Financial Industry Regulatory Authority

March 9, 2009

Dear Executive Representative:

We are writing to highlight new and existing areas of particular significance to FINRA's examination program for 2009. We hope you will use the information in this letter to gain valuable insight into some key FINRA examination topics, and to help you assess your firm's compliance and supervisory programs.

Before discussing specific examination priorities, we want to address some general concerns given the current market environment. As the challenges faced by our industry in 2008 have demonstrated, strong compliance, supervision and risk management are more critical than ever. In light of the challenging market conditions, firms are focusing on reducing expenses. This, in many instances, has taken the form of headcount reductions throughout the organization. Moreover, in many organizations, the non-income producing areas have suffered significant reductions in staff. While firms maintain the discretion to determine the adequacy of headcount, we recommend that they carefully consider the impact of headcount reductions in areas such as compliance, finance and operations, and other control functions to determine whether they are commensurate with the business-line reductions in those areas.

As income from traditional securities products and activities has decreased, many firms and their associated persons have sought new income streams. It is imperative that firms proactively review and vet new products or activities, create supervisory procedures and policies specifically addressing new products, and ensure that prospective customers receive timely, clear and comprehensive disclosures regarding the products' features and risks. Further, in light of current market conditions, firms also should evaluate the parameters used in their exception or risk management reports and systems, including sales activities involving new products. Firms' own education efforts, including the annual needs analysis and written training plan, should take these factors into account as well. When developing such educational programs, firms should tailor their focus to the appropriate audience—whether representatives, supervisors, compliance personnel or management.

FINRA urges firms to consult *Notice to Members 05-26 (www.finra.org/ntm/05-26)*, which describes the types of questions a firm should ask as part of its new product review process, and *Notice to Members 99-92 (www.finra.org/ntm/99-92)*, which identifies sound practices in risk management.

New Developments

In addition to the regulatory topics outlined in this letter, we would like to update you on some other developments.

- **Firm Profile on Firm Gateway:** All firms have access to the new Firm Profile available on the Firm Gateway *(www.finra.org/firmgateway)*, effective December 15, 2008. The Firm Profile compiles information contained in various FINRA systems, including the information required to be submitted via the Firm Clearing Arrangement Form. Firms may also use the Firm Profile to view

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and update their contact information from the FINRA Contact System. Introducing firms should contact their clearing firms if they have questions about the details of the clearing arrangement contained in their Firm Profile.

- **Examination Webcast:** To help firms prepare for an examination, we updated our What to Expect webcast on cycle examinations *(www.finra.org/webcasts/whattoexpect)*. The webcast explains the examination process and highlights enhancements to our examination program in light of the consolidation of NASD and NYSE member regulation. Firms that have not yet had a FINRA examination since the consolidation may find this webcast particularly helpful.

- **Examination Priorities Webinar:** On March 18, 2009, FINRA will host a webinar on 2009 examination priorities *(www.finra.org/webinars)*. The webinar is part of a new series of interactive, online programs that includes panel discussions with FINRA staff and industry experts, and features online resource materials. An on-demand version will be available shortly after the live program occurs.

Before turning to areas of examination focus, we want to remind you that in previous letters and on the Improving Examination Results Web page we highlighted issues that were of particular significance. Some of these topics remain high priorities in 2009 and, as such, are included in this letter. Periodically reviewing previous letters should prove useful when preparing for routine examinations. You can reference the letters and Web page at:

- *www.finra.org/exampriorities/08letter*
- *www.finra.org/exampriorities/07letter*
- *www.finra.org/improvingexamresults*

Note that FINRA's exam process is risk-based, meaning that the frequency of your firm's examinations is based on an assessment of the risk, scale and scope of your operations. Selection of specific review areas on examinations is also risk-based, so examinations vary from firm to firm.

Below, we discuss topics that remain a high priority for firms to consider when reviewing their supervisory and compliance programs.

Consolidated FINRA Rulebook

As you are aware, following the consolidation of NASD and NYSE's member regulation functions into FINRA, we established a process to develop a new FINRA Rulebook that will eventually replace the current NASD and Incorporated NYSE Rules. FINRA has proposed, and will continue to propose in phases, new consolidated rules for approval by the SEC.

