

Legal Update

FINRA Publishes 2019 Report on Examination Findings and Observations

On October 16, 2019, the Financial Industry Regulatory Authority ("FINRA") released its 2019 Report on FINRA Examination Findings and Observations (the "Report").¹ The Report documents key issues from the examination of FINRA member firms, including "findings", based on a firm's violation of Securities and Exchange Commission ("SEC"), FINRA, or other relevant rules, and "observations", suggestions as to how a firm can address perceived weaknesses that may elevate risk but may not rise to the level of a rule violation.

The Report addresses findings and observations relating to the following categories: (1) Sales Practice and Supervision, (2) Firm Operations, (3) Market Integrity, and (4) Financial Management. Each of the four categories is split into sub-issues where FINRA details its findings and observations.

FINRA Examination Findings

SALES PRACTICE AND SUPERVISION

Supervision. FINRA Rule 3110 requires that a firm establish and implement a supervision system for the firm and its associated persons. Firms must update these supervisory processes and written supervisory procedures ("WSPs") to address new or amended rules, as well as products and services.

FINRA provides the following noteworthy examination findings, including firms' failures to:

- update WSPs to account for the requirements of new or amended rules;
- implement adequate branch supervision and inspection programs;
- maintain accurate information in account documents, impacting the ability of the firm to evaluate consolidated account reports and detect forgeries; and
- limit the activity of restricted and insider accounts, limit access to margin accounts, and supervise activity in options accounts.

Suitability. FINRA Rule 2111 (Suitability) establishes three primary obligations for firms and their associated persons: (1) reasonable-basis suitability, (2) customer-specific suitability and (3) quantitative suitability. FINRA observed that some firms failed to implement systems to review their recommendations to customers in light of these obligations.

Noteworthy findings include the failure to:

- supervise the suitability of recommendations that customers exchange certain products;

- identify certain “red flags”, such as similar recommendation patterns across a variety of customers with different risk profiles;
- maintain current customer account information;
- monitor trading activity for excessive trading or churning; and
- identify unsuitable options strategy recommendations.

Digital Communication. Rules 17a-3² and 17a-4³ under the Securities Exchange Act of 1934 (“Exchange Act”),⁴ FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) and FINRA Rule Series 4510 (Books and Records Requirements) require a firm to, among other things, create and preserve in an easily accessible place originals of all communications received and sent relating to its “business as such.”

The Report indicates that some firms prohibited certain digital channels for customer communications but failed to maintain processes to identify and respond to “red flags” where a registered representative may be using those channels to conduct firm business. Additionally, some registered representatives conducted electronic sales seminars through digital channels not permitted by their firm and outside of supervision or recordkeeping programs.

To manage registered representatives’ use of digital channels, FINRA recommends that firms: (i) establish governance processes to manage new digital channels, (ii) define permissible digital channels, (iii) manage the lifecycle of video content, (iv) provide training on approved digital channels, and (v) institute discipline for the misuse of digital channels.

Anti-Money Laundering (“AML”). The Bank Secrecy Act (“BSA”) requires firms to monitor for, detect, and report suspicious activity to the U.S. Treasury’s Financial Crimes Enforcement Network (FinCEN). FINRA Rule 3310 (Anti-Money Laundering

Compliance Program) requires that members develop and implement a written AML program to comply with BSA requirements. FINRA identified firms with several types of AML program design deficiencies that affected their ability to monitor transactions effectively. FINRA also found that some introducing firms relied too heavily upon clearing firms to monitor transactions and report suspicious activity when they needed to conduct their own monitoring activities.

Uniform Transfers to Minors Act (“UTMA”) and the Uniform Gifts to Minors Act (“UGMA”) Accounts. FINRA Rule 2090 (Know Your Customer) requires firms to learn certain “essential facts” about every customer, including the authority of each person acting on behalf of such customer. FINRA found that some firms failed to establish or follow a proper supervisory system to learn these “essential facts” for UTMA/UGMA Accounts, such as when a beneficiary reaches the age of majority and how an account custodian’s authority may change over time, and in some cases, failed to follow through on changes in authority over the accounts.

