to claims within seven business days, as required under Exchange Act Rule 15c3-1(c)(2)(iv)(D), thereby resulting in the receivables not being allowable for purposes of net capital, and the firm being required to take the full charge for the customer claim.
- ▶ **Inadequate Documentation of Methodology for Expense-Sharing Agreements** – Some firms did not maintain sufficient documentation to substantiate their methodology for allocating specific broker-dealer costs to the firm or an affiliate. Some firms were not accurately accruing expenses—such as technology fees, marketing charges, retirement account administrative fees and employees’ compensation—on their books and records. Further, some firms incorrectly netted intercompany accounts with different affiliated entities,<sup>25</sup> resulting in books and records that did not accurately reflect the firms’ operating performance and financial condition.

### Additional Resources

- ▶ [Interpretations of Financial and Operational Rules](#)
- ▶ [Notice to Members 03-63](#) (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers)

## ENDNOTES

1. See *Regulatory Notice 10-19* (FINRA Reminds Firms of Responsibilities When Providing Customers with Consolidated Financial Account Reports).
2. On June 5, 2019, the SEC voted to adopt a package of rulemakings and guidance, including Regulation Best Interest (Reg BI). This section is intended to provide firms with findings solely related to compliance with existing FINRA suitability and related supervisory obligations and does not address Reg BI. For additional information, please see FINRA's [Topic Page on SEC Regulation Best Interest \(Reg BI\)](#).
3. In addition to the items discussed in this document, FINRA reminds firms to consider the findings FINRA shared previously regarding [overconcentration in illiquid securities](#), [reasonable due diligence for private placements](#) and certain [variable annuity exchanges](#).
4. See FINRA Rule [2330\(d\)](#) (Members' Responsibilities Regarding Deferred Variable Annuities).
5. FINRA continued to note many of the challenges we discussed in the [Abuse of Authority](#) section of the [2018](#) Report, including registered representatives engaging in discretionary trading without written authorization.
6. See *Regulatory Notices 17-40* (FINRA Provides Guidance to Firms Regarding Anti-Money Laundering Program Requirements Under FINRA Rule 3310 Following Adopting of FinCEN's Final Rule to Enhance Customer Due Diligence Requirements For Financial Institutions) and [18-19](#) (FINRA Amends Rule 3310 to Conform to FinCEN's Final Rule on Customer Due Diligence Requirements for Financial Institutions) for additional information.
7. See *Regulatory Notice 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations) for a list of potential red flags that firms should consider when designing an effective AML compliance program that is tailored to their business.
8. See [Frequently Asked Questions \(FAQ\) Regarding Anti-Money Laundering \(AML\)](#), Question No. 22.
9. This obligation includes protection against any anticipated threats or hazards to the security or integrity of customer records and information, as well as unauthorized access to or use of such records or information. Also, the rule requires firms to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their rights.
10. Pursuant to *Regulatory Notice 19-06* (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rule on Business Continuity Plans and Emergency Contact Information), FINRA is conducting a retrospective review of Rule [4370](#). This section is intended to provide firms with findings solely relating to compliance with existing Rule [4370](#) and does not address the outcome of that review or any potential revisions to the rule.
11. See FINRA Rule [4370\(d\)](#).
12. Specifically, the amendments require firms to disclose the mark-up or mark-down for principal trades with retail customers that a firm offsets on the same day with other principal trades in the same security. Disclosed mark-ups and mark-downs must be expressed as both a total dollar amount for the transaction and a percentage of PMP. In addition, for all retail customer trades in corporate, agency and municipal debt securities (other than municipal fund securities), firms must disclose on the confirmation the time of execution and a security-specific link to the FINRA or MSRB website where additional information about the transaction is available, along with a brief description of the information available on the website.
13. See, e.g., [Frequently Asked Questions \(FAQ\) About the Trade Reporting and Compliance Engine \(TRACE\) FAQ 3.1.33](#) (stating that prices reported to TRACE should be inclusive of mark-ups and mark-downs).
14. See FINRA [Fixed Income Confirmation Disclosure: Frequently Asked Questions \(FAQ\)](#), FAQ 2.3 and MSRB [Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions](#), FAQ 2.3.
15. See FINRA [Fixed Income Confirmation Disclosure: Frequently Asked Questions \(FAQ\)](#), FAQ 4.2; MSRB [Confirmation Disclosure and Prevailing Market Price: Frequently Asked Questions](#), FAQ 4.2.
16. See also *Regulatory Notice 15-46* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets).
17. See U.S. Securities and Exchange Commission, Division of Market Regulation: Staff Legal Bulletin No. 13A Frequently Asked Question about Rule 11Ac1-6, Question 14: Disclosing Internalized Order Flow.
18. See U.S. Securities and Exchange Commission, Division of Market Regulation: Staff Legal Bulletin No. 13A Frequently Asked Question about Rule 11Ac1-6, Question 13: Disclosing Payment for Order Flow.
19. See Exchange Act Rule 17a-3(a)(23).
20. See Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 (July 30, 2013), 78 Fed. Reg. 51824 (Aug. 21, 2013), at 51848; see also FINRA's [Resource Page for the SEC's July 2013 Financial Responsibility Rule Amendments](#).
21. See the SEC's Note E(5) to Exhibit A of SEA Rule 15c3-3 and the associated interpretation, [Determination of the Includible Amount of a Customer's Concentrated Margin Debit Balance in the Reserve Formula](#), Exchange Act Rule 15c3-3, Exhibit A - Note E(5)/01, in the Interpretations of Financial and Operational Rules.
22. Regarding foreign banks, see [Foreign Banks - Customer and Non-Customer Classification](#), Exchange Act Rule 15c3-3(a)(1)/032, in the Interpretations of Financial and Operational Rules.
23. These requirements were adopted as part of the SEC's 2013 credit ratings amendments. See Exchange Act Release No. 71194 (Dec. 27, 2013), 79 Fed. Reg. 1522 (Jan. 8, 2014).
24. See Exchange Act Rule 15c3-1(c)(2)(viii); see also [Moment Net Capital](#), Exchange Act Rule 15c3-1(a)(1)/001, in the Interpretations of Financial and Operational Rules.
25. See [Netting of Intercompany Receivables and Payables with Affiliates](#), Exchange Act Rule 15c3-1(c)(2)(iv)(C)/073 in the Interpretations of Financial and Operational Rules.