The first phase of new consolidated FINRA rules, approved by the SEC in August and September 2008, became effective on December 15, 2008 (see *Regulatory Notice 08-57 (www.finra.org/notices/08-57*)). In November 2008, the SEC approved additional consolidated rules relating to warrants, options and security futures, which became effective on February 17, 2009 (see *Regulatory Notice 08-78 (www.finra.org/notices/08-78*)). And in January 2009, the SEC approved a new consolidated rule on trading ahead of research reports, which will take effect on April 20, 2009 (see *Regulatory Notice 09-11 (www.finra.org/notices/09-11))*.

Firms have inquired about our expectations for updating written supervisory procedures (WSPs) to reflect new consolidated FINRA rules. We expect firms to have a process in place to periodically review and update their WSPs as new rules become effective. For instance, when your firm goes

through its regular review and update, you should make the necessary changes to reflect the new FINRA rules. **Of course, as rules become effective, you must carefully review the new rule requirements to ensure compliance with those rules; but changes to rule citations in your WSPs can wait until your firm's next scheduled update, provided that the update cycle frequency is reasonable.** FINRA also expects firms to communicate the specific requirements of rule amendments to appropriate firm personnel and provide education and training to the extent deemed necessary for full compliance with the requirements.

FINRA has discussed the rule consolidation process in several *Information Notices* in 2008. *Information Notice 3/12/08 (www.finra.org/notices/information/031208)* outlines the rule consolidation process. *Information Notice 10/6/08 (www.finra.org/notices/information/100608)* describes the protocol by which FINRA will announce the effective dates of new FINRA rules that are being adopted as part of the consolidated rulebook. And *Information Notice 12/8/08 (www.finra.org/notices/information/120808)* discusses the continuing application of NASD Rules and Incorporated NYSE Rules during the course of the rule consolidation process.

FTC's Red Flags Rule

Pursuant to the 2003 Fair and Accurate Credit Transactions Act (FACT Act), the Federal Trade Commission (FTC) implemented the Red Flags Rule and other regulations applicable to broker-dealers. While all of these regulations became effective November 1, 2008, the FTC delayed the enforcement of the Red Flags Rule until May 1, 2009. FINRA issued *Regulatory Notice 08-69 (www.finra.org/notices/08-69*) to alert firms about these regulations. Among other things, the *Notice* provides specific details regarding the requirement that, pursuant to the Red Flags Rule, firms subject to the rule must develop and implement a written identity theft program. Since the regulations addressed by the *Regulatory Notice* are FTC Rules and not FINRA Rules, questions about compliance with the regulations should generally be directed to the FTC.

Alternative Investments

Given recent market conditions, investors may seek alternative investments to conventional equity and fixed-income investments. For instance, investors may be seeking higher yield products, such as high-yield bonds and bond funds, structured products and other non-conventional investments. FINRA reminds firms to take appropriate steps to understand the terms, conditions, risks and rewards of any security that they sell to retail customers by performing a reasonable-basis suitability analysis. Firms also must determine that such an investment is appropriate for a particular customer before recommending it to that customer by performing a customer-specific suitability analysis.

Sales materials and oral presentations must be fair and balanced regarding both the risks and benefits of investing in alternative investments. Any presentation to a customer concerning an investment's yield should be balanced with a discussion of any applicable credit risk or risk of default associated with the issuer, and how that risk might affect the safety of the invested principal. The discussion should also address interest rate risk—the risk that interest rate changes might affect the market value of an instrument prior to its call or maturity date—and liquidity risk—the risk that sell orders may not be executed immediately or may be executed at prices well below the purchase price or anticipated market price.

For more information on your obligations with regard to the sale of non-conventional investments and high-yield securities, see *Notice to Members 03-71 (www.finra.org/ntm/03-71)* and *Regulatory Notice 08-81 (www.finra.org/notices/08-81)*.

FINRA has also seen an increase in membership applications from firms interested in conducting retail foreign currency exchange (forex) business and an increase in retail forex activities among current FINRA firms. Retail forex is particularly risky for individual investors, and it has generated problems from abusive sales practices to the financial failure of retail forex merchants. As discussed in *Regulatory Notice 08-66 (www.finra.org/notices/08-66)*, FINRA will closely examine firms engaging or proposing to engage in retail foreign exchange activities.

