

2017 Exam Priorities Podcast – Part 3

Hello and welcome. I'm Tori Crane.

And I'm Steve Polansky

TC: This is the third podcast in a four-part series about FINRA's 2017 Regulatory and Examination Priorities Letter. In these podcasts, we highlight some of the most generally relevant priorities for the coming year. So keep in mind, FINRA's priorities are not limited to the ones we focus on in this podcast. And you can learn more about these and other priorities by checking out the Letter itself on our website.

SP: Let's dive into our look at the operational risks highlighted in the Letter. First up is cybersecurity, which is still one of the biggest threats firms face. As a result, FINRA continues to look closely at how firms mitigate those risks. There is no "one size fits all" approach to cybersecurity, so FINRA tailors its exam to each firm based on factors like business model, size and risk profile. Among the areas FINRA may review are:

- data loss prevention;
- vendor relationships; and
- protections against insider threats, with an eye towards how personally identifiable information is handled and by whom.

TC: FINRA is also drawing firms attention to two areas where exams have found repeated shortcomings: branch office cybersecurity controls and correct data storage. FINRA keeps finding firms with controls that are weaker at branch offices, especially in areas like password strength and sharing, data encryption, portable storage device use and virus protection. FINRA keeps finding firms that fail to store certain records in

non-rewriteable, non-erasable format, sometimes called worm format, as required by Securities and Exchange Act rules. This is a format meant to prevent tampering with the data after it is initially stored.

SP: For the next priority, FINRA is assessing firms' testing of their own supervisory controls. Regular testing is critical to allow firms to find and mitigate gaps or inadequate controls that if left undetected, could lead to systemic control breakdowns. Such problems can happen at any time but FINRA found them to be more common when a firm increases the scale or scope of its business or changes from legacy to new compliance systems. Some problems to look out for include:

- poorly set parameters and automated control systems;
- failures to deliver required disclosures to clients; and
- inaccurate data about things like order types.

TC: Now let's turn to the next priority highlighted in the 2017 Letter: customer protection and segregation of client assets. FINRA is looking for compliance with Securities Exchange Act Rule 15c3-3, which is the part of the customer protection rule that lays out how to manage reserves and custody of securities. FINRA is focusing on things like whether firms have sufficient documentation to show that securities are held free of liens and encumbrances, and if the firms' related processes are sufficient.

SP: In addition, FINRA is concerned that in some instances, firms may be engaging in transactions with little or no economic substance, just to reduce their reserve or segregation requirements under the Financial Responsibility Rules. This behavior can put customer assets at risk and FINRA is reviewing it from two perspectives. First,

FINRA is examining the mechanisms firms use to identify, review and approve these transactions. And second, FINRA is reviewing client transactions that result in outsized profit for a client compared to others of similar risk, as well as transactions that shift profit or loss between a firm and its affiliates that are not supported by the situations' economics.

TC: The Letter goes into more depth about segregation of assets. So to learn more, be sure to read the Letter on our website and check out SEA Rule 15c3-3

SP: Moving now to the next topic, FINRA continues to check firms' compliance with Securities and Exchange Commission Regulation SHO, which addresses short sales practices. In light of SEC enforcement actions in late 2016, as well as FINRA's own observations of failures in this area, FINRA is looking to see if firms have reasonable grounds to believe securities are available for borrowing before they accept a short sale.

TC: Next stop is a continued focus on anti-money laundering and suspicious activity monitoring. FINRA has seen shortcomings like gaps in automated trading and money movement surveillance systems, caused by data integrity problems. And we've seen poorly set parameters or surveillance patterns that do not capture problematic behavior like suspicious microcap activity. Other areas with potential weaknesses to look out for include foreign currency transaction monitoring and controls around accounts held by nominee companies. And it's important to note, firms may do AML monitoring using the same trading surveillance system they use for supervision. But it must also include alerts tailored to the firms' AML red flags.

SP: The last operational risk highlighted in the Letter is municipal advisor registration. State and local governments may call on municipal advisors to help them issue securities to raise funds. And FINRA found some firms are not registering correctly with both the SEC and the Municipal Securities Rulemaking Board or not properly updating their registration when it changes. Firms also may not be identifying all employees engaged in municipal advisory activity as required by SEC rules. And FINRA is checking that firms who take advantage of statutory exceptions to provide services to municipal customers without registering as municipal advisors are doing so correctly. Also in September 2016, the Series 50 Exam for municipal advisors became available. People already engaged in municipal advisor activities have one year to pass the exam.

TC: And with that, we reach the end of the third episode in this four-part podcast series about FINRA's 2017 Regulatory and Examination Priorities Letter. These podcasts are just an overview, so check out the Letter itself for more information on all of the topics we have covered.

SP: And stay tuned for the next episode, where we'll talk about market integrity topics like manipulation and the Market Access Rule.

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