Financial Industry Regulatory Authority

February 8, 2011

Dear Executive Representative/Chief Compliance Officer:

FINRA is publishing its 2011 Annual Regulatory and Examination Priorities Letter to highlight new and existing areas of significance to our regulatory programs. This edition of the letter includes topics of heightened importance to FINRA's Member Regulation, Market Regulation and Enforcement Departments, and the Office of Fraud Detection and Market Intelligence. The information in this letter represents our current assessment of certain key issues facing the industry. Since business and regulatory environments are fluid, FINRA continually tracks new concerns, changes or areas of risk and integrates them into the scope of our regulatory programs. We trust that the information in this letter will help firms refine their compliance, supervisory and ethics programs.[1]

I. Recent Developments

Our regulatory programs change to meet new challenges and requirements, such as those that may arise through recently enacted federal legislation. Among other things, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) brought, and will continue to bring, substantial regulatory changes to the financial services industry. Under Dodd-Frank, the SEC and other regulators are required to create new rules and standards, many of which will affect FINRA-registered broker-dealers depending on their business activities and structure. Many of these initiatives remain in development, but new rules are expected to be implemented during 2011. Therefore, it is important for FINRA member firms to follow the progress of rulemaking so they have ample time to implement procedures and systems to comply with new regulatory requirements.

The SEC recently released two of several studies mandated by the Dodd-Frank Act. On January 19, the SEC published its study on enhancing examinations for investment advisers,[2] and in another study released on January 22, SEC staff recommended creating a uniform standard of care for brokers and investment advisers that provide personalized investment advice to retail investors.[3]

Below are some of the more significant rulemaking initiatives and programmatic changes we undertook during the past year.

Rulemaking

On the rulemaking side, FINRA has received approval for approximately 85 percent of the Consolidated FINRA Rulebook. The rules better reflect changes to the securities markets and evolving investor protection concerns.

1 *See* previous Annual Letters for additional reference on regulatory and compliance matters.

2 *See* *http://www.sec.gov/news/studies/2011/914studyfinal.pdf*.

3 *See* *http://www.sec.gov/news/studies/2011/913studyfinal.pdf*.

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In addition to rules described in greater detail throughout this letter, the following significant rules were approved by the SEC and/or went into effect in 2010:

Suitability: FINRA Rule 2111, which takes effect on October 7, 2011, generally is modeled after former NASD Rule 2310 and requires a broker to have a reasonable basis to believe that a recommended transaction or *investment strategy* involving a security or securities is suitable. The rule makes clear that a *strategy* includes an explicit recommendation to *hold* a security or securities. Rule 2111 also requires a broker to make reasonable efforts to obtain and analyze more customer-specific factors than the current rule requires by adding age, investment experience, time horizon, liquidity needs and risk tolerance to the existing list from the NASD rule (*e.g.,* other holdings, financial situation and needs, tax status and investment objectives). There is some flexibility in that a broker would not have to seek information on a specific factor if there is a documented, reasonable basis to believe that the factor is not relevant to a suitability assessment. In addition, the new rule emphasizes that a broker must perform reasonable diligence to understand the potential risks and rewards of a recommended security or investment strategy. Finally, the new rule modifies the existing institutional customer exemption in a number of ways. See *Regulatory Notice 11-02*.

Know Your Customer: FINRA Rule 2090, which also takes effect on October 7, 2011, is modeled after former NYSE Rule 405(1) and requires that a firm use "reasonable diligence," in regard to the opening and maintenance of every account, to know the "essential facts" concerning every customer. "Facts 'essential' to 'knowing the customer' are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules." The obligation arises at the beginning of the customer/broker relationship and does not depend on whether the broker has made a recommendation. See *Regulatory Notice 11-02*.

Financial Responsibility: The SEC approved amendments to financial responsibility rules (FINRA Rules 4110, 4120, 4130, 4140 and 4521 and amendments to FINRA Rules 9557 and 9559), which took effect on February 8, 2010. Among other things, the rules enable FINRA to prescribe greater net capital requirements for carrying and clearing member firms in certain circumstances. The rules address circumstances under which a firm may not withdraw capital without the prior approval of FINRA; circumstances under which a firm must suspend its business, is prohibited from expanding its business or is required to reduce its business; and other related requirements. The rules also provide certain expedited hearing processes. See *Regulatory Notice 09-71*.

