FINRA®
Financial Industry Regulatory Authority

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

Business Conduct Priorities

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

Suitability

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

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

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

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

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

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

Focus on Recidivist Brokers

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

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

Conflicts of Interest

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

Cybersecurity

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

Qualified Plan Rollovers

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

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

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

Initial Public Offering Market

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

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

General Solicitation and Advertising of Private Placements

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

Due Diligence and Suitability of Private Placements

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

Offerings of Securities through Private Placements

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

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

Anti-Money Laundering (AML)

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

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

Municipal Advisors

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

Crowdfunding Portals

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

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

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

Senior Investors

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

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

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

Fraud Priorities

Microcap Fraud

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

Insider Trading

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

Financial and Operational Priorities

Funding and Liquidity Risk

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

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

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

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

Risk Control Documentation and Assessment

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

Accuracy of Firm's Financial Statements and Net Capital

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

Auditor Independence

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

Market Regulation Priorities

Algorithmic Trading and Trading Systems

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

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

High Frequency and Other Algorithmic Trading Abuses

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

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

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

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

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

Audit Trail Integrity

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

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

Best Execution of Equities, Options and Fixed Income Securities

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

Conclusion

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

Endnotes

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