Cash Alternatives

Firms sell a wide variety of investments as alternatives to cash holdings, and these can represent an important component of an investment portfolio. Sales materials and oral presentations regarding cash alternatives must present a fair and balanced picture regarding both the risks and benefits of investing in these products. In virtually all cases, a statement to retail investors that an investment is a "cash equivalent," that it is as "safe as cash" or that it carries no market or credit risk would raise serious questions under FINRA's advertising rules.

Before recommending a cash alternative, firms must reasonably believe that the product is suitable for a customer seeking a cash alternative. Firms must perform appropriate due diligence and have a reasonable basis for characterizing an investment as a cash alternative; it is not sufficient to simply rely upon a third-party's characterization. Firms must monitor market and economic developments that may affect the continued accuracy of characterizing an investment as a cash alternative and must have procedures to quickly alert their sales and marketing staff to developments that will make such a characterization unwarranted. Firms must also ensure that a particular investment is suitable as a cash alternative for a specific customer (*i.e.,* customer-specific suitability). Firms should consider, along with typical suitability concerns such as financial status, the customer's need for liquidity and price stability, and the ability of the investment to meet that need. For more information on your sales practice obligations with regard to cash alternatives, see *Regulatory Notice 08-82 (www.finra.org/notices/08-82)*.

Supervision

Comprehensive supervisory procedures and their effective administration are the keys to compliance for all business activities in which a firm engages. Accordingly, examiners will continue to focus on the extent to which firms establish, maintain and administer their supervisory systems. FINRA reminds firms of their ongoing obligation, pursuant to NASD Rule 3012, to test and verify that their supervisory procedures are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, and to amend those supervisory procedures when such testing identifies a need to do so. As noted above, differing market conditions can affect both trading patterns and the types of sales activity in which registered representatives engage. Each firm's testing and verification procedures should address not only whether its exception reports are functioning as intended, but also whether such exception reports are reasonably designed to capture and highlight potential regulatory problems for high-risk business activities.

In most circumstances, office inspections may not be conducted by any person with supervisory responsibilities for the office or any individual who is directly or indirectly supervised by such person(s).[1] As previously mentioned, the need for strong compliance and supervision is more critical than ever, and this includes a robust inspection program for both branch and non-branch locations. This includes review, approval and supervisory systems for private securities transactions where firms permit such conduct. Similarly, notice and knowledge of outside business activities are critical

1 For additional information, *see* NASD Rule 3010(c).

to determine and address potential investor protection issues. In this environment, it is paramount that inspections are comprehensive and conducted according to a schedule in order to timely identify and resolve breakdowns in compliance and supervision.

Firms are also reminded of their annual CEO certification requirements pursuant to FINRA Rule 3130[2] and, for NYSE member firms, the additional requirements under NYSE Rule 342.30(a) through (c) which include the submission to FINRA of each NYSE member organization's CEO certification as part of an Annual Report addressing prescribed supervision and compliance efforts during the previous year.

Senior Investors

FINRA continues to pay close attention to sales practices aimed at senior investors and baby boomers. FINRA's efforts include educating investors, firms and registered representatives on key issues surrounding investors in or approaching retirement. In September 2008, FINRA again participated in the SEC's Seniors Summit *(www.sec.gov/investor/seniors/ss3.htm)* and coordinated with the SEC and NASAA to issue a report on sales practices and other issues related to senior investors *(www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf)*. The report provides practical examples to firms seeking to strengthen their infrastructure and work with senior investors in an ethical, respectful and informed manner. (Topics include communications, training and education, account opening, advertising and marketing, and supervision.) In *Regulatory Notice 07-43 (www.finra.org/notices/07-43)*, FINRA outlined other reminders for firms when dealing with investors approaching retirement.

Anti-Money Laundering

FINRA examiners continue to focus on anti-money laundering (AML) requirements. Firms should ensure that their AML policies and procedures are appropriately tailored to the firm's business model, risk profile and volume of transactions, particularly with regard to monitoring, detecting and reporting suspicious activity. Procedures and systems that focus solely on money movements and do not address potentially suspicious activities related to securities transactions may not be appropriate.

