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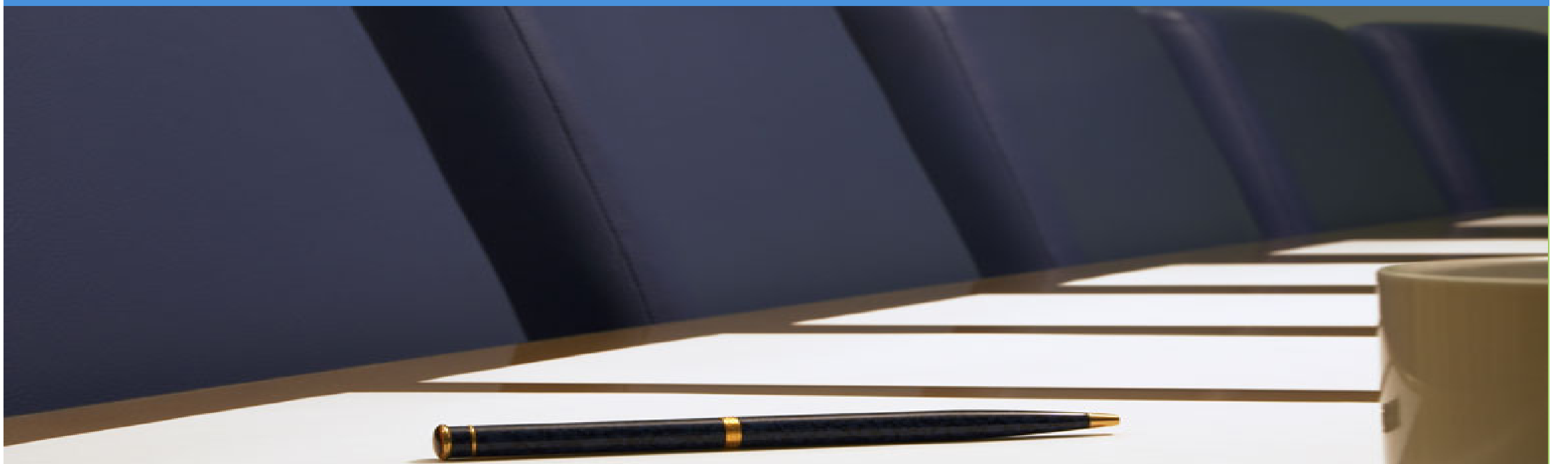

Financial Regulatory & Compliance/Securities Litigation | Alert

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FINRA's 2017 Annual Regulatory and Examination Priorities

On Jan. 4, 2017, FINRA released its 12th annual Regulatory and Examination Priorities Letter in which it identifies its areas of examination focus for 2017, recurring challenges faced by firms, and possible risks impacting the financial sector. FINRA's 2017 exam priorities do not appear to be revolutionary or new relative to its pronouncements during the past several years. For example, FINRA will continue its focus on interest sensitive securities, "high risk" brokers, senior investors, and management of cyber-security risks. Other areas of examination focus, such as sales practices surrounding complex investment products, financial controls, and order routing practices, appear to be new for 2017.

High Risk and Recidivist Brokers

FINRA's "High Risk Broker" program was implemented in 2013 and expanded in 2014. The program utilizes two computer algorithms, the "Broker Migration Model" and the "Problem Broker Model," to monitor brokers' disclosure events and movement between firms. In 2017, FINRA will devote particular attention to firms' hiring and monitoring of high-risk and recidivist brokers, including whether firms establish appropriate supervisory and compliance controls for such persons.

Senior Investors

Protecting senior investors was a prominent part of FINRA's Exam Priorities in 2014, 2015, and 2016. In 2017, FINRA intends to continue its heightened review of communications with seniors, the suitability of investment recommendations made to seniors, training related to senior-specific issues, and the supervisory procedures. By all indications, senior investors will remain a focal point for the foreseeable future.

Product Suitability and Concentration

FINRA will assess how firms conduct reasonable-basis and customer-specific suitability reviews. In 2017, FINRA will also increase its focus on the controls firms use to monitor recommendations that could result in excess concentration in customers' accounts.

Excessive and Short-term Trading of Long-term Products

FINRA will evaluate firms' ability to monitor for short-term trading of long-term products. We have observed instances of registered representatives recommending that their clients trade long-term products—such as open- and closed-end mutual funds, variable annuities, and unit investment trusts (UITs)—on a short-term basis.

