

# 2018 Annual Regulatory and Examination Priorities Letter

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## Introduction

The 2018 Regulatory and Examination Priorities Letter identifies topics that FINRA will focus on in the coming year, and these include some new topics as well as others that remain ongoing areas of focus. FINRA's [2017 Examination Findings Report](#) presents observations on both concerns and effective practices relevant to some of these areas, and FINRA encourages broker-dealers to use that report and this letter as resources to enhance their compliance, supervisory and risk management programs, and to prepare for their FINRA examination.

## Fraud

Fraud is always a major area of focus for FINRA. Fraudulent activities such as insider trading, microcap pump-and-dump schemes, issuer fraud and Ponzi-type schemes harm investors and damage the integrity of the market. In the past year, FINRA has made hundreds of referrals to the U.S. Securities and Exchange Commission (SEC) for potential insider trading and other fraudulent activities involving individuals or entities outside FINRA's jurisdiction, and we will continue to pursue our investigations in these areas aggressively.

In addition, FINRA will focus on microcap fraud schemes, including schemes that target senior investors. FINRA investigations have identified senior investors who have been victimized by unregistered individuals using high-pressure sales tactics as part of a pump-and-dump scheme. Last year's Regulatory and Examination Priorities Letter described controls firms can use to protect elderly investors, and, with the addition of FINRA's new Rule 2165 and amendments to FINRA Rule 4512 (discussed later in this document), firms have even more tools to protect senior investors from these types of schemes. In addition, FINRA reminds firms of their obligation to file a Suspicious Activity Report (SAR) for illicit activity involving the exploitation of senior investors.<sup>1</sup>

Firms should be attentive to their brokers' activity in microcap stocks, particularly when brokers show a new or sudden interest in buying microcap stocks for their own accounts or those of their customers. FINRA will investigate brokers who use their own or their customers' accounts to coordinate trading in microcap stocks with known or unknown counterparties. Firms should also evaluate internal policies and training regarding permissible communications and interactions with microcap stock promoters to assist in preventing brokers from participating in any fraudulent scheme.

## High-risk Firms and Brokers

Building on our work in 2017, a top priority for FINRA will continue to be identifying high-risk firms and individual brokers and mitigating the potential risks that they can pose to investors.<sup>2</sup> FINRA will focus on firms' hiring and supervisory practices for high-risk brokers, including, for example, firms' remote supervision arrangements; supervision of point-of-sale activities, including individual broker accountability when using joint rep codes; and branch inspection programs. FINRA reminds firms of their existing obligation to adopt and implement tailored heightened supervisory procedures under FINRA Rule 3110 (Supervision) for high-risk individuals.

FINRA will also continue to focus on the risks that these firms and brokers pose to investors, including unsophisticated or senior investors. For example, we will focus on recommendations for speculative or complex products by high-risk brokers to investors who may not have the necessary sophistication, experience or investment objectives. We will also review situations where registered representatives have control of investors' finances as power-of-attorney or trustee on customer accounts, or have future rights to customer assets as a named beneficiary on customer accounts. We will also evaluate rollovers of qualified plans into non-qualified accounts for senior investors.

In addition, FINRA will continue to focus on registered representatives who conduct approved private securities transactions by raising funds from investors they serve away from their firm. FINRA will assess firms' ability to monitor the proper use of proceeds from these offerings and whether registered representatives make adequate disclosures about their interest in, control of, or association with the issuer.

FINRA will also continue to review firms' controls regarding the outside business activities of registered persons, including to identify instances of settling away where registered representatives borrow money from their customers or make payments to customers from their outside business bank accounts.<sup>3</sup>

## Operational and Financial Risks

### Business Continuity Planning

Recent events such as Hurricanes Harvey and Maria underscore the need for firms to maintain written Business Continuity Plans (BCPs) that address continued access to critical systems, including in situations where firms may not have physical access to locations, potentially for an extended period. FINRA Rule 4370 requires firms to maintain plans that are reasonably designed to enable them to meet their existing obligations to customers in an emergency or business disruption. FINRA will review firms' BCPs with a focus on their implementation of the plan. For example, we will review how and under what circumstances firms activate their BCPs, how they classify systems as mission-critical or secondary, how they accomplish data backup and recovery, and where applicable, how firms coordinate with their affiliates and vendors during a business continuity situation. We will also review firms' plans for restoring systems, procedures and records once they are prepared to return to normal business, as well as how they make those decisions.

