

FINRA Podcast

FINRA's 2016 Regulatory and Examination Priorities Letter – Part 1

- SP Hello and welcome. I'm Steve Polansky.
- SR And I'm Sarah Risok.
- SP This is the first podcast in a three-part series about FINRA's 2016 Regulatory and Examination Priorities Letter. In this series we'll talk about some highlights related to major topics featured in the Letter. But it's important to note there are more priorities in it covering more details on all of them. So, once you're done listening, check out the Letter itself to learn more about the topics related to your business.
- SR In this episode we focus on some broad issues in the Letter. Let's start with firm culture. FINRA uses the term "firm culture" to refer to the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors, and employees make and implement decisions in the course of conducting the firm's business. And, in 2016, FINRA is formalizing its firm culture assessment. FINRA is not trying to dictate firm culture but, rather, understand how it affects compliance and risk management practices at firms. That understanding will inform our evaluation of firms and the regulatory resources we devote to them.
- SP In our assessments we are focusing on frameworks firms use to develop, communicate and evaluate cultural conformity. To do that, we are looking at five indicators. First, whether control functions are valued within the organization. Second, whether policy or control breaches are tolerated. The third indicator is whether the firm proactively seeks

to identify risk and compliance events. The next one is whether supervisors are effective firm culture role models. And the fifth indicator is whether subcultures that may not conform with the overall corporate culture are identified and addressed. For example, some branch offices, trading desks, or investment banking departments may develop cultures of their own.

SR And that leads us to the topic of supervision, risk management, and controls, because a firm's culture is both an input to and a product of its supervisory system. FINRA rules create an obligation for firms to set up and maintain a system to supervise their associated people, and it must be designed to achieve compliance with securities laws and regulations as well as FINRA rules. In 2016 FINRA is focusing on four areas where we have seen repeated concerns affect firm's business conduct and market integrity. Those four areas are conflicts of interest, outsourcing, anti-money laundering, and technology. We will talk about highlights of the first three in this podcast and then take a deeper dive into technology and, especially, cyber security in the next episode in this podcast series.

SP For now, let's move to conflicts of interest. In 2016 FINRA is completing the targeted examination we launched in late 2015 about incentive structures and conflicts of interest in connection with firms' retail brokerage business. This exam is especially focused on how firms address conflicts of interest in three key areas: registered representative compensation plans, proprietary or affiliated product sales, and revenue sharing agreements. These areas continue to be priorities for FINRA in 2016.

SR FINRA is also focusing on the relationship between research analysts and investment banking at firms. In the past FINRA fined 10 firms over \$43 million for FINRA research

rule violations related to the Toys “R” Us IPO. And the same concerns that drove those actions remain present today. It’s important to keep in mind firms may not use research analysts or the promise of favorable research to win investment banking business. FINRA is assessing whether firms’ research analysts are inappropriately involved in their investment banking activities and whether investment banking personnel exercise undue influence on analysts.

SP In 2016 FINRA is also examining what firms are doing about information leakage whether within or outside the firm. For instance, details could leak between different areas of a firm’s trading activities or through the front-running of pending rating changes. These and other situations raise conflicts of interest concerns firms should manage with targeted controls.

SR Another area FINRA is examining is outsourcing. FINRA is reviewing firms’ due diligence and risk assessment of providers, and FINRA is looking at how firms supervise those services. It’s important to note, while third parties can do some tasks, the supervision responsibility remains with the firm. And it’s not the outsourcing provider but the firm that is responsible for making sure applicable federal securities laws and regulations, as well as self-regulatory organization rules, are followed. And, among other things, firms must avoid outsourcing functions that require a qualified registered person.

SP Now, let’s turn to anti-money laundering controls. FINRA continues to assess the adequacy of firms’ monitoring for suspicious activity. This includes money movement and trading activity surveillance. Firms should routinely test systems and verify data accuracy to make sure all types of customer accounts and activity, especially those that

are high-risk, are properly identified and reviewed. And the review must be designed to detect and report potentially suspicious activity. If a firm decides to exclude certain transactions from AML surveillance, the rationale for doing so must be documented and will be checked.

SR FINRA makes it a priority to assess firms' monitoring of high-risk customer accounts and transactions. Some examples include cash management accounts that offer banking services to brokerage customers as well as microcap securities. If your firm deals in microcap securities specifically, you should check out the Priorities Letter to learn more about what FINRA expects. But, in general, firms should make sure that they understand the business purpose of any high-risk transaction, and they should make sure their customer activity reviews cover a large enough period of time to see patterns and assess the full picture.

SP FINRA also continues to be concerned with liquidity. When firms failed to manage liquidity in the past, it led to both individual firm failures and systemic crises. So FINRA is reviewing firms' contingency funding plans in light of their business models. Firms should be using effective practices like rigorously evaluating their liquidity needs in the event of both marketwide and idiosyncratic stresses. Firms should also develop contingency plans to weather those stresses, and they should do stress tests and other reviews on those plans.

SR FINRA is especially focused on liquidity planning and controls at firms that engage in high frequency trading. Given the number of orders these firms have in the market at one

time, sudden changes in the firms' execution rate, whether triggered by a market event or other factors, could create liquidity challenges for the firm.

SP And with that we complete our first segment in our podcast series about FINRA's 2016 priorities as laid out in the Regulatory and Examination Priorities Letter. It's important to note the Letter has more about each one not covered here so you can learn more by reading the Letter on FINRA's website.

SR But there's more to come. In the next episode we will dive into technology priorities and highlight some things to remember from FINRA's cyber security report. So, stay tuned.

SP Until then, for all of us at FINRA, thanks for listening.