Outside Business Activities and Private Securities Transactions

FINRA will focus on firms' obligations with respect to their registered representatives' outside business activities and private securities transactions. FINRA will also focus on firms' procedures for handling associated persons' notifications of proposed private securities transactions and firms' ongoing supervision over associated persons' approved private securities transactions for compensation.

Social Media and Electronic Communications Retention and Supervision

FINRA will review firms' compliance with their supervisory and record-retention obligations with respect to social media and other electronic communications in light of the increasingly important role they play in the securities business.

Financial Risks, Liquidity Risk, & Credit Risk

As noted in the 2015 and 2016 letters, in 2017, FINRA will review firms' funding and liquidity plans, and assess whether firms adequately evaluate their liquidity needs related to market-wide and idiosyncratic stresses, develop contingency plans so that they have sufficient liquidity to endure those stresses, and conduct stress tests and other reviews to gauge the effectiveness of their contingency plans.

Customer Protection/Segregation of Client Assets

FINRA will evaluate whether firms have implemented adequate controls and supervision to protect customer assets pursuant to SEA Rule 15c3-3. FINRA will assess firms' compliance with the specific requirements of the rule, for example, whether firms properly include customer securities positions and money balances on multiple platforms in the reserve formula and in the possession or control calculations.

Cyber Security

Cyber security was discussed in the 2013, 2014, 2015, and 2016 letters. It will be a concern for the foreseeable future. Among the areas FINRA may review are firms' methods for preventing data loss, including understanding their data (*e.g.*, its degree of sensitivity and the locations where it is stored), and its flow through the firm, and possibly to vendors.

Anti-Money Laundering

Anti-Money Laundering is a perennial concern for FINRA—it has appeared in the last 5 letters. In 2017, FINRA will continue to focus on firms' anti-money laundering programs, especially gaps in firms' automated trading and money movement surveillance systems caused by data integrity problems, poorly set parameters, or surveillance patterns that do not capture problematic behavior such as suspicious microcap activity.

Municipal Advisors and Securities

In 2014, the SEC rules regarding municipal advisors, including definitions of what constitutes municipal advisory activity requiring registration with the SEC, became effective. Since that time, FINRA has been tasked as the examination and enforcement authority with municipal advisor oversight.

Not surprisingly, municipal advisors and securities remain an examination focus in 2017. FINRA's examination review will specifically focus on proper application of exclusions and exemptions as well as potential unregistered activity.

Market Manipulation

The 2017 letter emphasizes that through enhanced surveillance FINRA will aggressively pursue firms whose brokers or customers utilize abusive algorithms in an effort manipulate markets. Similarly, FINRA will continue to implement enhanced equity and option cross-market surveillance patterns during 2017.

Order Routing Practices and Best Execution

In July 2014, FINRA commenced an investigation to determine whether trading-fee rebates create conflicts of interest that may compromise the execution quality of customer orders. This issue has been an area of concern, particularly given the rebates that different trading venues offer brokers that send orders their way and the conflict of interest this can cause with meeting best-execution requirements.

In 2017, FINRA's examiners will review best-execution practices related to fixed-income transactions and focus on firms' pricing practices, including whether firms are obtaining the best price for their customers of debt securities and not charging excessive markups or markdowns.

Audit Trail Reporting, Tick Size Pilot, and Market Access Rule

FINRA's Audit Trail Reporting Early Remediation Initiative identifies and alerts firms to potential equity audit trail issues not typically detected through routine compliance sweeps and reviews. In 2017, FINRA will expand this initiative to other areas such as Regulation NMS trade-throughs and locked and crossed markets.

Fixed Income Trading

As of late, fixed-income trading has undergone stricter scrutiny by FINRA as well as the SEC. Notably, in 2017, FINRA plans to launch a pilot program for examinations focused solely on fixed-income issues, including compliance with books and records requirements and supervision and order execution practices. The 2017 letter promises that FINRA will continue to focus on these products.

Of course, what FINRA does not address, nor at this early date can address, is how and if its examination and enforcement efforts will change with the new Presidential administration and new SEC leadership. Some believe that the newly constituted SEC, led by Chairman-elect Jay Cooper, may relax the SEC's rule making and enforcement, and leave much of that work to FINRA and to the States. If that occurs, FINRA may come to enjoy greater responsibilities.

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