# 2020 Risk Monitoring and Examination Priorities Letter

January 2020

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## Introduction

This 2020 Risk Monitoring and Examination Priorities Letter describes the areas of focus for FINRA's risk monitoring, surveillance and examination programs in the coming year. Continuing the approach we started in 2019, the letter addresses new and emerging areas in greater depth, and ongoing priorities with shorter summaries. (Information on the latter is available in previous [annual priorities letters](#).)

In addition, we recognize the significant efforts that firms make to comply with federal securities laws and regulations, as well as FINRA rules. To support firms in this important endeavor, the letter includes a list of practical considerations and questions for each of the highlighted topics, which firms may use to evaluate the state of their compliance, supervisory and risk management programs. These considerations are not all-inclusive, may not apply to all firms, and should not be read to create obligations beyond those in federal securities laws and regulations and FINRA rules.

We also encourage firms to avail themselves of the resources offered in the endnotes and the appendix to refresh their understanding of their fundamental compliance obligations.

## Sales Practice and Supervision

### Introduction

FINRA will continue to evaluate firms' compliance with sales practice obligations to their customers—as well as the supervision of those practices—in areas that we have discussed frequently in previous annual priorities letters, exam findings reports (Reports) and other FINRA publications. These areas of focus include complex products,<sup>1</sup> variable annuities,<sup>2</sup> private placements,<sup>3</sup> fixed income mark-up/mark-down disclosures,<sup>4</sup> representatives acting in certain positions of trust or authority<sup>5</sup> and senior investors.<sup>6</sup> In addition to these topics, FINRA will review firms' compliance with obligations related to several new or emerging areas discussed below.

### Regulation Best Interest (Reg BI) and Form CRS

On June 5, 2019, the U.S. Securities and Exchange Commission (SEC) adopted Reg BI, which establishes a “best interest” standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer

of any securities transaction or investment strategy involving securities, including recommendations of types of accounts. As part of the rulemaking package, the SEC also adopted new rules and forms to require broker-dealers to provide a brief relationship summary—Form CRS—to retail investors. Firms must comply with Reg BI and Form CRS by June 30, 2020.

In the first part of the year, FINRA will review firms' preparedness for Reg BI to gain an understanding of implementation challenges they face and, after the compliance date, will examine firms' compliance with Reg BI, Form CRS and related SEC guidance and interpretations.<sup>7</sup> FINRA staff expects to work with SEC staff to ensure consistency in examining broker-dealers and their associated persons for compliance with Reg BI and Form CRS.

FINRA may take the following factors, among others,<sup>8</sup> into consideration when reviewing for compliance with Reg BI after June 30, 2020:

- ▶ Does your firm have procedures and training in place to assess recommendations using a best interest standard?
- ▶ Do your firm and your associated persons apply a best interest standard to recommendations of types of accounts?
- ▶ If your firm and your associated persons agree to provide account monitoring, do you apply the best interest standard to both explicit and implicit hold recommendations?
- ▶ Do your firm and your associated persons consider the express new elements of care, skill and costs when making recommendations to retail customers?
- ▶ Do your firm and your associated persons consider reasonably available alternatives to the recommendation?
- ▶ Do your firm and your registered representatives guard against excessive trading, irrespective of whether the broker-dealer or associated person "controls" the account?
- ▶ Does your firm have policies and procedures to provide the disclosures required by Reg BI?
- ▶ Does your firm have policies and procedures to identify and address conflicts of interest?
- ▶ Does your firm have policies and procedures in place regarding the filing, updating and delivery of Form CRS?

### **Communications with the Public**

FINRA will continue to assess firms' compliance with obligations relating to FINRA Rule [2210](#) (Communications with the Public), as well as related supervisory and recordkeeping requirements set forth in FINRA Rule [3110\(b\)\(4\)](#) (Supervision), FINRA Rule Series [4510](#) (Books and Records Requirements) and Securities Exchange Act of 1934 (Exchange Act) Rules 17a-3 and 17a-4 (Books and Records Requirements).

In addition to ongoing reviews for compliance with these core obligations, FINRA will also focus on the following two areas:

- ▶ **Private Placement Retail Communications** – FINRA will review how firms review, approve, supervise and distribute retail communications regarding private placement securities via online distribution platforms<sup>9</sup>, as well as traditional channels.