Of note in 2008, FinCEN issued no-action guidance *(www.fincen.gov/statutes_regs/guidance/html/fin-2008-g002.html)* stating that only introducing firms are required to comply with the requirements of the customer identification program rule with respect to customers introduced to a clearing firm, so long as the clearing agreement allocates functions in the manner described in the guidance. Firms are reminded to review their clearing agreements to understand the allocation of functions and AML responsibilities.

Foreign Corrupt Practices Act

FINRA reminds firms of their obligations under the Foreign Corrupt Practices Act (FCPA). The FCPA prohibits any person or entity from giving or promising anything of value to a foreign government official, political party or party official with the intent to influence that official or to obtain or retain business. This applies to all U.S. individuals and companies, and includes the actions of any agents working on their behalf. The FCPA also requires all companies that are publicly traded in the U.S. to maintain accurate books and records and to implement adequate internal controls to provide reasonable assurance that transactions are recorded properly.

2 Formerly NASD Rule 3013 and IM-3013. For additional information, *see* SR-FINRA-2008-030 and *Regulatory Notice 08-57* (p. 31).

Unregistered Resales of Restricted Securities (Including Penny Stock Liquidations)

FINRA reminds firms to be diligent with respect to schemes involving low-priced securities or penny stocks. Recent SEC and FINRA investigations have revealed instances in which firms failed to recognize certain red flags that signaled the possibility of an illegal, unregistered distribution, typically in low-priced securities.[3] In *Regulatory Notice 09-05*, FINRA reminds firms of their responsibilities to ensure that they comply with the federal securities laws and FINRA rules when participating in unregistered resales of restricted securities. These responsibilities are particularly important in situations where the surrounding circumstances place the firm on notice that it may be participating in illegal, unregistered resales of restricted securities, such as when a customer physically deposits certificates or transfers in large blocks of securities and the firm does not know the source of securities.

FINRA has found that firms that participated in unregistered securities distributions also may have ignored a number of red flags that may have triggered suspicious activity reporting requirements under the Bank Secrecy Act.[4] Some of the potentially problematic trading has been in securities of issuers that were the subject of unsolicited promotional emails, or "spam," and by customers (or a person publicly associated with the customer) who had questionable backgrounds or were the subject of news reports indicating possible criminal, civil or regulatory violations. These red flags demonstrate the importance of knowing your customer and conducting appropriate due diligence when red flags arise. For more information on red flags, see *Regulatory Notice 09-05 (www.finra.org/notices/09-05)* and *Notice to Members 02-21 (www.finra.org/ntm/02-21)*.

Variable Annuities

Examiners continue to focus on the sale and supervision of variable annuities and to closely review recommendations made to senior investors to purchase or redeem variable annuities. They also continue to review the rationale for instances where a variable annuity is exchanged for another annuity, including exchanges that involve equity-indexed annuities, exchanges resulting from a representative's change in employment and exchanges that may be based on the financial condition of the issuing insurance company. For more information on variable annuities, see *www.finra.org/variable_annuities*.

FINRA's rule covering purchases and exchanges of deferred variable annuities (NASD Rule 2821) became partially effective on May 5, 2008. The effective paragraphs (a), (b) and (e) of NASD Rule 2821, include the general considerations discussion, recommendations, requirements and training obligations. Paragraph 2821(c) regarding principal review and approval, paragraph (d) concerning supervisory procedures and a Supplementary Material section are the subject of a pending rule filing. For information on FINRA's proposed rule change to amend certain provisions of Rule 2821, see filing SR-FINRA-2008-019 at *www.finra.org/rulefilings/2008-019*.

Protection of Customer Information and IT Security

While technology can create significant efficiencies, it can also expose a firm to new and increased risks. As such, firms should review their IT security procedures to ensure they are sufficient to deter security breaches, hacking, cyber attacks, account intrusions and other security threats. Brokerage account intrusions, whereby persons illegally access customer accounts, continue to affect the

3 *See, e.g., NevWest Securities Corporation*, NASD AWC E0220040112-01, March 21, 2007, and related case SEC v. CMKM Diamonds, Inc., *et. al,* U.S. Dist. Court for the District of Nevada, Civil Action No. 08-CV 0437 (Lit. Rel. No. 20519 / April 7, 2008) and *Barron Moore, Inc.,* Disc. Proceeding No. 2005000075703, July 21, 2008.