Networking Arrangements: FINRA Rule 3160, which took effect on June 14, 2010, applies to networking arrangements under which a member firm conducts broker-dealer services on or off the premises of a financial institution. The rule, among other things, incorporates certain requirements of the Gramm-Leach-Bliley Act and Regulation R regarding the obligations of a member firm in a networking arrangement with a financial institution. See *Regulatory Notice 10-21*.

Reporting Requirements: FINRA Rule 4530 requires member firms to report certain events to FINRA, including quarterly statistical information regarding written customer complaints, and to file certain documents. The rule, which is effective July 1, 2011, is based in large part on current NASD Rule 3070, taking into account certain requirements under Incorporated NYSE Rule 351. The rule will apply to all FINRA firms and has several new requirements, including a requirement to report to FINRA within 30 calendar days after a member has concluded, or reasonably should have concluded, on its own that the member or an associated person of the member has engaged in certain violative conduct. See *Regulatory Notice 11-06*.

Market Regulation Expansion

As a result of a multi-year extension of the NASDAQ Regulatory Services Agreement (RSA) and a new RSA with the NYSE family of markets, FINRA's Market Regulation department is now responsible for surveillance of 80 percent of the trading volume in U.S. equity markets and 35 percent of the volume in U.S. options markets. The expansion of surveillance duties allows FINRA to better capture and analyze data that can help us detect problematic trading activity across multiple markets and financial products.

Order Audit Trail System (OATS)

In November 2010, the SEC approved FINRA's proposal to expand the OATS reporting requirements to all NMS stocks. As a result, effective July 11, 2011, firms will be required to report to FINRA not only order information in NASDAQ-listed and OTC equity securities, but also order information in all other NMS stocks (*i.e.,* those listed on the NYSE, NYSE Amex, NYSE Arca and all other national securities exchanges). The expansion of OATS to all NMS stocks will enhance significantly FINRA's ability to perform market surveillance on a cross-market basis and will result in NYSE eliminating its Order Tracking System (OTS) requirements, which will reduce duplicative reporting. FINRA published a new version of the *OATS Reporting Technical Specifications* on January 11, 2011, that explains the changes to OATS. See *Regulatory Notice 11-03*.

Trade Reporting

In March 2010, the SEC approved FINRA's proposal to reduce the time period for reporting trades. Effective November 1, 2010, firms must report over-the-counter transactions in equity securities to FINRA within 30 seconds of execution. The new reporting time frame also applies to trade cancellations. Also effective as part of the November 1, 2010, changes, firms must report secondary market transactions in non-exchange-listed direct participation program securities within 30 seconds of execution, which makes the standard uniform for all listed and unlisted equity securities. Such transactions also are now subject to regulatory transaction fees under Section 3 of Schedule A to the FINRA By-Laws. See *Regulatory Notice 10-24*.

Membership Applications

FINRA recently centralized its Membership Application Program (MAP). Through the MAP process, entities seeking to become FINRA member firms submit applications for FINRA review. FINRA member firms also use the MAP process to seek approval of certain changes to their ownership, control or business operations, including modifications to existing membership agreements under the NASD Rule 1010 Series. The centralized function with dedicated MAP staff is designed to ensure an effective and consistent review of applications and implementation of policies across the country. Firms may continue to direct MAP-related matters to their Regulatory Coordinator, as well as to the centralized MAP team.

Thematic Reviews

In 2010, FINRA began using a thematic approach to certain examinations. Conducted in partnership with traditional examination teams, these examinations are designed to facilitate a more comprehensive understanding of broader, systemic concerns. The 2010 reviews focused on two themes: new products and information technology/cyber security. As these examinations are concluded, FINRA will determine whether publishing our findings would help broker-dealers bolster their supervisory and compliance programs.

II. Examination Priorities

Upcoming examination priorities represent issues that FINRA examines for across a general population of firms or reviews on a targeted basis. Our examination program is, however, risk-based, meaning that the scope, content, frequency and nature of a firm's examination will depend on characteristics inherent to the firm, including the risk, scale and nature of operations and business lines. If your firm engages in the activities captured in this section, we advise you to assess whether your internal controls, supervisory systems and risk management practices properly address the matters discussed.

FINRA expects firms to have policies and procedures in place to address timely and effectively regulatory findings in examinations or disciplinary proceedings. When FINRA identifies deficiencies through an examination, we communicate the findings to firms in writing, and firms must respond in writing, outlining corrective actions they have taken to address the findings. In instances where firms undertake prescribed remedial steps in connection with a disciplinary proceeding, examiners will validate whether remediation was appropriately completed. A delay in addressing identified regulatory weaknesses can lead to repeat violations and subject the firm or associated persons to additional disciplinary action.

