Financial Industry Regulatory Authority

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Each year, FINRA publishes its regulatory and examination priorities to highlight areas of significance to our regulatory programs. These priorities represent our current assessment of the key investor protection and market integrity issues on which we will focus in the coming year. Since business and regulatory environments are fluid, FINRA continually assesses new risks and integrates them into the scope of its regulatory programs.

Business Conduct and Sales Practice Priorities

FINRA recognizes that retail investors have been challenged to find attractive returns within their risk tolerance. The current slow growth, low-interest-rate environment leaves retail investors particularly vulnerable. Central bank purchases and investors' efforts to lower balance sheet risk and shift assets to safer investments have contributed to an unprecedented compression of credit risk premiums and yields in the United States.[1] At the same time, retail investors are increasingly shifting funds from equity to debt markets. Investor appetite for yield, among other factors, has bid up market prices on investment-grade and high-yield debt, putting pressure on upside growth potential and creating significant downside risks. In this environment, FINRA is particularly concerned about sales practice abuses, yield-chasing behaviors and the potential impact of any market correction, external stress event or market dislocation on market prices. Against this background, we intend to focus our examination efforts on the following areas.

Suitability and Complex Products—FINRA's recently revised suitability rule (FINRA Rule 2111) requires broker-dealers and associated persons to have a reasonable basis to believe a recommendation is suitable for a customer. Given the market conditions discussed above, we are particularly concerned about firms' and registered representatives' full understanding of complex or high-yield products, potential failures to adequately explain the risk-versus-return profile of certain products, as well as a disconnect between customer expectations and risk tolerances. More specifically, we are concerned about:

- the market risk exposures associated with interest-rate-sensitive investments and the corresponding alignment with customer risk tolerances given today's low-yield environment;
- credit risk exposures associated with investments where the creditworthiness of counterparties may not necessarily be transparent to or align with the risk tolerance of customers; and
- liquidity risk exposures associated with investments where the timing of cash flows or the ability to quickly liquidate positions may not align with customer cash flow needs.

Certain, sometimes complex, products have recently surfaced as potentially unsuitable and otherwise problematic for retail investors based on their underlying market, credit and liquidity risk characteristics. The following list is not intended to be exhaustive.

Business Development Companies (BDCs)—BDCs are typically closed-end investment companies. Some BDCs primarily invest in the corporate debt and equity of private companies and may offer attractive yields generated through high credit risk exposures amplified through leverage. As with other high-yield investments, such as floating-rate/leveraged loan funds, private REITs and limited

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partnerships, investors are exposed to significant market, credit and liquidity risks. In addition, fueled by the availability of low-cost financing, BDCs run the risk of over-leveraging their relatively illiquid portfolios. A noteworthy development in the BDC market has been the increasing issuance of non-traded BDC funds. Due to the illiquid nature of non-traded BDCs, investors' exit opportunities may be limited only to periodic share repurchases by the BDC at high discounts.

Leveraged Loan Products—Leveraged loans are adjustable-rate loans extended by financial institutions to companies of low credit quality that have a high amount of debt relative to equity. Funds that invest in leveraged loans have seen relatively heavy inflows during 2012.[2] Unlike traditional fixed income bonds, floating-rate loans do not trade on an organized exchange, making them relatively illiquid and difficult to value. Funds that invest in floating-rate loans may be marketed as products that are less vulnerable to interest rate fluctuations and offer inflation protection, but the underlying loans held in the fund are subject to significant credit, valuation and liquidity risks that may not be transparent to investors.

Commercial Mortgage-Backed Securities (MBS)—As noted earlier, FINRA has concerns about yield compression, and those concerns apply to agency MBS as a fixed-income instrument. But not all CMOs are alike. FINRA has heightened concerns about the sale and marketing of commercial mortgage-backed securities to retail investors. Specifically, we are concerned that firms are not fully disclosing in a transparent manner the considerable risks given today's low-interest-rate, low-yield environment. The commercial mortgage-backed securities space, in particular, has seen a significant compression in risk premium in 2012 as investors have bid up prices and driven down yields while default rates remain high as compared to historical norms.