4 For additional information, *see* 31 CFR § 103.19.

industry. Intruders can use a number of methods to obtain login credentials needed to access customer accounts, such as stealing customer login credentials or robbing firm employees of their system passwords. Once inside an account, the intruders may wire out funds or use the account for a market manipulation scheme in tandem with other accounts. Account intrusions affect introducing and clearing firms of all sizes and securities of many types.

Insider threats remain an elevated risk, especially during this time of corporate downsizing in response to current economic conditions. FINRA has seen several high-profile problems result from poor IT account management within the employee ranks. Systems that are used to control employee activities and provide a check and balance should be reviewed to ensure that only currently authorized personnel are granted access to these systems. The same holds true for other systems, such as trading systems that can be used to commit firms to a trade or contract. Weaknesses in these controls can be costly and can significantly damage a firm's business and/or reputation.

The SEC's Regulation S-P requires firms to have policies and procedures that address administrative, technical and physical safeguards for the protection of customer information and records. Firms must ensure that their policies and procedures are reasonably designed to protect against any anticipated threats or hazards to the security and integrity of customer records and information. Among other things, firms should consider how they protect customer information stored on electronic devices, such as hard drives, CDs, flash drives, floppy disks, laptops and PDAs when they are in use and after they are discarded by the firm. Firms also should consider how they mitigate the risk of insider threats, such as through internal surveillance monitoring and controls.

In addition, firms offering online customer access and trading should assess their internal surveillance and develop plans for handling account intrusions. This assessment might include a review of the online interface with customers to determine if there are any inefficiencies or gaps that can be strengthened in order to reduce the ability of intruders to access customer accounts and records. Introducing and clearing firms should work together to mitigate the risk of intrusions. Firms should also be diligent in their review of account activity for red flags that may indicate suspicious activity.

For more information, visit the following pages on FINRA's Web site:

- Customer Information Protection *(www.finra.org/customerprotection)*
- Firm Identity Protection *(www.finra.org/customerprotection/firmid)*
- Firm Checklist for Compromised Accounts *(www.finra.org/customerprotection/checklist)*

Outsourcing

During the last several years, the number of broker-dealers that outsource key operational functions, including many back office securities processing activities, has increased. As discussed in *Notice to Members 05-48 (www.finra.org/ntm/05-48)*, while certain functions may be outsourced, supervision and oversight may not be. Firms must perform the necessary due diligence and counterparty risk assessment when outsourcing functions to service providers, and must also establish controls and procedures to ensure that vendors are fulfilling their duties responsibly and in compliance with applicable rules and service agreements. These ongoing obligations may be fulfilled by requiring vendors to meet measurable performance standards, meeting frequently with vendor personnel and management, and assigning qualified personnel to monitor, review and supervise the activities of the service provider. In addition, firms should consider the risks of activities that are outsourced to entities operating in foreign jurisdictions and determine the impact of outsourcing arrangements on the firm's business continuity plans.

Information Barriers

FINRA reminds firms that they must have procedures in place to monitor or otherwise control the flow of material, non-public information within the firm and with its affiliates, clients and others to prevent insider trading or other misuse of material and non-public information.

Firms must tailor their information barrier procedures to their business activities and organizational structure. Firms should have robust procedures addressing the use of restricted and watch lists, monitoring systems, supervision, review of proprietary and employee trading (both at the firm and away from it), review of questionable activities and recordkeeping requirements. Procedures should identify the appropriate department(s) or individual(s) with responsibility for executing the firm's policy on monitoring for insider trading. Given the importance of this issue, FINRA's special review of information barriers is ongoing. For more information, see *www.finra.org/sweepletters/infobarriers*.

Back to Basics: Customer Protection

The failure and/or merger of several large firms during 2008 reinforces the significance of the customer protection rules. Thus, FINRA reminds firms of the importance of complying with Exchange Act Rule 15c3-3 by adequately computing the reserve formula as well as reducing customer fully paid and excess margin securities to possession or control.