Fraud Detection

FINRA's regulatory programs emphasize the detection of fraud and other egregious misconduct. FINRA examiners are trained to spot and investigate red flags that may indicate fraudulent behavior, whether associated with offerings, stock manipulations, misrepresentations or other misconduct. Also, as fraudulent schemes may be conducted through or with the material assistance of non-member affiliates, examiners will spend time gaining a thorough understanding of affiliate activity, how it interacts with broker-dealer business and any conflicts of interest it may pose. Where red flags associated with fraud and other serious misconduct exist, we will refer matters to other regulators.

Firms are reminded that FINRA Rule 4160 became effective February 1, 2011, and it strengthens FINRA's ability to verify independently customer and proprietary assets maintained by a member firm at a non-member financial institution. Specifically, if FINRA is unable to obtain prompt written verification of assets held by a non-member financial institution, the member firm, when notified by FINRA, will be prohibited from continuing to custody or retain record ownership of the assets at such non-member financial institution. This important new rule will be used to help the staff determine whether investor assets are safe or whether serious misconduct may have occurred. See *Regulatory Notice 10-61*.

Fraudulent Activity Associated With Customer Accounts

Just as firms have a primary responsibility to supervise their associated persons and ensure that they are not involved in fraudulent schemes, firms must also be vigilant regarding their customers. Customer-initiated schemes can expose firms to regulatory, operational and reputational risk. FINRA expects firms to maintain robust supervisory systems and AML monitoring systems that reasonably are designed to detect and report suspicious transactions. These types of procedures should assist firms in identifying clients who engage in high-risk activity and determining whether their business activity is appropriate and whether the firm can adequately mitigate any risks associated with such client activity.[4]

4 *See also* "Master-Sub Account Relationships" as described later in this letter.

High-Frequency Trading, Algorithms, Sponsored Access, Direct Market Access and Trading Pauses

Market events such as the May 6, 2010, "flash crash" and the predominance of high-frequency trading (HFT) and algorithmic trading in today's highly automated equities markets place a heightened focus on member firms' efforts to establish effective controls over electronic order routing and market access arrangements, including surveillance of algorithmic trading and HFT strategies.

On November 3, 2010, the SEC adopted Securities Exchange Act (SEA) **Rule 15c3-5** relating to risk management controls for brokers or dealers with market access. The rule has an effective date of January 14, 2011—although firms have until July 14, 2011, to comply with the rule. The rule applies to trading in all securities on an exchange or Alternative Trading System (ATS). Among the various requirements of the new rule for brokers and dealers with market access, or those that provide customers with market access, is the requirement that the firm's CEO or equivalent officer certify annually that the risk management controls and supervisory procedures comply with SEA Rule 15c3-5 and that regular reviews were conducted.[5]

FINRA evaluations under SEA Rule 15c3-5 and ***Notice to Members (NTM) 04-66*** will focus on reviewing and testing firms' policies and procedures, verifying that the annual review and certification requirements are conducted, and assessing whether firms are adequately addressing operational risks associated with engaging in these businesses. In addition, FINRA expects firms generating orders by use of HFT models or trading algorithms to have written policies and procedures in place that are reasonably designed to ensure that such trading complies with applicable FINRA rules and federal securities laws and regulations, including anti-manipulation provisions.

FINRA also has implemented a trading pause pilot for OTC transactions in exchange-listed securities whenever a trading pause has been initiated by the primary listing market. This single stock trading pause pilot went into effect for S&P 500 securities on June 10, 2010, and works in concert with exchange rules that provide for a pause in trading whenever the price of any covered security moves 10 percent or more from a sale in a preceding five-minute period. The trading pause pilot was expanded on September 14, 2010, to Russell 1000 securities and a list of specified Exchange-Traded Funds and is currently set to end on April 11, 2011. See *Regulatory Notices* ***10-30*** and ***10-43***.

Short Sales and Regulation SHO

FINRA continues its focus on short sale compliance in 2011 as concerns detailed in the 2010, 2009 and 2006 versions of this letter remain, including those involving locate responsibilities. In a recent enforcement matter, firms implemented Direct Market Access trading systems for their customers that were designed to block the execution of short sale orders unless a "locate" had been obtained and documented. FINRA found, however, that the firm disabled this system in certain instances and its clearing firm created a separate system for certain customers. In both instances, the systems no longer blocked some short sale orders that did not have valid, associated locates.[6]

5 The SEC noted it would expect in many cases that the CEO certification required by SEA Rule 15c3-5 would be completed in conjunction with a firm's annual review and certification under FINRA Rule 3130; however, the SEC made clear that the SEA Rule 15c3-5 certification was a separate and distinct certification from the Rule 3130 certification (although they could be combined in the same document).