## **Customer Protection and Verification of Assets and Liabilities**

The protection of customer assets and the accuracy of firms' financial data are perennial priorities in FINRA's examinations. FINRA will examine the accuracy of firms' net capital and reserve computations under Securities Exchange Act (SEA) Rules 15c3-1 and 15c3-3. In our examination of firms' records, we will review their processes for verifying customer assets and proprietary assets and liabilities in those financial records. We may also contact appropriate entities, such as custodial banks, to assess the validity of reported positions.

In our examination of firms' compliance with SEA Rule 15c3-3, we will evaluate whether firms have implemented adequate controls and supervision to protect customer assets and assess their compliance with the specific requirements of the rule (*e.g.*, whether they properly perform their possession or control calculations). In addition, FINRA will review whether firms maintain sufficient documentation to demonstrate that securities are held free of liens and encumbrances, especially for securities held at foreign custodians. FINRA will review whether firms' foreign depositories, clearing agencies and custodial banks are good control locations, including whether firms have filed applications with the SEC for such foreign custodial arrangements. We may also look at the underlying arrangements with foreign custodians to determine if they permit cross-liens or use temporary holding accounts. Where customer securities may be held in, or move through, temporary holding accounts, we will consider whether these accounts are good control locations and whether firms have instituted reasonable procedures to monitor them for customer securities.

## **Technology Governance**

FINRA will review firms' information and technology change management policies and procedures. Some firms have experienced significant customer service and regulatory problems as a result of operational breakdowns caused by the implementation of new systems as well as enhancements and modifications to existing proprietary or vendor systems. These breakdowns can arise from coding issues, system capacity limitations or other flaws, and may have a significant adverse impact on order entry or execution, data integrity or customer protection. It is critical that firms maintain strong controls over changes to their information technology to prevent inaccurate, incomplete, untested or unauthorized changes to their production environments. These can result in system defects or outages, data inaccuracies or unintended consequences that can negatively affect customers, the firm or the market.

## **Cybersecurity**

Cybersecurity threats remain a significant risk and will continue to be a priority. FINRA will evaluate the effectiveness of firms' cybersecurity programs to protect sensitive information, including personally identifiable information, from both external and internal threats. FINRA will review firms' preparedness, technical defenses and resiliency measures, among other things. Firms should review the Examination Findings Report for additional information about FINRA's observations regarding concerns and effective practices related to cybersecurity. FINRA also reminds firms that they must have policies and procedures in place to assess whether to file a SAR when they identify a cybersecurity event.

## Anti-Money Laundering

FINRA will assess the adequacy of firms' anti-money laundering (AML) programs. FINRA continues to identify concerns related to, for example, the adequacy of (1) firms' policies and procedures to detect and report suspicious transactions; (2) resources for AML monitoring; and (3) independent testing required under FINRA Rule 3310(c). Firms should review the Examination Findings Report to understand FINRA's areas of concern and observations on effective practices related to AML. In addition to those concerns, firms should be attentive to the potential use of their foreign affiliates to conduct high-risk transactions through accounts at member firms, including in microcap and dual-currency securities. FINRA has observed situations where firms do not monitor, or may monitor less closely, accounts opened for an affiliate. Firms should also confirm that their AML surveillance programs cover accounts used in connection with securities-backed lines of credit (SBLOCs) and aggregate activity across accounts when they use multiple accounts to receive and disburse funds in connection with an SBLOC.

## Liquidity Risk

FINRA will continue to focus on firms' liquidity planning, compare strengths and weaknesses across firms' liquidity plans and share effective practices. FINRA will evaluate whether a firm's liquidity planning is appropriate for the firm's business and customers, and whether it includes scenarios that are consistent with its collateral resources and client activity. In addition, FINRA will focus on the adequacy of firms' material stress testing assumptions, including how firms identify unencumbered assets and encumbered cash in their liquidity stress tests. A stress test that clearly identifies the largest liquidity sources and uses can enhance a firm's liquidity planning. FINRA urges firms to review [Regulatory Notice 15-33](#) for effective practices that may be useful in developing liquidity management plans.