Similarly, products that we previously identified as troublesome continue to cause us concern based on the risks described above.

High-Yield Debt Instruments—Since the domestic financial crisis, the high-yield debt market has been viewed as an attractive alternative to other financial products. Given the inverse relationship between price and yield, this influx of cash into the high-yield market has increased prices and put downward pressure on yields. In September 2012 alone, investors put an estimated $8.8 billion in high-yield-bond funds, bringing the 2012 total as of October 5 to a record $64.5 billion—more than double the previous high of $31.8 billion in 2009, according to EPFR Global.[3] Risk premiums have compressed across the sector, resulting in significant market risk exposures. In addition, an increasingly diverse range of companies have recently engaged in high-yield underwritings, and some of these companies have very high-level cash flow or funding demands that raise significant credit risks.

Structured Products—These products may be marketed to retail customers based on attractive initial yields and in some cases on the promise of some level of principal protection. These products are often complex, and have cash-flow characteristics and risk-adjusted rates of return that are uncertain or hard to estimate. In addition, these products generally do not have an active secondary market.

Exchange-Traded Funds and Notes—Retail investors may not understand the differences among exchange-traded index products (*e.g.,* funds, grantor trusts, commodity pools and notes) and the risks associated with these investments, particularly those that employ leverage to amplify returns. We are also concerned about the proliferation of newly created index products lacking an established track record, such as those with valuations and performance tied to volatility, emerging markets and foreign currencies.

Non-Traded REITs—We are concerned that customers of non-traded REITs may not fully understand the sales costs deducted from the offering price and the repayment of principal amounts as dividend payments in the early stages of a REIT program.

Closed-End Funds—In today's low-interest-rate environment, retail investors find the high distribution rates associated with many closed-end funds attractive. Distributions may be composed of dividends, interest income, capital gains and/or return of capital. We are concerned that retail investors may not understand that some funds are returning capital to maintain high distribution rates, causing the closed-end funds to trade at high premiums compared to their NAV.

Municipal Securities—Rated municipal securities, on the aggregate, have demonstrated relatively strong repayment patterns as compared to similarly rated corporate bonds. General obligation bond default rates typically hover around 0.1 percent. However, market sectors dependent upon private profit-making or nonprofit performance, for example, experienced significantly higher default rates.[4] We are concerned that brokers may fail to disclose the material risks associated with these kinds of higher risk bonds, and that customers searching for safe-harbor investments may assume that these instruments share the same risk-versus-reward profile of general obligation municipal securities.

Variable Annuities—Although variable annuity products can offer valuable benefits to investors seeking predictable income streams, tax deferral for investment gains and flexible investment choices, long holding periods in conjunction with significant surrender charges can make them unsuitable for investors who have near-term liquidity needs. In addition, high fees and expenses above typical subaccount fees reduce performance, and high commissions make the product a target for switching. Moreover, consolidation in insurance companies offering variable annuities may provide an inappropriate incentive for brokers to recommend exchanges. Where the insurance company offers to buy back the product or increase the account value to forgo product guarantees, it may also present both brokers and investors with a less-than-clear picture of the financial benefit to the investor as well as the challenge of finding a similar product with the features included in the prior product.

Our examiners will focus on the suitability of recommendations, the brokers' level of product-specific knowledge, the level of due diligence in assessing the risk tolerance and liquidity needs of the customer when making investment recommendations, the manner in which material risk exposures are disclosed to customers and the impact on broker compensation associated with competing investment alternatives.

Cyber-Security and Data Integrity—Given the steady number of cyber-security issues that affected the financial services industry in 2012, FINRA continues to be concerned about the safety and integrity of sensitive customer data. The frequency and intensity of threats, such as denial of service attacks and the number of data security breaches, raises concerns that the securities industry is vulnerable to disruption and unauthorized access to customer account information. Our primary concern 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.