6 *See* FINRA Fines Deutsche Bank Securities, National Financial Services a Total of $925,000 for Systemic Short Sale Violations.

The SEC adopted amendments to Regulation SHO that become effective February 28, 2011. Among other things, the amendments implement a short-sale related circuit breaker for NMS stocks triggered by a 10 percent or more decrease in the price of the security from the security's closing price at the end of regular trading hours on the prior trading day. Regulation SHO, as amended, generally requires trading centers to establish, maintain and enforce written policies and procedures reasonably designed—once a circuit breaker is triggered—to prevent the execution or display of short sale orders of an NMS stock at a price that is less than or equal to the current national best bid for the remainder of the day and the following day, unless an exemption applies. See *Regulatory Notice 10-48*.

Information Barriers

FINRA remains concerned about weak information barrier controls around the flow of material, non-public information within the firm and with its affiliates, clients and others that are intended to prevent insider trading, front running or other misuse of material and non-public information. FINRA's proposed Rule 5320, pending with the SEC at the time of this letter, addresses the protection of customer limit and market orders, and it codifies and expands "no knowledge" exceptions to these protection rules in line with similar exceptions in NYSE Rule 92. With respect to NMS stocks, if a member firm implements and uses an effective system of internal controls, including appropriate information barriers that prevent "walled off" proprietary desks from obtaining knowledge of customer orders, those desks may trade at prices that would satisfy a customer order without triggering an obligation for the firm (as long as the requirements of this exception are met). Please review prior versions of the Annual Letter for additional details on information barriers, including information on policies, controls, insider trading and front running.

Firms also should be aware of information they are receiving and the potential that it may be considered material, non-public information. The company-specific information provided by outside research firms or "expert networks" in some cases may be considered material, non-public information, depending on the source and how it is disseminated. Firms should review present controls with respect to inside information and consider whether additional controls and procedures regarding their use of such information are necessary.

Private Placements and Private Self-Offerings

FINRA continues to focus on the retail sales of private placement interests, especially those issued by broker-dealers and control affiliates. FINRA's examinations and investigations have identified significant failures in firms' compliance with suitability, supervision and advertising rules, as well as potential instances of fraud and participation in illegal distributions of unregistered securities. A number of these investigations have led to enforcement actions. In 2010, FINRA expelled a firm for marketing a series of fraudulent private placements offered by its affiliate in a massive Ponzi scheme[7] and filed a temporary cease-and-desist order against another firm to halt allegedly fraudulent and illegal sales activities at the firm relating to eight unregistered private placement offerings selling interests in oil and gas joint ventures.[8]

7 *See* Dallas-Based Provident Asset Management Expelled for Marketing Fraudulent Private Placements Offered by Affiliate in Massive Ponzi Scheme.

8 *See* FINRA Seeks Cease-and-Desist Order to Halt Ongoing Fraud and Misuse of Funds by Pinnacle Partners and Its President Brian Alfaro.

Regulatory Notice 10-22 reminds firms of their obligations to conduct reasonable investigations into Regulation D offerings. The *Notice* describes specific issues that pertain to firms' responsibilities and how the scope of a firm's responsibility to conduct a reasonable investigation necessarily depends upon its affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail investors or more sophisticated institutional investors. It also provides information on practices that some broker-dealers have adopted to help them discharge their reasonable investigation obligations. Similarly, FINRA Rule 5122 plays an important part in the effort to protect investors in the private placement market where the broker-dealer or a control entity is the issuer. FINRA is requesting comment on an expansion of the provisions of Rule 5122 to cover all private placements in which broker-dealers participate, subject to limited exemptions, to provide investors with additional protection from fraud and abuse. The comment period expires March 14, 2011. See *Regulatory Notice 11-04*.

Trading in Non-Public Securities

FINRA has closely followed trends regarding trading in the unregistered shares of companies that report no public information. Some of the private firms whose securities have been "trading" in this market are well known to the general public. We are concerned that such public attention, along with the fact that this sector is opaque compared to the public securities markets, could attract bad actors who may engage in misconduct. The regulations that require an issuer to register its securities with the SEC and report financial and other vital information prior to any public trading of its securities are fundamental to investor protection. Also, any transaction, primary or secondary, in unregistered securities must be conducted pursuant to a valid exemption from registration requirements. Such exemptions require careful compliance (*e.g.,* observing prohibitions on general solicitations). Aside from registration compliance, firms engaged in this activity are also required to abide by all other securities rules, including those addressing suitability, fair pricing to customers and communication standards, particularly the need to make full and fair disclosures of risk to customers considering purchases of unregistered shares.