## Short Sales

FINRA will examine firms' policies and procedures for establishing and monitoring the rates charged to customers for short sales. FINRA has observed some instances where, for example, securities are borrowed into a conduit account and then loaned to a house account at a significantly higher rate, which then may be marked up further. FINRA will review whether firms calculate such rates in a manner consistent with their procedures.

## Sales Practice Risks

### Suitability

As the number and complexity of products available to investors continue to increase, FINRA will continue to assess the adequacy of firms' controls to meet their suitability obligations. This includes reviewing how firms identify products that are subject to new product vetting, the vetting process itself, and the supervisory systems and controls firms put in place to ensure personnel are appropriately educated and trained on the sale and supervision of the product and that recommendations are suitable.<sup>4</sup> As part of the vetting process, firms should identify the risks associated with a product and include those risks in their product training so that registered representatives can appropriately evaluate them prior to recommending the product to a customer. FINRA will pay particular attention to suitability determinations in those situations where registered representatives recommend complex products to unsophisticated, vulnerable investors.

FINRA will review firms' handling of products where FINRA has observed firms experiencing problems implementing effective controls, such as firms' handling of Unit Investment Trusts (UITs) and multi-share class products as addressed in the Examination Findings Report, or products that are higher risk or complex. Moreover, FINRA will review for recommendations that result in undue concentration in securities positions, including recommendations resulting in concentrated positions in interest-rate-sensitive instruments or recommendations that result in short-term trading of products typically intended to be held on a long-term basis.

Employer-sponsored retirement plans play a critical role in many individuals' retirement planning and for this reason will be an important area of focus for FINRA. In this regard, FINRA will focus on the suitability of firms' and registered representatives' recommendations made to plan participants, including Individual Retirement Account rollover recommendations involving securities transactions.<sup>5</sup> FINRA will also review the supervisory mechanisms firms establish for these recommendations.

In addition, FINRA will review situations in which registered representatives recommend a switch from a brokerage account to an investment adviser account where that switch clearly disadvantages the customer, such as where the registered representative recommended that the customer purchase a securities product subject to a front-end sales charge in a brokerage account and then shortly thereafter recommended that account be transferred to a fee-based account.

### **Initial Coin Offerings and Cryptocurrencies**

Digital assets (such as cryptocurrencies) and initial coin offerings (ICOs) have received significant media, public and regulatory attention in the past year.<sup>6</sup> FINRA will closely monitor developments in this area, including the role firms and registered representatives may play in effecting transactions in such assets and ICOs. Where such assets are securities or where an ICO involves the offer and sale of securities, FINRA may review the mechanisms—for example, supervisory, compliance and operational infrastructure—firms have put in place to ensure compliance with relevant federal securities laws and regulations and FINRA rules.

### **Use of Margin**

FINRA will assess firms' disclosure and supervisory practices related to margin loans. FINRA has observed situations where registered representatives solicited customers to engage in share purchases on margin, but customers were not aware of the risks associated with those transactions. Moreover, in some cases, registered representatives entered into margin transactions without written authority from the customer. FINRA will examine whether firms and registered representatives adequately disclose the risk of margin loans and whether firms maintain controls reasonably designed to prevent excessive margin trading.

## Securities Backed Lines of Credit

The use of SBLOCs has increased significantly in the past years, and FINRA will review firms' compliance with sales practice and operational obligations that apply to SBLOCs. FINRA will assess the adequacy of disclosures firms provide customers regarding the potential risks associated with SBLOCs, including the potential impact of a market downturn, the potential tax implications if pledged securities are liquidated and the potential impact of an increase in interest rates.

Separately, where the SBLOC lender is an affiliate of the member firm or other third party, the firm must establish controls to earmark the collateral securing the SBLOC and ensure that the SBLOC collateral is not dually pledged for any other extension of credit (*e.g.*, a margin arrangement with the firm). In these cases, firms must also be alert to red flags indicating that proceeds of an SBLOC are possibly being used to purchase or carry margin stock and follow-up to ensure that they are not improperly arranging credit.