Microcap Fraud—High-risk, speculative microcap and low-priced OTC securities are regularly touted to investors through telemarketers, promotional emails and brochures delivered to investors' homes through the U.S. mail. 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 include:

- heightened supervision of firm employees who maintain direct or indirect outside business activities associated with microcap and OTC companies;
- heightened supervision of traders involved in trading microcap and low-priced OTC securities;
- ensuring that any research for microcap and low-priced OTC companies produced by the firm is accurate and balanced, and appropriately discloses risks to investors;
- monitoring 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;
- heightened supervision of firm activities where an affiliate of the firm is the transfer agent for the microcap or low-priced OTC securities;
- implementing anti-money laundering (AML) responsibilities that require firms to monitor for suspicious activity and file Suspicious Activity Reports where warranted; and,
- monitoring 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.

Private Placement Securities—FINRA continues to be concerned about the sale and marketing of private placement securities. To improve our understanding of these offerings, FINRA implemented Rule 5123, which requires member firms that sell an issuer's securities in a private placement to individuals to file with FINRA a copy of the offering document. We will use this new filing requirement and the underlying information it provides to enhance our risk-based supervision of the private placements market and better identify and assess higher-risk transactions. FINRA also reminds member firms that the relative scarcity of independent financial information and the uncertainty surrounding the market- and credit-risk exposures associated with many private placements necessitates reasonable due diligence on prospective issuers. Due diligence should focus on the issuer's creditworthiness, the validity and integrity of their business model, and the plausibility of expected rates of return as compared to industry benchmarks, particularly in light of the complex fee structures associated with many of these investments. Our primary concern is that inadequate due diligence regarding private placements could expose customers to harm and result in insufficient disclosure. Our examiners will focus on due diligence policies and procedures, valuation processes, placing special emphasis on the integrity and independence of third-party valuation services, and the timely disclosure of material risks.

Anti-Money Laundering—FINRA examiners continue to focus on AML compliance, particularly at firms with higher-risk business models due to their clients, products and service mix, or location in which they operate. This year, the Department of Justice's case against HSBC has highlighted, among others, the potential risks associated with foreign affiliates and the business they transact through their U.S. financial institution affiliates.[5] In our examinations, we have seen an increase in foreign currency conversion transactions. In these types of transactions, foreign financial institutions purchase U.S.-denominated bonds, generally issued by foreign governments, with the local currency, which are then transferred to a U.S. broker-dealer and sold, with proceeds then transferred offshore. In this regard, U.S. broker-dealers that act as intermediaries in these transactions may receive foreign bonds or other securities worth millions of U.S. dollars without knowing who or how many underlying customers may be involved. Reviews of this business have raised concerns regarding the level of due diligence performed by firms and inadequate reviews for potential suspicious activity. Money laundering risks are continually changing, requiring firms to be vigilant in reviewing for suspicious activity and adapting their AML programs accordingly. FINRA examiners will continue to focus on AML issues from the fundamentals to more esoteric issues as the financial economic crime environment continues to change.

Automated Investment Advice—The use of software solutions to dispense automated investment advice to retail clients has grown in recent years. While automated investment advice may be helpful to investors, FINRA is concerned that in some instances, the platforms may not adequately gather the necessary attributes of the investor to determine an investment profile. In other situations, the use of technology platforms could fail to properly match securities or portfolios with the investor's risk appetite. Our examiners will focus on the attendant controls associated with these automated investment tools and assess the integrity and transparency of underlying business rules, policies and procedures, and testing protocols.

Branch Office Supervision—FINRA continues to review branch office supervision practices. Firms must ensure that they have a robust supervisory structure and that their branch office inspection programs are reasonable and appropriate to the scale and scope of activities and risks at the branch. FINRA examiners will continue to focus on branch offices that exhibit a higher likelihood of sales practice abuses, especially where brokers have complaints, disclosures or disciplinary histories on their records.