When reviewing a firm’s communication materials, FINRA may consider the following:

- Do they omit material information necessary to make the communications fair and not misleading by failing to, for example, explain that private placements may involve a high degree of risk, are not liquid and that investors may lose money?
  - Do they balance promotional content with the key risks specific to the issuer offered?
  - Do they contain false, misleading or promissory statements or claims, such as the likelihood of a future public offering of the issuer, claims about the future success of the issuer’s new or untried business model, or inaccurate or misleading assertions concerning the regulation or relative risk of the offering?
  - When forecasting issuer metrics, such as revenue, are the presentations reasonable and accompanied by clear explanations of both the assumptions used to create the forecasts and the risks that might impede achievement of such forecasts?
  - Do they contain predictions or projections of investment performance to investors that are generally prohibited by FINRA Rule [2210\(d\)\(1\)\(F\)](#) (Communications with the Public), unless they meet the stated criteria in the rule?
- ▶ **Communications via Digital Channels** – Firms’, registered representatives’ and customers’ use of an increasingly broad array of digital communication channels (e.g., texting, messaging, social media or collaboration applications) may pose challenges to firms’ ability to comply with obligations related to the review and retention of such communications.

FINRA may consider the following, among other factors, when reviewing firms’ use and supervision of digital channels:

- Does your firm have a process in place to evaluate new tools available to your registered representatives to determine whether there are digital communication channels that should be captured, included in your firm’s routine electronic communications supervisory reviews and stored in accordance with books and records requirements?
- Is your firm periodically testing its systems to ensure these communications are being captured for review and retention?
- Do your firm’s supervisors know the “red flags” they should keep in mind during their routine supervisory reviews and which indicate a registered representative may be communicating through unapproved communication channels? Are your firm’s supervisors following up on such red flags, which include, but are not limited to:
  - email chains that include non-approved email addresses for registered representatives;

- references in emails to communications with a registered representative that occurred outside approved firm channels; or
- customer complaints mentioning such communications?<sup>10</sup>

### **Cash Management and Bank Sweep Programs**

As commission practices change, cash management services that sweep investor cash into firms' affiliated or partner banks or money market funds (Bank Sweep Programs) have taken on a greater significance. Firms' Bank Sweep Programs may offer retail investors a variety of additional services, such as check writing, debit cards and ATM withdrawals.

While these Bank Sweep Programs may offer useful features to customers—and in some but not all cases, offer higher-than-average interest rates—they have also raised several concerns about firms' compliance with a range of FINRA and SEC rules. FINRA will evaluate these firms' compliance with, for example, FINRA Rules [1017](#) (Application for Approval of Change in Ownership, Control, or Business Operations),<sup>11</sup> [2010](#) (Standards of Commercial Honor and Principles of Trade), [2210](#) (Communications with the Public), Exchange Act Rule 15c3-1 (Net Capital Rule) and Exchange Act Rule 15c3-5 (Customer Protection Rule).

FINRA may take the following factors, among others, into consideration when reviewing your firm's Bank Sweep Programs:

- ▶ Does your firm clearly communicate the nature of the sweep arrangement?
- ▶ Does your firm clearly communicate the alternatives for cash management available to customers, the terms provided by the Bank Sweep Program and any alternatives?
- ▶ Has your firm incorrectly implied that a brokerage account is similar to or the same as a "checking and savings account" at a bank?
- ▶ Has your firm incorrectly implied that the brokerage accounts themselves are bank deposit accounts insured by the Federal Deposit Insurance Corporation (FDIC)?
- ▶ Do your firm's customer statements clearly disclose that the Bank Sweep Program deposits are obligations of the destination bank, and not cash balances held by your firm?
- ▶ Does your firm have a documented process to perform reconciliations of customer balances held at each destination bank in the Bank Sweep Program?
- ▶ Does your firm include in the Bank Sweep Program customer balances not yet swept into a destination bank as a customer credit in the reserve formula computation?
- ▶ Has your firm omitted or misrepresented material information concerning the:
  - amount of FDIC insurance coverage for the deposits;
  - nature and structure of the accounts;
  - relationship of the brokerage accounts to any partner banks in the Bank Sweep Program;
  - amount of time it may take for customer funds to reach the bank accounts;
  - nature and terms of the arrangements; or
  - risks of participating in such programs?

## Sales of Initial Public Offering (IPO) Shares

As the IPO market has grown and received additional attention over the past year, FINRA is focusing its attention on firms' obligations under FINRA Rules [5130](#) (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and [5131](#) (New Issue Allocations and Distributions).<sup>12</sup>

FINRA may consider the following factors, among others, when reviewing your firm's IPO practices:

- ▶ Does your firm have procedures in place to detect and address potential instances of flipping?
- ▶ When acting as book-running lead manager, does your firm provide reports of aggregate retail demand to issuers' pricing committees? How does your firm calculate this aggregate demand?
- ▶ How does your firm develop and implement its IPO allocation methodologies?
- ▶ What controls does your firm have to prevent allocations to restricted persons?
- ▶ What controls does your firm have to detect and address potential instances of "spinning"?
- ▶ How does your firm obtain, record and verify customer information for individuals receiving IPO allocations?

## Trading Authorization

FINRA will assess whether firms maintain reasonably designed supervisory systems relating to trading authorization, discretionary accounts and key transaction descriptors, such as solicitation indicators. FINRA will review whether firms have reasonably designed supervisory systems to detect and address registered representatives exercising discretion without written authorization from the client, as required under FINRA Rule [3260](#) (Discretionary Accounts).<sup>13</sup>

FINRA may take the following factors, among others, into consideration when reviewing your firm's procedures and controls:

- ▶ How does your firm surveil for potential red flags of registered representatives exercising discretion without written authorization?
- ▶ Do your firm's supervisors know the types of red flags that may indicate that registered representatives are exercising discretion without written authorization (*e.g.*, trading in unrelated accounts in the same security in a certain time period, large numbers of trade reneges in the same security in a certain time period)?
- ▶ If a red flag is identified, what follow-up steps do your supervisors take to investigate them further (*e.g.*, phone log, email or other digital communication reviews to look for evidence of communications between the customer and the registered representative; non-complaining customer reach-outs)?
- ▶ How does your firm identify instances where registered representatives may be marking trades as unsolicited even though they are, in fact, solicited?