With respect to the computation of the reserve formula, firms are reminded:

- to include bank overdrafts and zero balance account overdrafts as credits in the formula when not related to vendors;
- to obtain a satisfactory netting agreement and legal opinion before taking advantage of netting bank balances;
- to include net equity balances in non-regulated commodities accounts as a credit when these balances are not required to be included in any commodity computations;
- to include aged suspense items as a credit;
- not to include as a debit receivables from money market funds which result from prepayments to customers;
- to review for concentrated debits (money and security) that must be excluded from the formula;
- to ensure accounts are properly coded for allocation purposes;
- to review for unpriced securities in the allocation and determine the exposure to the formula;
- to ensure that deposits to the Special Reserve Account are timely and do not cause an overdraft in another bank account; and
- to ensure withdrawals are not made without a computation that justifies the withdrawal.

With respect to possession or control, clearing firms are reminded to:

- ensure that deficits are not created by removing securities from a control location, including the return of securities borrowed;
- obtain a no-action letter from the SEC to permit the use of a foreign depository as a good control location;
- test margin and segregation programs to ensure that securities required to be segregated are accurately identified; and
- take prompt action to recall outstanding stock loans to resolve deficits.

With respect to introducing firms that are exempt from computing the reserve formula and possession or control requirements, firms are reminded to:

- ensure that their procedures for handling customer money or securities are in line with the exemption in Exchange Act Rule 15c3-3(k)(2)(ii);
- review procedures to prevent customers from transmitting funds and securities to the firm; and
- review procedures to promptly transmit customer funds received in error to the clearing firm by noon of the next business day.

Excess SIPC Protection

In light of the financial events of the past year, FINRA will review the disclosures provided to customers with regard to excess SIPC insurance. Firms that have not replaced excess SIPC surety bond coverage that was offered through the Customer Asset Protection Company (CAPCO) are expected to notify customers of this reduction in coverage. If firms have made alternative arrangements for excess SIPC coverage, the new arrangements should be clearly disclosed to customers, including the dollar amount of protection available to each customer.

Inventory and Collateral Valuations

Firms are reminded of the importance of having controls in place to independently value inventory and collateral positions, particularly positions that are less liquid and more complex. Our examiners continue to identify issues in this area, primarily as a result of the continued reliance on traders for inputs to pricing models. Senior front office personnel are reminded to pay diligent attention not only to each trader's value at risk, but also to the notional size of positions, the daily marks on positions and the effectiveness of hedging. Product controllers and other independent valuation groups must have the resources and the support of senior management to effectively challenge traders' valuations in these difficult markets, and the basis for such reliance should be adequately documented. Management should consider extending best practices used for valuation of inventory to the valuation of collateral for reverse repo and securities borrowed transactions.

Funding and Liquidity

Firms are encouraged to revisit their funding and liquidity practices to incorporate lessons learned from recent market events. In this respect, firms should evaluate the quality and reliability of funding sources, liquidity stress tests and contingency funding plans to ensure the viability of the broker-dealer under both normal and stressed market conditions.

Counterparty Credit Risk

Firms are expected to evaluate and actively manage counterparty credit risk arising from trading activities of the broker-dealer, including derivative transactions. The effect of stressed market conditions on the financial position of the broker-dealer with respect to potential counterparty default, market illiquidity, additional collateral calls and contingent funding commitments should be evaluated and mitigated.

Intercompany Reconciliations

Firms are reminded of the importance of both accurately recording bona fide intercompany transactions and reconciling intercompany accounts. In difficult market environments, it is especially important to understand the nature of any differences that may result from a review of the reconciliation of intercompany accounts. Once a firm identifies the cause of the difference, it should take prompt action to resolve the difference.

Suspense Account Reconciliations

FINRA examiners have noted inaccurate books and records resulting from firms' failures to promptly establish and reconcile suspense accounts. System conversions in connection with mergers and acquisitions are particularly troubling as they can increase balances in suspense and difference accounts and stock record breaks that may remain unresolved for a period of time. These breaks, no matter what the cause, affect the accuracy of a firm's books and records and often result in significant net capital charges and increased customer reserve requirements. Firms should reconcile promptly all suspense accounts and take appropriate action, such as treating any balances as customer related when no clear determination can be made otherwise.