Insider Trading

Insider trading continues to be a top regulatory priority for FINRA, the SEC and federal criminal law enforcement. Firms must be vigilant in safeguarding material, non-public information, and should periodically assess information barriers and risk controls to ensure they are adequate. Examples of such risk controls include:

- routine review of 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;
- maintaining appropriate information-barrier policies and procedures that are designed to limit or restrict the flow of material, non-public information within the firm to employees on a "need-to-know" basis;
- monitoring employee trading activity both inside and outside the firm to identify suspicious activity;
- conducting regular reviews of proprietary and customer trading in securities that are placed on a watch/restricted list;
- conducting employee training with respect to the use and handling of material, non-public information; and,
- a process for identifying suspicious customer trading in securities of their employer or corporate affiliates.

Financial and Operational Priorities

Given today's challenging economic environment, FINRA also remains concerned about firms' abilities to adequately fund their operations under various stress conditions and will focus significant efforts on net capital issues and the protection of customer assets. We continue to be concerned regarding the accuracy and integrity of firms' books and records. As such, we will review, among other issues, the implementation of Generally Accepted Accounting Principles (GAAP) and the accurate recording and reporting of required liabilities, securities valuation issues and the concentration of market, credit and liquidity risk concentrations on the balance sheet.

Guarantees and Contingencies—GAAP requires that firms determine the dollar amount of losses that could result from guarantees or contingencies, and accrue such losses in computing their net worth when their occurrence is probable and the amount can be reasonably estimated. Recent net capital reviews have detected deficiencies by firms regarding the accounting of guarantees and contingencies. Although recent deficiencies center on contingencies resulting from legal matters and guarantees of third-party financial obligations, FINRA is focused on whether firms are identifying all contingencies and guarantees, and have documented the basis for any associated liability accrual or lack thereof. Given our recent findings, the more specific areas of concern that FINRA will continue to pursue during examinations will include the following.

- Compliance with the requirements of SEA Rule 15c3-1c(d) when a firm guarantees, endorses or assumes, directly or indirectly, any obligation or liability of a subsidiary or affiliate, and a determination of whether such obligations or liabilities are properly reflected as a deduction from net worth in the computation of net capital and included in the calculation of aggregate indebtedness, as applicable, absent a consolidation.
- Whether adverse awards in an arbitration proceeding are recorded by the broker-dealer as a liability at the time the award is made, even though the award is on appeal or under consideration by a court.
- Whether a broker-dealer that is the subject of an adverse SRO, administrative or court judgment, or a lawsuit, that could have a material impact on its net capital has recorded a liability for the adverse judgment or the lawsuit, or alternatively, has obtained an opinion of outside counsel regarding the potential effect of such an action on the firm's financial condition (see interpretation to the SEA Rule 15c3-1 (Net Capital Rule)). Absent such opinion, the firm will be asked to demonstrate the basis of their determination to not record a liability. At a minimum, any such adverse judgments or lawsuits would be a contingent liability and must be included in aggregate indebtedness.
- Whether firms have entered into arrangements to guarantee the satisfaction of financial obligations of third parties or affiliated entities, including their parent, where such arrangements were not comprehended in the firm's computation of its net capital. Guarantees to repay or satisfy the financial obligations of third parties or related parties may result in net capital charges up to the full amount of such obligations.
- Whether a firm has pledged allowable assets as collateral to secure a third party's financial obligation, and if so whether the firm is required to treat such assets as non-allowable and deduct them from net worth in computing net capital.

Margin Lending Practices—The valuation and marketability of certain securities that collateralize margin receivables raise concerns when margin loans are collateralized by thinly traded equities, municipal bonds and highly structured collateralized mortgage obligations. We have seen situations where these securities have represented concentrated positions in a single account. When a publicly quoted market value exists, it may not be representative of the liquidation value of the security, and the firm may realize a loss upon liquidation if the customer fails to meet a margin call. Firms should have a governance process to judiciously determine whether extensions of credit are appropriate on various asset classes and to determine the amount of margin that should be extended on less-liquid positions. Further, as more swaps move to a central clearing facility, firms acting as principal or as clearing agent for these swap transactions need to determine, using independent risk techniques, whether the clearing house margin is adequate or whether additional house margin should be collected.