## Market Integrity

### Manipulation

Protecting the integrity of our markets must remain a top priority for firms, as it is for FINRA. To capture new threat scenarios and changes in market participants' behavior, we regularly evaluate our surveillance program, and enhance and expand it to address these changes, and firms should be aware that FINRA may review their programs in these areas. For example, we launched the Cross Market Auction Ramping surveillance pattern in August 2017. This pattern leverages machine learning techniques to identify aggressive and dominant trading surrounding the open or close. We also (1) revised our Cross Market Marking the Open and Close surveillance pattern to reduce false positives and more accurately identify potential instances of marking the open or close and (2) enhanced the Cross Market Layering surveillance pattern in July 2017 to detect collusion among multiple market participants engaged in layering. In addition, we are working on incorporating machine learning techniques to aid in further detection of manipulative layering activity.

### Best Execution

Best execution is an important investor protection requirement and remains a FINRA priority. In addition to the concerns identified in the Examination Findings Report, FINRA is expanding our equity best execution surveillance program to assess the degree to which firms provide price improvement when routing customer orders for execution or when executing internalized customer orders. Once the new surveillance pattern is in production, we will review systematically both the frequency of price improvement, as well as the relative amount of price improvement obtained or provided when compared to other routing or execution venues.<sup>7</sup>

In addition, FINRA initiated an examination sweep in November 2017 that focuses on broker-dealers' best execution obligations when they receive order routing inducements, such as payment for order flow and maker-taker rebates, or when they internalize order flow. If a broker-dealer receives an order routing inducement, it must not let that inducement or its proprietary interests interfere with its duty of best execution. FINRA

will review how broker-dealers manage the conflict of interest that exists between their duty of best execution and their own financial interests, including whether the broker-dealers' procedures provide for a regular and rigorous evaluation of the execution quality they are likely to obtain from the market centers trading a security.

We will also expand our review of execution quality and fair pricing in fixed income securities. For example, we expect to implement surveillance patterns that focus on fair pricing and best execution in transactions in Treasury securities.

### **Regulation SHO**

FINRA will increase our focus on evaluating firms' compliance with Rule 201 of Regulation SHO. That rule requires firms to develop policies and procedures to prevent the execution or display of a short sale order at a price that is equal to or less than the national best bid when a Short Sale Circuit Breaker (SSCB) is in effect for a National Market System (NMS) security.<sup>8</sup> If a firm's Rule 201 policies and procedures include an automated, rules-based control to ensure compliance, FINRA expects the firm to develop a supervisory system to test that the control works properly and to conduct thorough supervisory reviews both before and regularly after it is operational.

If a firm chooses to rely on an exemption to Rule 201, it must ensure that its activity or short sale transactions qualify for the exemption. For example, FINRA has observed that firms engaging in exchange-traded fund arbitrage activity are availing themselves of the Domestic Arbitrage Exemption detailed in Rule 201(d)(3), although SEC written guidance states that (1) the exemption does not apply to such activity and (2) a "*bona fide* market making" exemption to Rule 201 does not exist. Finally, firms that choose to execute a short sale in reliance on an exemption to Rule 201 must mark the order and report the trade as short exempt.

### **Fixed Income Data Integrity**

Data integrity remains a priority for FINRA's fixed income surveillance and trading examination programs. In anticipation of the launch of Treasury securities reporting to the Trade Reporting and Compliance Engine (TRACE) in July 2017, FINRA developed a suite of data integrity surveillance patterns to monitor firms' transaction reporting in Treasury securities. The patterns identify instances of late reporting, failing to report inter-dealer trades, misreporting of inter-dealer trades and inaccurate execution time reporting, and we remain focused on these issues in 2018.

In addition, FINRA will expand our examinations to include Treasury securities in our reviews for complete, timely and accurate reporting of TRACE-eligible securities. A crucial aspect of these reviews involves electronic communications with customers and potential discrepancies in the transaction information contained in the electronic communications compared to the firms' records or reports to TRACE.