Bank Sweep Programs

As a result of 2008 credit market events, we have seen increased use of bank deposit programs for the sweeping of customer free credit balances. Firms considering establishing new programs or making changes to existing programs are urged to contact their FINRA Coordinator ahead of time. Our examiners will continue to review the disclosures made to customers with respect to FDIC and SIPC protection, methodology for determining interest rates on the balances swept and disclosure of any compensation the broker-dealer and/or registered representative receives arising from the arrangement. The examiners also will review the documentation between the bank where the funds are maintained as well as an intermediary bank that may be used to facilitate the arrangement. Further, examiners will review the reconciliations performed with the deposit bank to determine whether any differences are promptly resolved.

Fully Paid Lending Programs

During the last year we have seen an increase in the use of customer fully paid securities for lending programs. As a result of these programs, customers lose their SIPC protection. It is therefore important that customers fully understand the risks they are taking by consenting to participate in these programs. Examiners will review the recording of these transactions on firms' books and records, the disclosures made to customers and the rebates that are paid to customers.

Sales of Equity Securities

Effective October 17, 2008, the SEC adopted Regulation SHO Rule 204T to address abusive naked short selling and the negative market impacts associated with large and persistent fails to deliver.[5] Rule 204T requires a participant of a registered clearing agency to deliver securities for ***any equity long or short sale*** transaction by settlement date (T+3). If delivery is not made on settlement date, the participant must close out the fail-to-deliver by the beginning of regular trading hours (*i.e.,* 9:30 a.m., ET) on the day after settlement date (T+4) for short sales. Failures to deliver long sales or short sales effected pursuant to bona fide market making activity must be closed out by the beginning of regular trading hours on the third consecutive settlement day after settlement date (T+6).[6] If a participant does not close out its fail-to-deliver as required, then Rule 204T prohibits the participant, and any broker-dealer for which it receives trades for clearance and settlement, from accepting or effecting a short sale in the subject equity security, without first pre-borrowing the security or entering into a bona fide arrangement to borrow the security. This pre-borrow requirement also

5 *See* Securities Exchange Act Release No. 58773 (October 14, 2008), 73 FR 61706 (October 17, 2008).

6 Fails-to-deliver caused by sales under Rule 144 or sales pursuant to an effective registration statement may be closed out by the beginning of regular trading hours on the 36th consecutive settlement day following the settlement date of the transaction.

applies to market makers that would normally be exempt from the locate requirement under Reg SHO Rule 203(b). Reg SHO Rule 204T is a temporary rule that will be in effect until July 31, 2009, unless extended to a later date by the SEC.

In order to further address fails-to-deliver associated with abusive naked short sales, the SEC also adopted Rule 10b-21 on October 17, 2008.[7] Exchange Act Rule 10b-21 is an antifraud rule designed to target short sellers who deceive their broker-dealers about their ability to deliver shares by settlement date and then ultimately fail to deliver those shares. This is a permanent rule.

FINRA reminds firms of the requirement to have adequate supervision and written supervisory procedures to ensure compliance with Reg SHO Rule 204T and Exchange Act Rule 10b-21. FINRA conducted special examinations in 2008 and will continue to review firms' compliance with Rules 204T and 10b-21 during 2009.

Circulation of Rumors

In 2008, complaints to financial regulators and press reports asserted that the circulation of negative rumors regarding certain companies in the financial industry exacerbated declines in the share prices of these companies. As a result, FINRA and other securities industry regulators have heightened surveillance efforts with respect to rumors.

Firms are reminded of their obligations under FINRA Rule 6140(e) and NYSE Rule 435(5). FINRA Rule 6140(e) prohibits registered persons from making a statement or circulating and disseminating any information that might reasonably be expected to influence the market price of certain securities. Similarly, NYSE Rule 435(5) prohibits circulation of sensational rumors that might reasonably be expected to affect market conditions on the Exchange. In addition to these requirements, registered persons have obligations under FINRA Rule 2010[8] to refrain from any conduct or activity inconsistent with just and equitable principles of trade. Firms should review their internal controls, procedures and surveillance practices with regard to rumors to ensure that potential misconduct is identified and reviewed in a timely manner (see FINRA's March 31, 2008, news release, Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity, at *www.finra.org/news/falserumors)*.