High-Yield Investments

As a result of the continuing low interest rate environment, customers seeking higher investment returns increasingly have turned to high-yield municipal, corporate and other credit obligations. FINRA has significant concerns that retail investors who are attracted to the yield offered on certain securities may not consider or understand fully the trade-offs of higher yield with respect to credit risk and liquidity. Firms recommending low-rated or non-rated securities, particularly to retail customers, are reminded of their obligation to perform reasonable-basis and customer-specific suitability analyses based on information known about the particular product and the investment objectives and risk tolerance of the customer. In addition, firms must ensure that investors are informed that certain products bear an inverse relationship to interest rate moves and that preservation of principal is not guaranteed. Further, the information presented to customers about these investments must be fair and balanced.

Municipal Securities

Municipal securities dealers must understand the municipal securities they sell to meet their disclosure, suitability and pricing obligations, and obligation to deal fairly with customers under the rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws. Firms must review their procedures for compliance with MSRB Rule G-32, which requires the delivery of an official statement, or a notice of its availability on the MSRB's Electronic Municipal Market Access (EMMA) system, to any customer purchasing a municipal security during the primary offering disclosure period.[9]

9 In November 2010, the FINRA Report Center introduced a new report that identifies transactions that were subject to this delivery requirement. *See* the Report Center for further details.

Generally, however, disclosure, suitability and pricing obligations—and the obligation to deal fairly with customers—are not limited to primary market transactions. In any transaction in a municipal security, a dealer must obtain, analyze and disclose to customers all material facts about the transaction that are known to the dealer, as well as material facts that are reasonably accessible to the market through established industry sources.

Material information must be disclosed to customers at or before the time of trade to enable them to evaluate these investments. Continuing disclosures made by issuers to the MSRB via EMMA are part of the information that dealers must obtain, disclose and consider in meeting their regulatory obligations. The SEC recently amended SEA Rule 15c2-12, which governs continuing disclosures.[10] In any transaction in a municipal security, firms also must have reasonable grounds for determining that a recommendation is suitable for a customer based on information available from the issuer or otherwise, and must use information that is available to determine the prevailing market price of a security as the basis for establishing a fair price in a transaction with a customer. To meet these regulatory requirements, among other things, firms must perform an independent analysis of the municipal securities they sell and may not rely solely on a security's credit rating. Accordingly, any firm that sells municipal securities must review and, as necessary, update their procedures to ensure compliance with MSRB rules and the federal securities laws, including the recent amendments to SEA Rule 15c2-12. See *Regulatory Notice 10-41*.

Non-Conventional Investments

FINRA is focusing on firms that offer structured products and certain riskier asset-backed securities to retail investors. Recent enforcement cases highlight the importance of training brokers on products the firms sell and reasonable supervision to ensure suitable recommendations.[11] Brokers must understand the risks and costs associated with the products they recommend and disclose them to customers. For instance, collateralized mortgage obligations (CMOs) present a variety of risks, including credit and default risk, interest rate risk, prepayment risk and extension risk. CMOs are structured into different tranches, each with their own set of rules by which interest and principal are distributed. It is important for brokers to understand the features of the tranche they are selling and the rules governing its income stream as these affect the product's risk. Firms also should pay careful attention to recommendations that may lead to unsuitable concentration levels of non-conventional investments.

Residential and commercial real estate market concerns continue to weigh on products, such as non-traded REITs. Non-traded REITs may attract investors who do not understand the extent of the risks, including lack of liquidity, lack of accurate and up-to-date valuations, impact of fees, potential conflicts between the interests of investors and those of REIT managers, and dividends that may represent a return of investors' capital rather than operating income. Recently, there have also been share devaluations, dividend cuts and suspensions of share buyback programs. FINRA examiners will closely review sales of these products to unsophisticated investors to ensure firms conducted appropriate pricing due diligence and suitability analyses and disclosed all risks.[12]

10 17 CFR 240.15c2-12.