## Options

FINRA developed a surveillance pattern to detect potential front running in correlated options products in 2017 and will remain focused on this area in 2018. We designed the surveillance pattern to detect related scenarios involving options where a market participant may engage in transactions in one product while having knowledge of a pending transaction in a correlated product prior to the public dissemination of the terms of the order. This activity may improperly benefit the participant that engaged in the front running activity, to the potential detriment of other market participants.

FINRA will also focus on options “marking the close” activity where orders are being sent immediately prior to the close that impact the final national best bid or offer (NBBO) to benefit positions held by that account or accounts with which they are acting in concert. FINRA has identified a number of firms with deficient or non-existent supervisory systems relating to “marking the close” activity.

FINRA will continue to conduct reviews of potential options-related violations of SEA Rule 14e-4, which governs partial tender offers and requires that participants tender no greater than their “net long position.” SEA Rule 14e-4 provides that if a market participant sells call options after the tender offer is announced with a strike price less than the tender offer price, it must reduce its long position by the shares underlying the options for purposes of calculating its net long position. Those tendering in excess of their net long position by not offsetting the options may improperly receive a greater share of the tender offer consideration, to the detriment of other market participants. During 2017, FINRA identified participants who have not properly accounted for their options positions when tendering shares in the offer.

## Market Access

FINRA will continue to review broker-dealers’ compliance with SEA Rule 15c3-5 (the Market Access Rule). The Market Access Rule requires that broker-dealers establish reasonable pre-trade financial controls, among other things. FINRA has seen instances where broker-dealers have not maintained reasonable documentation to support financial limits and have not conducted periodic reviews to assess the reasonableness of those thresholds (through a credit or capital utilization review, for example). Firms should review the Examination Findings Report for additional information about FINRA’s observations regarding concerns and effective practices related to market access.

## Alternative Trading System Surveillance

As registered broker-dealers and FINRA members, alternative trading systems are required to maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, including, for example, rules on disruptive or manipulative quoting and trading activity. FINRA will review alternative trading systems’ supervisory systems in the context of reviews opened as a result of surveillance alerts related to potential manipulative activity occurring on or through an alternative trading system.



## Report Cards

In 2018, FINRA will launch several new report cards to assist firms with their compliance efforts, and we will review whether and how firms make use of these report cards.

- ▶ The Auto Execution Manipulation Report Card will highlight and assist firms with their supervision efforts to identify instances in which a market participant uses non-*bona fide* orders to move the NBBO.
- ▶ The Alternative Trading System Cross Manipulation Report Card will identify instances in which a market participant engages in potential manipulation of the NBBO, which results in the modification of a security's prevailing midpoint price on an alternative trading system crossing venue.
- ▶ The Fixed Income Mark-up Report Card will provide information to firms—including median and mean percentage mark-ups for each firm—and the industry, which firms will be able to display based on certain criteria such as investment rating, product (*e.g.*, corporate or agency) and length of time to maturity. FINRA will consider adding additional products in the future.

## New Rules

FINRA draws firms' attention to some significant new rules that are currently scheduled to become applicable in 2018. FINRA may discuss with some firms the steps they are taking to implement the obligations under these rules.

- ▶ **Financial Exploitation of Specified Adults:** FINRA Rule 2165 will become effective February 5, 2018, and permits members to place temporary holds on disbursements of funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of these customers.
- ▶ **Amendments to FINRA Rule 4512 (Customer Account Information):** An amendment to FINRA Rule 4512 requires members to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a non-institutional customer's account. The amendment will become effective February 5, 2018.
- ▶ **The Financial Crimes Enforcement Network's (FinCEN) Customer Due Diligence Rule (CDD Rule):** Firms have until May 11, 2018, to comply with FinCEN's CDD Rule.<sup>9</sup> FinCEN issued the CDD Rule to clarify and strengthen customer due diligence for covered financial institutions, including broker-dealers. In the CDD Rule, FinCEN identifies four components of customer due diligence: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information.<sup>10</sup>
- ▶ **Amendments to FINRA Rule 2232 (Customer Confirmations):** The amended FINRA Rule 2232 requires a member to disclose the amount of mark-up or mark-down it applies to trades with retail customers in corporate or agency debt securities if the member also executes offsetting principal trades in the same security on the same trading day. The amended rule also requires members to disclose two additional items on all retail customer confirmations for corporate and agency debt security trades: (1) a reference,

and a hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains publicly available trading data for the specific security that was traded and (2) the execution time of the transaction, expressed to the second. These amendments are scheduled to become effective on May 14, 2018.