## Market Integrity

### Introduction

In addition to the areas of focus described in greater detail below, we will continue to review firms' compliance with the ongoing obligations discussed in prior years' letters, such as market manipulation, Trade Reporting and Compliance Engine (TRACE) reporting,<sup>14</sup> short sales<sup>15</sup> and short tenders.<sup>16</sup>

Further, FINRA reminds certain firms that they will be required to begin reporting to the Consolidated Audit Trail (CAT) in April 2020. We will continue to work with firms to answer their questions as they prepare for reporting. Once reporting begins, we will initiate our surveillance and investigative program to review firms' compliance with CAT reporting requirements.

We also remind firms to continue devoting necessary resources to ensure continually high levels of accuracy in their Order Audit Trail System (OATS) reporting. At this time, OATS remains a critical part of the audit trail data that FINRA uses to operate its cross-market equity surveillance program and meet its regulatory obligations.

### Direct Market Access Controls

The continued growth in automated and high-speed trading increases potential risks to the financial condition of firms, the integrity of trading on the securities markets and the stability of the financial system. We will assess firms' compliance with Exchange Act Rule 15c3-5 (Market Access Rule),<sup>17</sup> focusing on issues relevant to firms' business activities and associated risks.

FINRA may take the following factors, among others, into consideration when reviewing your firm's direct market access controls:

- ▶ If your firm is highly automated, how does it manage and deploy technology changes for systems associated with market access, and what controls does it use, such as kill switches, to monitor and respond to aberrant behavior by trading algorithms or other impactful market wide events?
- ▶ How does your firm make adjustments to credit limit thresholds for institutional customers (whether temporary or permanent)?<sup>18</sup>
- ▶ Does your firm use any automated controls to timely revert *ad hoc* credit limit adjustments?
- ▶ If your firm uses third-party vendor tools to comply with its Market Access Rule obligations, does it review during vendor due diligence whether the vendor can meet the obligations of the rule, and how does your firm maintain direct and exclusive control of applicable thresholds?
- ▶ What type of training does your firm provide to individual traders regarding the steps and requirements for requesting *ad hoc* credit limit adjustments?



## Best Execution

FINRA reaffirms the importance of firms' compliance with their best execution obligations.<sup>19</sup> FINRA will focus on whether firms use reasonable diligence to determine whether their customer order flow is directed to the best market given the size and types of orders, the terms and conditions of orders, and other factors as required by FINRA Rule [5310](#) (Best Execution and Interpositioning),<sup>20</sup> focusing on:

- ▶ **Routing Decisions** – FINRA will continue to review for potential conflicts of interest in order routing decisions, including the impact of the recent increase in zero-commission brokerage activity. FINRA may review, for example:
  - processes your firm implements to handle customer orders, particularly in light of remuneration received by the firm in the form of rebates or payment for order flow;
  - how your firm incorporates enhanced order routing information in its “regular and rigorous” review pursuant to FINRA Rule [5310](#) (Best Execution and Interpositioning); or
  - whether changing to the zero-commission model resulted in changes to your firm's routing practices, execution quality, regular and rigorous review policies, or the level of trading rebates or payment for order flow. FINRA may also assess disclosures and advertisements related to zero commissions.
- ▶ **Odd-Lot Handling** – FINRA has observed a significant increase in odd-lot activity, which has also become an increasing portion of U.S. equity trading volume. Odd lots in listed securities are currently not included in the National Best Bid or Offer (NBBO) distributed by the Securities Information Processors (SIPs), but are included in proprietary data feeds from individual exchanges. FINRA will be assessing whether firms are filling customer odd-lot orders at the NBBO disseminated by the SIPs and offsetting these trades with odd-lot executions at superior prices reflected in the exchanges' proprietary data feeds.
- ▶ **U.S. Treasury Securities** – FINRA will assess the reasonableness of firms' policies and procedures for best execution and fair pricing for U.S. Treasury securities. In conducting this assessment, FINRA may consider whether your firm takes into account differences in these securities' characteristics and liquidity, particularly if your firm includes them in more generally applicable fixed income policies and procedures.
- ▶ **Options** – FINRA has received complaints alleging large customer option orders received inferior execution prices. The complaints typically involve a number of small volume option executions at various prices (normally electronically), followed by a larger execution for the remainder of the order at inferior price levels for the customer. In response, FINRA initiated surveillance to identify this specific scenario, and we plan to expand our best execution surveillance to include additional scenarios to identify situations where customers may not be receiving best execution for their options orders.

Other considerations FINRA may take into account when reviewing your firm's best execution practices include:

- ▶ If your firm engages in fixed income and options trading, has it established targeted controls to perform its best execution obligations for these products?

- ▶ Does your firm perform its best execution obligations with respect to trading conducted in both regular and extended trading hours?
- ▶ Does your firm consider the risk of information leakage when assessing the execution quality of orders routed to a particular venue?

### **Disclosure of Order Routing Information**

The amended Regulation National Market System (NMS) Rule 606 bolstered the requirements for broker-dealers to publish reports on their routing of held orders in NMS stocks and listed options.<sup>21</sup> The amended rule requires broker-dealers to provide new customer-specific reports for not held orders in NMS stocks. These disclosures serve an important role in enhancing the transparency of the U.S. securities markets with respect to broker-dealers' handling and routing practices for both institutional and retail customer orders.

