

Securities Litigation & Enforcement News

Current Legal Developments in the Broker-Dealer Arena

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FINRA Welcomes in the New Year with its 2014 Priorities Letter for Broker-Dealers

FINRA has released its annual Regulatory and Examination Priorities Letter, in which it reveals its intended areas of exam focus for 2014 and what it describes as possible risks impacting the financial sector. Although similar in several respects to FINRA's January 2013 letter, the 2014 letter signals that, as the interest rate environment evolves, FINRA will be turning increasing attention to investments that it considers to be adversely impacted by rising rates. The 2014 letter also identifies new targets of attention, including FINRA's "risk scoring" systems for brokers, qualified plan rollovers and senior investors.

- **Interest Rate Sensitive Securities.** This year, FINRA highlights the potential risks of interest rate sensitive securities, particularly the risks associated with possible increasing long-term rates and longer term maturities. FINRA intends to focus on the disclosures firms and brokers make when they recommend interest rate sensitive securities, such as long duration bond funds, ETFs, corporates (including zero coupon and bullet bonds), mortgage-backed securities and emerging market debt. FINRA also expresses specific concern about the risks municipalities may face when they retire debt into issues at higher rates. As a result of this overall concern, FINRA intends to focus its examinations on accounts with "concentrations" in interest rate sensitive securities; however, it does not give guidance on what criteria it will use in determining whether an account is overly "concentrated."

These 2014 concerns are in contrast to those set forth in FINRA's 2013 Letter, in which FINRA discussed risks of the then-current "slow growth, low-interest-rate environment." FINRA then was particularly concerned with "yield-chasing behaviors," the suitability of complex high-yield debt products, credit risk and compression of risk premiums.

- **Broker "Risk Scoring."** FINRA now states that it intends to expand its so-called "High Risk Broker" program in 2014. In early 2013, in response to outside pressure, FINRA launched an initiative to scrutinize brokers with multiple complaints on their records more heavily. FINRA now uses two computer algorithms, its "Broker Migration Model" and its "Problem Broker Model," to track patterns of disclosure events by brokers and brokers' movements between firms. FINRA, however, reportedly expelled only 22 brokers in 2013 in connection with this large effort. Unfortunately, FINRA's computer models are opaque, leaving the securities industry in the dark as to what exactly will result in a "High Risk" designation. FINRA has given no indication that its "Problem Broker Model" distinguishes valid complaints against brokers from illegitimate complaints, such as product complaints that may be no fault whatsoever of the broker. Similarly, FINRA's "Broker Migration Model" apparently takes a guilty-until-proven-innocent approach, branding every broker who has

formerly been employed by a severely-disciplined firm as potentially “High Risk,” without any individual inquiry. FINRA has made no mention of what steps, if any, it will take to prevent innocent brokers from being unfairly swept up by these computer programs.

- **Qualified Plan Rollovers.** According to the 2014 letter, FINRA intends to make reviewing qualified plan rollover practices an examination priority and to evaluate marketing materials and supervision in this area. FINRA is responding to a GAO report (GAO-13-30), finding that financial industry participants (not limited to SEC-registered brokers) sometimes encourage employees to roll over assets from a 401(k) into an IRA without properly explaining that other options may be available. For example, depending on the specifics of the plans, an investor may have options to leave funds in the previous employer’s plan, roll funds over to the new employer’s plan, or cash out and pay a penalty. Yet, IRA rollover may in fact be the best option for the overwhelming majority of investors and, if so, FINRA may be creating a problem where none currently exists, driving firms to implement procedures that may ultimately only confuse investors.
- **Senior Investors.** Firms’ policies toward seniors have been an area of focus for years, and FINRA’s 2014 letter again raises the issue. FINRA and the SEC have been reviewing firms’ supervisory processes with respect to investors’ age, and according to FINRA, “may issue a report with observations of firms’ practices,” such as whether firms ascertain customers’ retirement status, future prospects for employment, and health care needs, and whether firms have product-specific suitability guidelines for seniors. Such practices have been impacted by FINRA’s revised know-your-customer and suitability rules. Among other things, Rule 2111 now applies to a recommendation of an “investment strategy,” which may include recommendations involving non-security investments relevant to seniors, such as insurance products. FINRA did not mention seniors in its 2013 letter.
- **Private Placements, Cybersecurity, Anti-Money Laundering, Microcap Fraud.** Each of these topics, among others, was discussed in both FINRA’s 2013 and 2014 letters. With regard to private placements, the 2014 letter highlights amendments to Rule 506 of Regulation D, which took effect in September 2013, allowing general solicitation and advertising when offering private placements, provided that all purchasers are accredited investors. On cybersecurity, FINRA notes ongoing concerns with the security of sensitive customer data and its intent to examine controls of such data. On the issue of anti-money laundering, FINRA has identified the increasing use by DVP/RVP (Delivery Versus Payment/Receipt Versus Payment) customers of executing broker-dealers to liquidate large volumes of low-priced securities as a concern. Finally, on microcap fraud, FINRA emphasizes that firms should maintain heightened supervision of employees who have outside business relationships with microcap and OTC companies or who are involved in trading microcap and low-priced OTC securities.

FINRA’s Regulatory and Examination Priorities Letters are available [here](#).

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