11 *See, e.g.,* FINRA Fines H&R Block Financial Advisers $200,000 for Inadequate Supervision of Reverse Convertible Notes Sales, Suspends and Fines Broker for Unsuitable Sales to Retired Couple and FINRA Fines HSBC $375,000 for Unsuitable Sales of Inverse Floating Rate CMOs to Retail Customers and Related Supervisory Failures.

12 For additional information on new products and non-conventional investments, *see Regulatory Notices 10-09, 09-73, 08-81* and *07-43, NTMs 05-26* and *03-71*, and the 2010, 2009 and 2008 *versions of this letter*.

Exchange-Traded Funds and Notes

FINRA has increased its focus on exchange-traded funds and notes (exchange-traded products or ETPs). Many of these products are complex and we have observed a considerable increase in the number of and trading volume in ETPs, as well as increased interest by retail investors. In addition to overall sales practice concerns, we have identified marketing materials that appear to omit the material risk disclosures necessary to provide a sound basis for evaluating a product as required by FINRA's advertising rules. In this regard, FINRA is conducting targeted exams to gather information on advertising and sales literature pertaining to ETPs that are not registered investment companies. See *Regulatory Notices* ***09-31*** and ***10-51***.

Vulnerable Customers

Certain types of customers, such as retired, elderly or ill customers, or those who are part of an affinity group, may be particularly vulnerable to certain risks. Promoting investments based on higher yields or principal protection may be attractive for such clients. Due to the low interest rate environment, firms must be particularly sensitive to ensure that brokers do not place vulnerable customers into inappropriately risky products through misleading sales pitches or without conducting a proper suitability analysis. Firms must be mindful that assets, liquidity and income levels of customers change over time and that certain life events may materially change a customer's profile. FINRA also reminds firms that if they permit registered representatives to use professional designations of any kind, including those that suggest an expertise in retirement planning, firms must have procedures in place to ensure these designations are legitimate and not used in a misleading manner.

Finally, as vulnerable customers may be more susceptible to fraud, firms must pay particular attention to their supervisory responsibilities, including when automated supervisory systems are employed. In a recent enforcement action, FINRA expelled a firm and barred two individuals for overcharging an elderly investor $1.2 million in undisclosed markups, including $767,000 in fraudulently excessive markups.[13] Further, FINRA ordered another firm to pay $1.44 million, barred a broker and sanctioned a former branch manager relating to pattern short-term trading that was clearly unsuitable for the customers involved.[14]

Electronic Communications and Social Media

Regulatory concerns associated with the use of email and instant messaging through firm-hosted networks have expanded to include other types of electronic communications, such as text messages, blogs, bulletin boards, interactive forums, social networks and Skype messaging. Firms are still required to establish an adequate system to retain and supervise all electronic communications relating to their business, including whether such activities are permitted and what procedures apply. As such, any electronic communication sent from a registered representative or firm to a customer or prospective customer relating to the firm's business, regardless of the communication medium or origination point (*e.g.,* office, home or public computer), is subject to applicable FINRA and SEC rules regarding communications with the public, as well as supervision and retention of such communication.

13 *See* FINRA Expels APS Financial, Bars Former President and Former Broker for Targeting an Elderly Investor with Fraudulently Excessive Mark-ups, Elderly Investor Was Overcharged $1.2 Million, Mark-Ups as High as 67 Percent.

14 *See* FINRA Orders SunTrust Investment Services to Pay $1.44 Million for Unsuitable UIT, Closed-End Fund and Mutual Fund Transactions, Sanction Includes $540,000 in Restitution to Disadvantaged Customers; Broker Barred in Separate Action, Former Branch Manager Suspended.

The content and audience of a communication are important in determining the type of electronic communication in use and therefore the applicable rules and regulations. For example, when considering social media, while prior approval by a registered principal is required for static content on such sites, interactive, real-time communications can be supervised using reasonable methods of post-use review. In 2011, firms can expect FINRA examiners to review supervisory systems and recordkeeping for electronic communications like social media. See FINRA's *Guide to the Internet for Registered Representatives*, which provides additional information on the supervision of various types of electronic communications, and *Regulatory Notices* *07-59* and *10-06*.

Consolidated Account Reports

In recent years, the use of consolidated financial account reports by firms has increased in response to customer and investment adviser demand for this service. Consolidated financial account reports generally offer a single document that combines a customer's financial holdings and may include alternative investments such as hedge funds, private placements and other financial holdings regardless of where those assets are held. FINRA remains concerned about the potential use of consolidated financial account reports that could mislead investors or be used to perpetrate fraudulent activity, including Ponzi schemes. When investments are displayed on consolidated financial account reports, customers get a sense of comfort or legitimacy. These reports are subject to applicable rules regarding communications with the public and firms must supervise them accordingly. As such, firms that accommodate the inclusion of a wide variety of asset classes on consolidated financial account reports—especially assets held outside the firm—must have procedures in place to conduct due diligence on the valuation of such assets prior to including them on financial account reports to customers.