FINRA may take the following into consideration, among other factors, when reviewing firms' compliance with amended Rule 606:

- ▶ Does your firm use the required layout and format and include all components of the detailed customer-specific not held order reports required by Rule 606(b)(3)?
- ▶ What policies and procedures does your firm have in place to address the accuracy and timeliness of published reports?
- ▶ If your firm claims an exemption from providing not held order reports required by Rule 606(b)(4) or (5), what policies and procedures does it have in place to determine if customers' order activity falls below the relevant reporting thresholds?
- ▶ Has your firm considered whether it should assess and analyze its use of third-party order routing and execution services (e.g., algorithms and smart order routers) and determine how your firm's traders use these services?
- ▶ Has your firm considered how it will obtain the necessary data from downstream venues to prepare the new reports?

### **Vendor Display Rule**

Capturing and reporting the current consolidated NBBO helps customers evaluate firms' routing decisions. Rule 603 of Regulation NMS (Vendor Display Rule) generally requires broker-dealers to provide a consolidated display of market data for NMS stocks for which they provide quotation information to customers. FINRA will evaluate the adequacy of firms' controls and supervisory systems to provide their customers with the current consolidated NBBO as required by the Vendor Display Rule.

FINRA may take the following factors, among others, into consideration when reviewing your firm's controls related to the Vendor Display Rule:

- ▶ Which firm systems or platforms provide quotation information to customers?
- ▶ How does your firm monitor whether the current quotation information is distributed to customers?
- ▶ Does your firm make the quotation information available to customers when they are placing their orders?
- ▶ Does your firm review the quotation information received from the SIP or vendors to determine whether that information is in compliance with all the requirements of Rule 603?



## Financial Management

### Introduction

In addition to our focus on the new areas noted below, FINRA will continue to evaluate firms' compliance programs relating to Exchange Act Rule 15c3-3 (Customer Protection Rule) and Exchange Act Rule 15c3-1 (Net Capital Rule), as well as firms' overall financial risk management programs.

### Digital Assets

Digital assets raise novel and complex regulatory issues under federal securities laws and regulations,<sup>22</sup> as well as FINRA rules.<sup>23</sup> FINRA is receiving an increasing number of New Member Applications (NMAs) and Continuing Member Applications (CMAs) from firms<sup>24</sup> seeking to engage in business activities related to digital assets. For example, some firms are seeking to facilitate private offerings of digital asset securities, operate secondary trading platforms or facilitate trades of indirect investment products, such as private funds investing in cryptocurrencies.<sup>25</sup> Some firms' proposals also involve clearance and settlement of securities transactions related to digital assets, even when the firm does not plan to provide custody.<sup>26</sup>

FINRA continues to work closely with the SEC to understand firms' business plans and determine how securities laws apply to those plans. In July 2019, SEC and FINRA staff released a joint statement addressing certain non-custodial services, as well as challenges related to custody and critical Exchange Act Rule 15c3-3 obligations for digital assets.<sup>27</sup>

FINRA may take the following factors, among others, into consideration when reviewing your firm's digital asset activities:

- If your firm is considering engaging in digital asset activities, has it filed a CMA with FINRA?
- Does your firm provide a fair and balanced presentation in marketing materials and retail communications, including addressing risks presented by digital asset investments, and not misrepresenting the extent to which digital assets are regulated by FINRA or the federal securities laws or eligible for protections thereunder (such as Securities Investor Protection Corporation coverage)?
- Do your firm's communications misleadingly imply that digital asset services offered through an affiliated entity are offered through and under the supervision, clearance and custody of a registered broker-dealer?
- If your firm is engaging in digital asset transactions, what controls and procedures has it established to support facilitation of such transactions, including initial issuance or secondary market trading of digital assets?

### Liquidity Management

FINRA will continue to review firms' liquidity management practices, as they are a critical control function and should be documented in a firm's books and records.<sup>28</sup> FINRA will focus on areas that we have addressed in *Regulatory Notice 15-33* (Guidance on Liquidity Risk Management Practices), as well as those that may create challenges for clearing and carrying firms' contingency funding plans.

FINRA may take the following factors, among others, into consideration when reviewing your firm's liquidity management practices:

- ▶ Do your firm's liquidity management practices include steps to address specific stress conditions and identify firm staff responsible for addressing those conditions? Does your firm have a process for accessing liquidity during a stress event and determining how the funding would be used?
- ▶ Does your firm's contingency funding plan take into consideration the quality of collateral, term mismatches and potential counterparty loss of your financing desks (in particular, in repo and stock loan transactions)?
- ▶ If your firm is also a Fixed Income Clearing Corporation (FICC) member, how would it manage operational risks—for example, different credit limits and trading hours—that may arise if it needs to rapidly move large amounts of bi-lateral or tri-party U.S. Government or agency securities financing trades to the FICC repo platform?

### **Contractual Commitment Arising From Underwriting Activities**

FINRA will review firms' compliance with their obligations under Exchange Act Rule 15c3-1(c)(2)(viii) when they engage in underwriting activities. FINRA may take the following into consideration when reviewing your firm's compliance with these obligations:

- ▶ Does your firm understand the nature of the underwriting (in particular, best efforts versus firm commitment underwriting) and maintain a list of all deals in which it is involved?
- ▶ Does your firm maintain evidence of the appropriate contractual commitment charges?
- ▶ What processes does your firm use to assess moment-to-moment and open contractual commitment capital charges when it engages in underwriting commitments?
- ▶ How do your firm's regulatory reporting groups track the appropriate net capital treatment of the underwritings in which your firm is involved?
- ▶ How is your firm documenting your compliance with the relevant requirements?