Leverage and Liquidity—With interest rates at historic lows, some firms have continued to increase their balance sheet to compensate for the lower net-interest revenue, without paying adequate attention to the maturity mismatch of assets and liabilities. In fixed-income instruments, firms may not be subjecting themselves to significant interest-rate risk but may be unduly exposed to liquidity risk, particularly when the asset side of the balance sheet is a reverse repurchase transaction or margin loan with no stated maturity. We will review whether firms are taking steps such as extending the maturity of their liabilities to better match their assets.

We continue to identify firms with large complex balance sheets that rely exclusively on their parent company for contingency funding. We will focus on whether firms regularly assess their funding and liquidity risk at the broker-dealer as a standalone entity, and take the necessary steps to be in a position to operate under adverse circumstances.

Market Regulation Priorities

Based on recent history, it is clear that the increasing complexity of the financial services architecture is vulnerable to disruption. FINRA views effective market regulation as a one of the cornerstones of our mandate to maintain market integrity. As such, we intend to focus significant resources on the following risks.

Algorithmic Trading—In light of several high-profile algorithmic trading failures that caused significant market disruption in 2012, FINRA continues to be concerned about how firms are supervising the development of algorithms and trading systems. Consistent with the Market Access Rule and other supervisory obligations, FINRA will continue to assess whether firms have adequate testing and controls related to high-frequency trading (HFT) and other algorithmic trading strategies and trading systems. FINRA's evaluation of firms' controls may take the form of examinations and targeted investigations. Potential areas of review will include, among other things:

- whether firms conduct separate, independent and robust pre-implementation testing of algorithms and trading systems;
- whether a firm's legal, compliance and operations staff is appropriately performing its respective roles in the design and development of the firm's algorithms and trading systems;
- whether a firm actively monitors algorithms and trading systems once they are placed into production, including procedures and controls to detect potential trading abuses such as wash sales, marking, layering and momentum-ignition strategies (among others); and
- whether the firm controls changes made after an algorithm and trading system is placed into production.

In addition, we will focus on whether broker-dealers have firmwide disconnect or "kill" switches, as well as procedures for responding to widespread system malfunctions.

High-Frequency Trading Abuses—While many HFT strategies are legitimate, others can be used for manipulative purposes. As a result, the surveillance of HFT remains a high priority for FINRA, and we will assess whether firms using HFT strategies and other trading algorithms test these strategies pre- and post-launch to ensure that the strategies do not result in abusive trading. Following are specific areas of concern that FINRA will pursue.

- 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 strategies where a market participant places a *bona fide* order on one side of the market and simultaneously "layers" *non-bona fide* orders on the other side of the market in an attempt to bait other market participants to react to the *non-bona fide* orders and trade with the *bona fide* order on the other side of the market.[6] FINRA has observed several variations of this strategy in terms of the number, price and size of the *non-bona fide* orders, but the essential purpose behind these orders remains the same, to bait others to trade at higher or lower prices.

FINRA also has seen wash sales used in conjunction with layering to give the appearance of *bona fide* transactions at artificial prices. Other examples of problematic HFT or algorithmic activity involve distorting disseminated market imbalance indicators through the entry of *non-bona fide* orders or aggressive trading activity near the open or close. FINRA will continue to aggressively pursue these types of problematic HFT strategies and algorithms.

- FINRA also will continue to focus on problematic HFT and algorithmic activity by sponsored participants who initiate their activity from outside of the United States. In this regard, member firms are reminded 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.[7] FINRA will continue to devote substantial resources to examining, detecting, surveilling and prosecuting such conduct.
- As in 2012, a major focus of FINRA's options program in the coming year will be the continued focus on options mini-manipulation strategies in which market participants attempt to manipulate the price of underlying equities, typically through HFT, to either close out pre-existing options positions at favorable prices or establish new positions at advantageous prices. FINRA has re-engineered its cross-product surveillance reviews to capture recently identified variations of these scenarios. FINRA will continue to devote substantial resources to the detection and litigation of such conduct.