FINRA noted some effective practices for verifying the authority of custodians of UTMA/UGMA Accounts, including: (i) maintaining systems to confirm when the beneficiary reaches the age of majority, (ii) notifying custodians to advise the firm when beneficiaries reach the age of majority, or of upcoming transfers or restrictions to the custodian’s trading authority, and (iii) providing notice to registered representatives when beneficiaries reach the age of majority.

FIRM OPERATIONS

Business Continuity Plans (“BCPs”). FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information) requires firms to create and maintain a written BCP with procedures reasonably designed to enable firms to meet their obligations to customers, counterparties and other broker-dealers during an

emergency or significant business disruption. Common BCP deficiencies existed where firms:

- did not identify all mission-critical systems;
- did not have sufficient capacity to handle increased activity during a business disruption;
- did not update BCPs after significant operational changes;
- did not update emergency contact information for customer use during a business disruption;
- allowed employees to store critical working documents on local computer drives, rather than on firm network storage; or
- had senior management personnel who conduct the annual BCP review fail to maintain required registered principal registration.

FINRA recommended that firms engage in annual testing of their BCPs to evaluate their effectiveness and incorporate these test results into trainings for staff.

Fixed Income Mark-up Disclosure. FINRA's and the Municipal Securities Rulemaking Board's ("MSRB") amendments to FINRA Rule 2232 (Customer Confirmations) and MSRB Rule G-15 require firms to provide additional transaction-related pricing information to retail customers for certain trades in corporate, agency and municipal debt securities (other than municipal fund securities).

FINRA identified issues also cited in its 2018 Report,⁵ as well as the following failures:

- disclosure of additional charges separately from mark-ups and mark-downs, even when reflecting firm compensation;
- disclosure of registered representatives' sales credits or concessions as separate line items on confirmations, in addition to the

mark-up or mark-down, without clear and accurate labeling;

- determination of prevailing market price not according to FINRA rules; and
- disclosure of inaccurate times of execution on customer confirmations.

MARKET INTEGRITY

Best Execution. FINRA Rule 5310 (Best Execution and Interpositioning) requires firms to conduct a "regular and rigorous" review of the execution quality of customer orders if the firm does not conduct an order-by-order review. FINRA highlighted the following issues:

- failure to compare execution quality of an existing arrangement against the quality the firm could have obtained from competing venues;
- inadequate reviews on a type-of-order basis;
- failure to consider factors required by FINRA rules in execution quality reviews;
- inadequate consideration and failure to address potential conflicts of interest relating to their routing of orders to affiliates; and
- inadequate disclosure relating to order routing reports required by Rule 606 of Regulation NMS.⁶

Direct Market Access Controls. Compliance with Exchange Act Rule 15c3-5 (Market Access Rule)⁷ requires firms that provide access to trading in securities on an exchange or ATS to incorporate appropriate controls to mitigate key risks. In addition to 2017⁸ and 2018 Report findings, FINRA identified firms that had:

- insufficient risk management controls and WSPs to address specified key risks;

- insufficient controls to support CEO certification under Exchange Act Rule 15c3-5(e)(2);⁹
- weak processes for requesting, approving, reviewing and documenting ad hoc credit threshold increases;
- inadequate controls relating to duplicative and erroneous orders; and
- for firms that provide direct market access via multiple systems, insufficient post-trade controls and surveillance.

Short Sales. In addition to the findings FINRA shared in its 2017 Report, it found some firms were not able to satisfy certain requirements relating to the Continuous Net Settlement (“CNS”) System, including fail-to-deliver close-out requirements and correct allocation of CNS fails to correspondents. FINRA recommended periodic review of policies relating to rates charged for borrowing, sourcing or locating securities in connection with short sales, including monitoring the aging of short positions and determining whether the rates assigned at the onset of those positions are still appropriate.