- ▶ **Margin Requirements for Covered Agency Transactions (Amendments to FINRA Rule 4210):**<sup>11</sup> FINRA's new margin requirements for Covered Agency Transactions are scheduled to become effective on June 25, 2018. Covered Agency Transactions include (1) To Be Announced (TBA) transactions, inclusive of adjustable rate mortgage (ARM) transactions; (2) Specified Pool Transactions; and (3) transactions in Collateralized Mortgage Obligations (CMOs), issued in conformity with a program of an agency or Government-Sponsored Enterprise (GSE), with forward settlement dates. Members are reminded that the risk limit determination requirements under the amendments to Rule 4210 became effective on December 15, 2016.
- ▶ **Consolidated FINRA Registration Rules:** The consolidated FINRA registration rules (FINRA Rules 1210 through 1240) will become effective October 1, 2018. The consolidated rules streamline, and bring consistency and uniformity to, the qualification and registration requirements. Among other things, FINRA has restructured the representative-level qualification examination program into a more efficient format whereby all representative-level applicants will take a general knowledge examination and a tailored, specialized knowledge examination (a revised representative-level qualification examination) for their particular registered role. Individuals who are not associated persons of firms, such as members of the general public, are also eligible to take the Securities Industry Essentials Exam. The restructured program, among other things, eliminates duplicative testing of general securities knowledge on representative-level examinations and eliminates several representative-level registration categories that have become outdated or have limited utility.

## Conclusion

This letter outlines FINRA's areas of focus as of the beginning of 2018, and FINRA urges firms to use it as a point of reference for their compliance, supervisory and risk management programs and to prepare for FINRA examinations. FINRA may adjust its priorities as circumstances change. As always, we urge you to contact your firm's FINRA 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 Steven Polansky, Senior Director, Regulatory Operations/Shared Services, at [steven.polansky@finra.org](mailto:steven.polansky@finra.org).

## Endnotes

- 1 See FinCEN [Advisory](#).
  - 2 See “[Protecting Investors From Bad Actors](#),” Robert W. Cook, President and CEO, FINRA, at the McDonough School of Business, Georgetown University, June 12, 2017.
  - 3 Following a FINRA360 retrospective review of rules regarding registered representatives’ outside business activities and private securities transactions, FINRA’s Board of Governors approved the publication of a *Regulatory Notice* seeking comment on a proposal that would reduce unnecessary burdens while maintaining strong investor protections.
  - 4 See *Regulatory Notices* [03-71](#), [05-26](#), [05-59](#), [09-31](#), [09-73](#), [10-09](#), [11-02](#), [11-25](#), [12-03](#), [12-25](#), [12-55](#) and [13-31](#).
  - 5 See *Regulatory Notice* [13-45](#).
  - 6 See FINRA Investor Alerts [Don’t Fall for Cryptocurrency-Related Stock Scams](#), December 21, 2017, and [Initial Coin Offerings: Know Before You Invest](#), August 31, 2017.
  - 7 In November 2015, FINRA issued [Regulatory Notice 15-46](#), which reiterated that simply obtaining the best bid or best offer may not satisfy a firm’s best execution obligation when routing order flow for automated execution, or internally executing such order flow, particularly for small orders.
  - 8 A 10 percent or more decrease in the price of a security from its closing price on the prior day triggers an SSCB.
  - 9 See FinCEN [Customer Due Diligence Requirements for Financial Institutions](#), 81 FR 29397 (May 11, 2016).
  - 10 See *Regulatory Notice* [17-40](#).
  - 11 See [Regulatory Notice 16-31](#) (announcing the SEC’s approval of amendments to FINRA Rule 4210 to establish margin requirements for Covered Agency Transactions) and [Regulatory Notice 17-28](#) (extending the effective date of the new margin requirements to June 25, 2018, and announcing the availability of a set of frequently asked questions and guidance to assist members in complying with the new requirements).
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