Alternative Trading Systems (ATS)—FINRA and the SEC have identified concerns regarding the manner in which ATS are operating and the adequacy and accuracy of disclosures provided to subscribers about their operations. Given these concerns and the increased volume of trading executed on ATS, FINRA is conducting a series of examinations of firms that operate an ATS and the firms' affiliates. In particular, FINRA is seeking to determine through its examination program whether firms are consistently and accurately representing and disclosing various aspects of their ATS operations to their subscribers, including with regard to:

- how they route, represent, interact or otherwise handle subscribers' order flow;
- general disclosure around ATS order types;
- the capacities in which they may participate in the ATS (agent and/or principal);
- how they are compensated for their services;
- how they handle errors;
- whether and how they use indications of interest (IOI);
- how they protect confidential customer order information; and
- what, if any, interaction occurs between the ATS and its affiliates.

In addition to focusing on the accuracy of firms' disclosures, FINRA is also examining whether ATS are operating consistently with the fair access requirements of Regulation ATS and identifying the various levels of access they make available to clients.

Options Origin Codes—FINRA remains focused on the proper use of order origin codes across the options industry. We are focusing on situations in which firms are improperly coding firm or broker-dealer orders as customer orders, thus impacting priority, the options audit trail and payment of exchange fees. FINRA's options surveillance and examination teams are also looking at whether firms are deliberately trying to circumvent the professional customer designation and thus maintain order priority status, along with reduced exchange fees. FINRA is conducting a sweep of firms to help determine the significance of order miscoding across the options industry. We recognize that the order-origin code requirements differ at the various options exchanges, and we are working with firms to help them properly identify origin codes across the various markets. We are also working with other options regulators to coordinate the review of options origin codes for firms that are members of multiple exchanges.

Large Options Position Reporting (LOPR)—An area of weakness in many firm compliance systems relates to LOPR. FINRA continues to review situations where firms are either misreporting positions or not reporting positions as required by exchange rules. Some of the issues that FINRA has identified involve position-aggregation errors, in-concert reporting errors, reliance on flawed vendor programs and the non-reporting of positions that are clearly within the scope of what the rules require be reported. LOPR deficiencies have a direct impact on industry wide insider trading reviews, as well as other manipulation reviews that are essential to the FINRA options surveillance program. We recommend that firms review the guidance in the Frequently Asked Questions on the OCC website to remediate any deficiencies.

Fixed Income—FINRA remains focused on trading issues such as best execution, inter-positioning and fair pricing in the fixed-income market, and continues to be concerned about firms charging fair and reasonable markups. FINRA is particularly focused on fair pricing in products such as collateralized mortgage obligations and mortgage-backed securities, as retail activity in these products has increased. FINRA takes into account the complexity of these products, the differences in their trading behavior and their liquidity relative to other TRACE-eligible securities when conducting surveillance. The expansion of TRACE to asset-backed and mortgage-backed securities has improved our ability to supervise these markets.

The transparency brought about by TRACE has also allowed FINRA to enhance its surveillance of potential schemes seeking to take advantage of a robust post-trade transparency regime. As a result, FINRA has developed automated surveillance patterns to spot areas of potentially problematic behavior common to transparent markets, such as wash sales, marking the close and trading ahead.

Conclusion

We encourage broker-dealers to use the information in this letter to enhance their supervisory and compliance programs to mitigate risk and better protect investors. As always, firms may contact their Regulatory Coordinator with specific questions or comments. In addition, if firms 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.

Endnotes

1 International Monetary Fund, "Global Financial Stability Report", pg. 12, October 2012

2 Since August, the funds have taken in more than $5 billion, nearly three-quarters of their $7 billion of net inflows last year through Oct. 31, according to Morningstar Inc.

3 Levisohn, Ben "Time to Trash Junk Bonds," *The Wall Street Journal*, October 5, 2012.

4 "Diversity and Risk of Municipal Bonds," Doty, Robert. May 2012.

5 "HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement"

6 *See* Trillium Brokerage Services, LLC, FINRA Letter of Acceptance, Waiver and Consent, No. 20070076782-01 (Aug. 5, 2010).

7 *See Regulatory Notice 10-18* and the SEC's Office of Compliance Inspections and Examination's National Exam Risk Alert dated September 29, 2011.