### **London Interbank Offered Rate (LIBOR) Transition**

FINRA will engage with firms—outside the examination program—to understand how the industry is preparing for LIBOR's retirement at the end of 2021,<sup>29</sup> focusing on firms' exposure to LIBOR-linked financial products; steps firms are taking to plan for the transition away from LIBOR to alternative rates, such as the Secured Overnight Financing Rate (SOFR); and the impact of the LIBOR phase-out on customers.

## Firm Operations

### Introduction

In addition to the new areas of focus described below, FINRA will also assess firms' supervisory controls relating to Exchange Act Rule 10b-10 and FINRA Rule [2232](#) (Customer Confirmations) and firms' compliance with FINRA Rule [3310](#) (Anti-Money Laundering Compliance Program)<sup>30</sup>.

### Cybersecurity

As firms leverage technology for their business systems and infrastructure, as well as engaging with customers and business partners, cybersecurity has become an increasingly large operational risk. Firms should expect that FINRA will thoroughly assess whether their policies and procedures are reasonably designed to protect customer records and information consistent with Regulation S-P Rule 30.<sup>31</sup> FINRA recognizes that there is no one-size-fits-all approach to cybersecurity, but expects firms to implement controls appropriate to their business model and scale of operations.

### Technology Governance

Firms' increasing reliance on technology for many aspects of their customer-facing activities, trading, operations, back-office and compliance programs creates a variety of potential benefits, but also exposes firms to technology-related compliance and other risks. In particular, problems in firms' change- and problem-management practices, for example, can expose firms to operational failures that may compromise firms' ability to comply with a range of rules and regulations, including FINRA Rules [4370](#) (Business Continuity Plans and Emergency Contact Information), [3110](#) (Supervision) and [4511](#) (General Requirements), as well as Exchange Act Rules 17a-3 and 17a-4.

FINRA may take the following into consideration, among other factors, when reviewing your firm's technology governance programs:

- ▶ If there have been material changes in your firm's business, what modifications, if any, has it made, or considered, to its BCP?
- ▶ During a BCP event, how will your firm maintain customers' access to their funds and securities, as well as manage back-office operations, to prevent delays or inaccuracies relating to settlement, reconciliation and reporting requirements?
- ▶ What controls does your firm implement to mitigate system capacity performance and integrity issues that may undermine its ability to conduct business and operations, monitor risk or report key information?
- ▶ How does your firm document system change requests and approvals?
- ▶ What type of testing does your firm perform prior to changes being moved into a production environment?
- ▶ What are your firm's procedures for tracking information technology problems and their remediation? Does your firm categorize problems based on their business impact?

\* \* \*

If you have general comments regarding this letter or suggestions on how we can improve it, please send them to Steven Polansky, Member Supervision, at [Steven.Polansky@finra.org](mailto:Steven.Polansky@finra.org), or Elena Schlickemaier, Member Supervision, [Elena.Schlickemaier@finra.org](mailto:Elena.Schlickemaier@finra.org).

## Endnotes

- 1 See also the [Product Suitability](#) section of the [2017](#) Report on Examination Findings (2017 Report); [Suitability for Retail Customers](#) section of the [2018](#) Report on Examination Findings (2018 Report); [Suitability Topic Page](#).
- 2 See also FINRA Rule [2320](#) (Variable Contracts of an Insurance Company); FINRA Rule [2330](#) (Members' Responsibilities Regarding Deferred Variable Annuities); [Suitability for Retail Customers](#) section of the [2018](#) Report; [Variable Annuities Topic Page](#).
- 3 See [Regulatory Notice 10-22](#) (Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings); [Reasonable Diligence for Private Placements](#) section of the [2018](#) Report; [Private Placements Topic Page](#).
- 4 See FINRA Rule [2232](#) (Customer Confirmations); MSRB Rule [G-15](#); [Regulatory Notice 17-24](#) (FINRA Issues Guidance on the Enhanced Confirmation Disclosure Requirements in Rule 2232 for Corporate and Agency Debt Securities); [Regulatory Notice 17-08](#) (SEC Approves Amendments to Require Mark-up/Mark-down Disclosure on Confirmations for Trades With Retail Investors in Corporate and Agency Bonds); [Fixed Income Confirmation Disclosure: Frequently Asked Questions \(FINRA\)](#); [Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions \(MSRB\)](#); [Fixed Income Mark-up Disclosure](#) section of the [2018](#) Report; [Fixed Income Mark-up Disclosure](#) section of the [2019](#) Report on Examination Findings and Observations (2019 Report); [Municipal Securities Topic Page](#); [Fixed Income Topic Page](#).
- 5 See [Abuse of Authority](#) section of the [2018](#) Report; [Regulatory Notice 19-27](#) (FINRA Requests Comment on Rules and Issues Relating to Senior Investors); [Regulatory Notice 19-36](#) (FINRA Requests Comment on a Proposed Rule to Limit a Registered Person from Being Named a Customer's Beneficiary of Holding a Position of Trust for or on Behalf of Customer).
- 6 See also [Regulatory Notice 19-27](#) (FINRA Requests Comment on Rules and Issues Relating to Senior Investors); [Frequently Asked Questions Regarding FINRA Rules Relating to Financial Exploitation of Senior Investors](#); [Senior Investors Topic Page](#).
- 7 For additional considerations, please see the SEC's Federal Register notices for [Reg BI](#), [Form CRS](#) and [Interpretation of Solely Incidental](#).
- 8 See also, FINRA's [Reg BI and Form CRS Firm Checklist](#).
- 9 See also, Online Distribution Platforms section of [2019 Annual Risk Monitoring and Examination Priorities Letter](#) (noting concerns relating to certain online distribution platforms that are operated by unregistered entities, which may use member firms as selling agents or brokers of record, or to perform activities such as custody, escrow, back-office and financial technology (FinTech)-related functions).
- 10 See also [Digital Communication](#) section of the [2019](#) Report.
- 11 FINRA notes that Bank Sweep Programs or bank-like cash management services may require FINRA review, as they may be considered changes to firms' "business operations."
- 12 See also [Regulatory Notice 19-37](#) (SEC Approves Amendments to FINRA Rules 5130 and 5131 Relating to Equity IPOs).
- 13 For additional discussion of FINRA's concerns about discretionary accounts, see [Abuse of Authority](#) section of the [2018](#) Report.
- 14 See [TRACE Reporting](#) section of the [2017](#) Report; [TRACE Reporting](#) section of the [2018](#) Report; [Trade Reporting Notice – 7/19/19](#) (FINRA Reminds Firms of Their Obligations Regarding TRACE Reporting).
- 15 See [Regulation SHO](#) section of the [2017](#) Report; [Short Sales](#) section of the [2019](#) Report.
- 16 See Exchange Act Rule 14e-4.