Order-Entry Controls

While always an important issue, recent market volatility warrants a renewed focus on firms' controls over the order-entry process. Firms need to have the necessary internal controls and processes to ensure that orders are entered and transmitted accurately. *Notice to Members 04-66 (www.finra.org/ntm/04-66)* is the most recent guidance regarding FINRA's expectations in this area. The absence of adequate order-entry controls can lead to instances of aberrant trading marked by extreme price swings due to erroneous trades. Another potential consequence of a firm having weak controls over order-entry practices is an increase in clearly erroneous trade filings. FINRA will continue to look closely at order-entry controls that lead to an inordinate number of clearly erroneous trade filings.

7 *See* Securities Exchange Act Release No. 58774 (October 14, 2008), 73 FR 61666 (October 17, 2008).

8 Formerly NASD Rule 2110. For additional information, *see* SR-FINRA-2008-028 and *Regulatory Notice 08-57* (p. 30 – 31).

Marking the Close

Given the overall decline in market prices and the increase in market volatility, evidenced particularly in the wide price swings in the last hour of trading, FINRA has intensified its focus on activity around the market close. Firms should review their internal controls, procedures and surveillance practices with regard to marking-the-close issues to ensure that potential misconduct is identified and reviewed in a timely manner. If your firm detects inconsistent share price movement or questionable activity in a security, please notify the Market Regulation Department immediately.

Trade Reporting

Transaction reporting is a constant focus of FINRA's automated surveillance and on-site examinations. Firms are again reminded that they are responsible for the accuracy of the transaction information reported by them or on their behalf, regardless of the means by which that information is reported to FINRA. FINRA has developed a set of frequently asked questions on equity transaction reporting, which is available at *www.finra.org/tradereportingfaq*.

Firms also are reminded that trade reporting obligations will change on August 3, 2009. The current market maker-based trade reporting structure will be replaced by an "executing party" structure. Additionally, firms with a trade reporting obligation that are acting in a riskless principal or agency capacity on behalf of another member firm will be required to submit non-tape reports to FINRA to identify the other firm as a party to the trade. Details of the new requirements are in *Regulatory Notice 09-08 (www.finra.org/notices/09-08)*.

Separately, effective July 1, 2009, firms are required to use two new trade reporting modifiers when reporting the "error correction" and "print protection" exemptions to the Order Protection Rule (Rule 611 of SEC Regulation NMS) to FINRA facilities. Additional information is in *Trade Reporting Notice 2/24/09 (www.finra.org/notices/trade/022409)*.

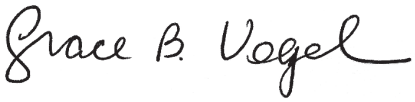
Order Audit Trail System (OATS)

On February 2, 2009, OATS implemented several enhancements to assist firms in the processing of daily OATS submissions. First, new rejection processing was implemented to allow for more efficient and accurate identification of repaired rejections. OATS provides firms with a unique identifier with each rejection that must be submitted back to FINRA with the repaired order event; this allows the order event to be recognized as repaired. FINRA also introduced enhanced processing to better facilitate name and/or MPID changes related to mergers and acquisitions involving member firms. Other changes include additional special handling codes and a new account type designation for firm error accounts. Firms are encouraged to review the OATS Frequently Asked Questions, reporting specifications and other information available on the OATS Web site *(www.finra.org/oats)* for more details regarding these and other OATS reporting requirements, or to call the OATS Helpdesk at (800) 321-6273. Firms also should note that in 2009, FINRA is offering customized OATS training sessions for individual firms conducted via WebEx and teleconference. The OATS Helpdesk has additional information on the training sessions.

We hope that by sharing these areas of potential examination focus and other developments, your firm will be well armed to assess your compliance operations, internal controls and supervisory systems. FINRA is committed to providing firms with prompt and accurate answers to regulatory questions. As part of that commitment, FINRA has assigned a dedicated point of contact—a Coordinator—to each firm. Your firm's Coordinator is responsible for responding to and following through with your queries. In the event that your Coordinator cannot answer a question directly, he or she will put you in touch with someone who can—and follow up to ensure you receive an answer. We encourage you to contact your FINRA Coordinator *(www.finra.org/coordinator)* with any questions you have about the information contained in this letter.

Sincerely,

Robert C. Errico
Executive Vice President
Member Regulation, Sales Practice



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