FINANCIAL MANAGEMENT

Segregation of Client Assets. Exchange Act Rule 15c3-3 (Customer Protection Rule)¹⁰ requires firms that maintain custody of customer securities and safeguard customer cash to segregate these assets from the firm’s proprietary business. In addition to the findings of its 2018 Report, FINRA noted that some firms had (i) blotters with either incomplete or inaccurate information, (ii) inadequate possession or control processes, and (iii) certain customer accounts and foreign bank accounts miscoded or incorrectly set up.

Net Capital Calculations. Exchange Act Rule 15c3-1 (Net Capital Rule)¹¹ requires firms to maintain net capital at specific levels to protect customers and creditors from monetary losses that can occur when firms fail. In addition to concerns highlighted in its

2017 and 2018 Reports, FINRA noted the following issues relating to net capital computation:

- incorrect application of haircuts to net capital through failure to assess and monitor the creditworthiness of fixed income securities;
- failure to provide a process to assess moment-to-moment and open contractual commitment capital charges on underwriting commitments;
- inaccurately classifying receivables, liabilities and revenues, resulting in inaccurate reporting of a firm’s financial position and, in some instances, a capital deficiency;
- failure to recognize insurance claims on their books and records; and
- failure to maintain sufficient documentation to substantiate their methodology for allocating specific broker-dealer costs to the firm or an affiliate.

FINRA Observations

In addition to its examination findings, FINRA identified some practices they observed firms using that other firms may take into account to mitigate certain operational risks relating to cybersecurity and liquidity and credit risk management.

Cybersecurity. FINRA highlighted the following practices that firms have implemented to strengthen their cybersecurity risk management programs:

- branch-level cybersecurity policies and controls;
- documented policies on vendor or third-party management when they provide critical services or handle sensitive client information;
- formal written incident response plans;
- encryption of confidential data;

- timely security patching of computer systems;
- implementation of data access controls;
- inventory management of technology assets, including hardware, software and data;
- training and awareness for registered representatives, personnel, third-party providers and consultants; and
- documentation, review, approval and management of hardware and software changes.

Liquidity and Credit Risk Management. To strengthen their liquidity and credit risk management controls, FINRA recommended that firms (i) develop a contingency plan for operating in a stressed environment, (ii) ensure liquidity risk management practices are updated for the firm’s current business activities, (iii) conduct stress tests, and (iv) maintain a robust internal framework to capture, measure, aggregate, manage and report credit risk.

Conclusion

The Report provides firms with awareness of significant recurrent issues facing the industry and

useful best practices to mitigate operational risks. Although there is no requirement that firms implement the specific practices recommended in the Report or those that extend beyond the requirements of existing securities rules and regulations, the Report is instructive for firms seeking to maintain compliance with SEC, FINRA and other rules. Each firm should tailor the scope of its compliance practices and procedures to its own operational needs, and the Report provides important perspective on how firms can manage and improve their compliance practices.

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Endnotes

- ¹ The Report is available at: <http://bit.ly/33QGUVi>.
- ² 17 C.F.R. § 240.17a-3.
- ³ 17 C.F.R. § 240.17a-4.
- ⁴ 15 U.S.C. § 78a, *et seq.*
- ⁵ The 2018 Report on FINRA Examination Findings is available at: <http://bit.ly/32C3Fcj>.
- ⁶ 17 C.F.R. § 242.606.
- ⁷ 17 C.F.R. § 240.15c3-5.
- ⁸ The 2017 Report on FINRA Examination Findings is available at: <http://bit.ly/33VKcnv>.
- ⁹ 17 C.F.R. § 240.15c3-5(e)(2).
- ¹⁰ 17 C.F.R. § 240.15c3-3.
- ¹¹ 17 C.F.R. § 240.15c3-1.

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