- 17 The Market Access Rule requires firms that provide access to trading in securities on an exchange or alternative trading system (ATS) to “appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system.” U.S. Securities and Exchange Commission, Risk Management Controls for Brokers or Dealers With Market Access, Exchange Act Release No. 63,241, 75 Fed. Reg. 69,792 (Nov. 15, 2010); see also U.S. Securities and Exchange Commission, Division of Trading and Markets, [Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access](#) (Apr. 15, 2014).
- 18 See [Direct Market Access Controls](#) section of the [2019](#) Report.
- 19 See [Best Execution](#) section of the [2019](#) Report.
- 20 See also *Regulatory Notice 15-46* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets).
- 21 See also [SEC Division of Market Regulation Staff Legal Bulletin 13A](#) and [SEC Division of Trading and Markets Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS](#).
- 22 See, e.g., Exchange Act Regulation D, Regulation S, Regulation A, Rule 15c3-1 (Net Capital Rule), Exchange Act Rule 15c3-3 (Customer Protection Rule), Exchange Act Rule 17a-5 (Financial Reporting Rule), Exchange Act Rule 17a-13 (Quarterly Securities Count Rule), as well as Exchange Act Rule 17a-3 and Rule 17a-4 (collectively, the Recordkeeping Rules).
- 23 See, e.g., FINRA Rules [3110](#) (Supervision), [2210](#) (Communications with the Public) and [3310](#) (Anti-Money Laundering Compliance Program).
- 24 In addition, some registered representatives are engaging in outside business activities involving digital assets.
- 25 As discussed in *Regulatory Notice 19-24* (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Relating to Digital Assets), we note that firms should inform FINRA if they plan to engage in digital asset transactions.
- 26 FINRA notes that the extent to which a broker-dealer comes into contact with customer funds and securities may impact its Net Capital Rule requirements and implicate the Customer Protection Rule for any assets received, held or deemed to be under the control of the broker-dealer.
- 27 See U.S. Securities and Exchange Commission, Division of Trading and Markets, Financial Industry Regulatory Authority, Office of General Counsel, [Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#) (July 8, 2019).
- 28 See Exchange Act Rule 17a-3(a)(23).
- 29 See U.S. Securities and Exchange Commission Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant, [Staff Statement on LIBOR Transition](#) (July 12, 2019).
- 30 See also *Regulatory Notices 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations) and *17-40* (FINRA Provides Guidance to Firms Regarding Anti-Money Laundering Program Requirements Under FINRA Rule 3310 Following Adoption of FinCEN’s Final Rule to Enhance Customer Due Diligence Requirements for Financial Institutions).
- 31 Regulation S-P Rule 30 requires firms to have written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information that are reasonably designed to: (1) ensure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. Regulation S-P also requires firms to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their right to opt-out of information sharing. Further, FINRA Rule [3110](#) (Supervision) requires firms to establish and implement a system that is reasonably designed to comply with Regulation S-P Rule 30, as well as related policies and procedures.

## Appendix 1 – Additional Resources

### Sales Practice and Supervision

#### Reg BI and Form CRS

- ▶ *Regulatory Notice [19-26](#)* (Regulation Best Interest: SEC Adopts Best Interest Standard of Conduct)
- ▶ [Reg BI and Form CRS Firm Checklist](#)
- ▶ [Regulation Best Interest \(Reg BI\) Topic Page](#)

#### Communications with the Public

- ▶ *Regulatory Notice [19-31](#)* (Disclosure Innovations in Advertising and Other Communications with the Public)
- ▶ [2018 Report – DBAs and Communications with the Public](#)
- ▶ [2019 Report – Digital Communication](#)
- ▶ [Advertising Regulation Topic Page](#)
- ▶ [Private Placements Topic Page](#)

#### Cash Management and Bank Sweep Programs

- ▶ [2017 Report – Net Capital and Credit Risk Assessments](#)
- ▶ [2018 Report – Accuracy of Net Capital Computations](#)
- ▶ [2018 Report – Segregation of Customer Assets](#)
- ▶ [2019 Report – Observations on Liquidity and Credit Risk Management](#)
- ▶ [2019 Report – Segregation of Client Assets](#)
- ▶ [Investor Alert – Cash Accounts: What They Are and How to Avoid Problems](#)
- ▶ [Update a Broker-Dealer Firm Registration](#)
- ▶ [Advertising Regulation Topic Page](#)