In *Regulatory Notice 10-19*, FINRA provides guidance and reminds firms of their responsibilities for compliance with applicable rules when using consolidated financial account statements, including, for example, when assets in the reports are not in the broker-dealer's possession or control ("assets held away"). When consolidated financial account reports contain assets held away, FINRA examiners may review the firm's procedures for verifying the existence of the assets and their valuation. Finally, the *Notice* reminds firms that if they cannot supervise the dissemination of consolidated reports by their registered representatives, then the distribution of those reports must be prohibited.

Hiring and Compensation Practices

FINRA examinations continue to focus on firms' hiring practices with particular attention to the supervision of newly hired individuals and enhanced compensation packages negotiated as part of the recruitment process. In addition to conducting a thorough review of an applicant's background, firms must assess whether enhanced compensation arrangements could create incentives for brokers to engage in conduct contrary to the best interests of their clients, and must review for and supervise these potential conflicts. For a further discussion of a firm's supervisory obligations in this area, see SEC Chairman Schapiro's open letter.

Outside Business Activities and Private Securities Transactions

FINRA has observed matters involving undisclosed or problematic outside business activities and private securities transactions. FINRA Rule 3270, which took effect December 15, 2010, prohibits registered persons from engaging in any outside business activity unless prior written notice has been provided to the firm, sets forth the firm's obligations upon receipt of a written notice and describes recordkeeping requirements. While the rule is effective for all new outside business activities, firms have until June 15, 2011, to review pre-existing activities under the standards set forth in the rule for registered persons who were engaged in an outside business activity prior to December 15, 2010.

To ensure compliance with FINRA rules, firms also must understand the nature and extent of any approved private securities transaction, thoroughly document the process undertaken to either approve or reject these requests, and effectively supervise approved private securities transactions. Firms can anticipate that examinations will continue to focus on notification and approval requirements, but should also expect substantive reviews of the activities themselves. See *Regulatory Notice 10-49*.[15]

Master/Sub-Account Relationships

Master/sub-account relationships raise a host of regulatory issues for firms and carry the risk that the firm does not know the identity of its "customer" as required by federal securities laws, including the Customer Identification Program (CIP) provisions of the Bank Secrecy Act, and FINRA Rule 3310. In some situations, despite the fact that there is an intermediary master account, a firm may be required to recognize a sub-account as a separate customer of the firm. FINRA examiners closely review firms' procedures for determining the beneficial ownership of each account within a master/sub-account structure in accordance with the guidance published in *Regulatory Notice 10-18*. FINRA examiners will review firms' systems for monitoring, detecting and reporting suspicious activity in master/sub-account structures, whether or not the sub-account should be considered the firm's customer for CIP purposes.

FINRA examiners also will focus on whether the firm is properly monitoring transactions in master/sub-account structures for potentially manipulative activity and reporting that activity, as appropriate, on a Suspicious Activity Report (SAR). In a recent enforcement action, FINRA sanctioned a firm for failing to adopt risk-based procedures to verify the identity of sub-account holders, even though these customers lived overseas in high-risk jurisdictions and could freely execute trades for their own profit, and also for failing to adopt effective procedures for detecting suspicious activity.[16] FINRA examiners also will assess whether the master account is acting as an unregistered broker-dealer. Further, if sub-accounts are represented as individual proprietary traders of the master, examiners will determine whether such proprietary traders are required to be registered and will also review the relationships to determine whether such traders should be recognized as separate customer accounts.

Master/sub-account relationships have also raised issues under other FINRA and SEC rules, such as margin rules and books and records requirements. If a determination is made during the course of an examination that the beneficial ownership of the sub-accounts is different from that of the master account, the sub-accounts would need to be recognized as separate customers and firms could encounter significant net capital charges for under-margined accounts and significant SEA Rule 15c3-3 reserve formula implications. See *Regulatory Notice 10-18* for additional information.