#### Sales of Initial Public Offering (IPO) Shares

- ▶ *Regulatory Notice [19-37](#)* (SEC Approves Amendments to FINRA Rules 5130 and 5131 Relating to Equity IPOs)
- ▶ *Regulatory Notice [17-14](#)* (FINRA Requests Comment on FINRA Rules Impacting Capital Formation)
- ▶ [Public Offerings Topic Page](#)

#### Trading Authorization

- ▶ [2018 Report – Abuse of Authority](#)
- ▶ [2019 Report – Suitability](#)
- ▶ [Suitability Topic Page](#)
- ▶ [Supervision Topic Page](#)
- ▶ [Books & Records Topic Page](#)



## Market Integrity

### Direct Market Access Controls

- ▶ *Regulatory Notice [15-09](#)* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)
- ▶ *Regulatory Notice [16-21](#)* (SEC Approves Rule to Require Registration of Associated Persons Involved in the Design, Development or Significant Modification of Algorithmic Trading Strategies)
- ▶ [2017 Report – Market Access Controls](#)
- ▶ [2018 Report – Market Access Controls](#)
- ▶ [2019 Report – Direct Market Access Controls](#)
- ▶ [Algorithmic Trading Topic Page](#)
- ▶ [Market Access Topic Page](#)

### Best Execution

- ▶ *Regulatory Notice [15-46](#)* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets)
- ▶ [2017 Report – Best Execution](#)
- ▶ [2018 Report – Best Execution](#)
- ▶ [2019 Report – Best Execution](#)
- ▶ [Report Center, Equity Report Cards](#) – FINRA’s Best Execution Outside-of-the-Inside Report Card

### Disclosure of Order Routing Information

- ▶ *Notice to Members [01-30](#)* (Member Obligations to Provide Statistical Information About Order Routing Under SEC Rule 11Ac-6 of the Securities Exchange Act of 1934)
- ▶ *Notice to Members [01-44](#)* (SEC Issues Interpretive Guidance Concerning Exchange Act Rules 11Ac1-5 and 11Ac1-6)
- ▶ [2017 Report – Best Execution](#)
- ▶ [2018 Report – Best Execution](#)
- ▶ [2019 Report – Best Execution](#)
- ▶ [Report Center, Equity Report Cards](#) section – FINRA’s Best Execution Outside-of-the-Inside Report Card

### Vendor Display Rule

- ▶ *Regulatory Notice [15-52](#)* (SEC Staff Provides Insight Into Firms’ Obligations When Providing Stock Quote Information to Customers)

## Financial Management

### Digital Assets

- ▶ *Regulatory Notice [19-24](#)* (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Relating to Digital Assets)
- ▶ [Report on Distributed Ledger Technology: Implications of Blockchain for the Securities Industry](#)
- ▶ [FinTech Topic Page](#)

## Liquidity Management

- ▶ [Regulatory Notice 15-33](#) (Guidance on Liquidity Risk Management Practices)
- ▶ [Regulatory Notice 10-57](#) (Funding and Liquidity Risk Management Practices)
- ▶ [2018 Report – Liquidity](#)
- ▶ [2019 Report – Observations on Liquidity and Credit Risk Management](#)
- ▶ [Funding and Liquidity Topic Page](#)

## Contractual Commitment on Underwriting Commitments

- ▶ [2019 Report – Net Capital Calculations](#)
- ▶ Exchange Act Rule 15c3-1(a)/001 [Moment to Moment Net Capital](#)
- ▶ Exchange Act Rule 15c3-1(c)(vii)/10 [Marketability of Nonconvertible Debt Securities Which Are Not Highly Rated](#)
- ▶ Exchange Act Rule 15c3-1(c)(2)(viii)(C)/03 [Haircuts on Contractual Commitments](#)
- ▶ Exchange Act Rule 15c3-1(c)(2)(viii)(C)/031 [Underwriting Commitments](#)
- ▶ Exchange Act Rule 15c3-1(c)(2)(viii)(C)/032 [Offsetting Sale Commitments](#)
- ▶ Exchange Act Rule 15c3-1(c)(2)(viii)(C)/04 [Selling Group Participations](#)
- ▶ Exchange Act Rule 15c3-1(c)(2)(viii)(C)/06 [Underwriting Backstop Agreement](#)

## Firm Operations

### Cybersecurity

- ▶ [Report on Cybersecurity Practices - 2015](#)
- ▶ [Report on Selected Cybersecurity Practices – 2018](#)
- ▶ [2017 Report – Cybersecurity](#)
- ▶ [2019 Report – Observations on Cybersecurity](#)
- ▶ [Small Firm Cybersecurity Checklist](#)
- ▶ [Core Cybersecurity Controls for Small Firms](#)
- ▶ [Common Cybersecurity Threats](#)
- ▶ [Customer Information Protection Topic Page](#)
- ▶ [Cybersecurity Topic Page](#)

### Technology Governance

- ▶ [Regulatory Notice 19-06](#) (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rule on Business Continuity Plans and Emergency Contact Information)
- ▶ [Business Continuity Plan FAQs](#)
- ▶ [2019 Report – Business Continuity Plans](#)
- ▶ [Small Firm Business Continuity Plan Template](#)
- ▶ [Business Continuity Planning Topic Page](#)