Funding and Liquidity Risk Management

The financial crisis provided many lessons for risk managers, regulators and market participants. Chief among them is the crucial role played by a risk-conscious culture, including having a holistic view of organizational risk and flexible risk management programs and systems to adjust to rapidly deteriorating market conditions to minimize losses and avert operational failures. Broker-dealers must be prepared to manage their daily operations under severe and prolonged adverse market conditions. Prudent funding and liquidity risk management practices enhance a broker-dealer's ability to continue financing its operations and meet its customer and counterparty obligations during periods of market turbulence and uncertainty resulting from market specific events or wider systemic shocks.

15 For additional information, *see also NTMs 03-79, 01-79, 96-33, 94-93, 94-44, 91-32,* and *90-37*.

16 *See* Pinnacle Capital Markets Fined $300,000 for Failing to Verify Foreign Customer Identities and to Detect and Report Suspicious Activity.

As such, broker-dealers are expected to manage their funding and liquidity requirements at the broker-dealer level. Prudent funding and liquidity risk management practices include a wide range of controls commensurate with the firm's trading practices, inventory composition, client base, counterparty exposures and current and future funding obligations. In this regard, we are highlighting the importance of independent risk oversight by senior management to monitor early warning signs. Firms should establish a risk-limit structure and corresponding management reports to ensure that risk tolerance is clearly defined and escalation procedures are outlined. Further, firms should strive to diversify funding sources and avoid over reliance on short-term funding sources to finance operations. In addition, periodic stress testing and scenario analysis, under a range of severity and duration assumptions, can help to identify potential sources of liquidity strain and quantify the potential effects on the firm's liquidity and solvency. Other prudent practices include independent price verification of inventory and effective collateral management to limit exposures to counterparties. Finally, firms should develop and maintain a contingency funding plan to outline the actions it will take, specify the funding sources it will employ and clarify decision-making authority during periods of liquidity strain. See *Regulatory Notice 10-57*.

Intercompany Transactions/Affiliate Relationships and Activities

Firms are expected to maintain accurate books and records for affiliate transactions, and to have a process in place to perform reconciliations and promptly resolve any differences, including those related to expense sharing, revenue sharing or other service level agreements (see *NTM 03-63*). Firms also are expected to maintain an effective internal control process around the recording of intercompany securities and derivative transactions, which includes identification of legal entity risk exposures to these transactions, maintenance of agreements, valuation and collateralization, and the net capital treatment of such transactions.

In addition, firms are reminded that non-broker-dealer affiliate accounts are to be treated as customer accounts for reserve formula purposes, unless the firm can meet the non-conforming subordination requirements under SEA Rule 15c3-3(a)(1)/021. Firms are reminded that all non-conforming subordination agreements should be submitted to FINRA for review and approval. In these circumstances, securities lent out by these affiliates are not protected under the Possession or Control requirements of SEA Rule 15c3-3. In addition, firms that classify foreign banks as non-customers must ensure they comply with the requirements of SEA Rule 15c3-3(a)(1)/032. Lastly, firms that pledge securities of proprietary affiliated foreign broker-dealer accounts for funding purposes must obtain written permission from the affiliated entity to utilize such assets.

Governance and Control Over Margin Lending

During FINRA's 2010 reviews of margin lending and quality of margin collateral, we noted instances where firms granted large margin loans to customers or firm employees without sufficient risk controls over the approval process. For example, if a firm makes individual margin loans that are material relative to its capital, or allows as collateral to these loans securities that are complex in structure or are of questionable marketability, the firm should have a governance process in place to approve such loans. In such cases, examiners will review the governance process to ensure that it is designed to control risks around margin lending, including assessing the type and sufficiency of collateral, credit worthiness of the borrower, valuation and liquidity of the collateral, concentrations of collateral, ability of the firm to fund the loan (liquidity risk) and other factors that are important to assessing risks around margin lending. FINRA will also review to ensure that appropriate levels of management representing diverse control functions are involved in the approval process. Firms that do not have such processes in place may be cited for not having sufficient controls over margin lending, especially in cases where large or non-standard margin loans are offered to customers.

III. Conclusion

FINRA will further explore the topics addressed in this letter in an upcoming webinar. An on-demand version will be available shortly after the live program occurs.

We hope that the topics addressed in this letter provide insightful information that will help firms understand FINRA's view of key risk areas. We encourage broker-dealers to use the information to enhance their supervisory and compliance programs to mitigate risk and better protect investors. As always, you may contact your firm's Regulatory Coordinator with specific questions or comments. In addition, if you have general comments regarding this letter or suggestions on how we can improve it, please send them to Daniel M. Sibears, Executive Vice President, Member Regulation Programs, at *dan.sibears@finra.org*.

Sincerely,

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