Some Old (and New) Wine in New Bottles: The 2018 SEC and FINRA Examination Priorities

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Introduction

As is often true, this year’s examination priorities of the Office of Compliance Inspections and Examinations (“OCIE”) of the Securities and Exchange Commission (“SEC”) and of the Financial Industry Regulatory Authority (“FINRA”) present both recent areas of focus and several new ones. The recent include such matters as the ongoing focus on senior investors and retirement investing, cybersecurity and oversight of technology, anti-money laundering compliance and best execution. The new areas cover such matters as the costs of investing, particularly as investors move (or are moved) to advisory accounts, financial professionals’ involvement in crypto-currencies and initial coin offerings, the ways in which business continuity plans address climate disasters and front-running in options transactions. While, as noted below, there is some overlap in the OCIE’s and FINRA’s priorities, the OCIE reaches diverse financial professionals under the SEC’s jurisdiction (and even FINRA itself) whereas FINRA focuses its attention on practices in broker-dealers, as its jurisdiction dictates. Compliance officers should pay close attention to the parts of their firm business implicated by these priorities because they can expect OCIE and FINRA examiners to target, and to demand records about, them. The following discusses the topics raised in each priorities document, identifying the areas of ongoing regulatory focus and those that are new.

OCIE’s 2018 Examination Priorities

Overview

This year, the sixth year of its publication, OCIE presents its examination priorities with more pomp and circumstance, but also with more substance, than in the past. The priorities come in a glossy brochure (even in pdf format), with pictures of the OCIE Director and the various OCIE directors and officers responsible for examinations of different kinds of regulated firms. This presentation does not appear to be (only) for purposes of vanity, but to identify individual regulators whom firms
can contact on examination matters of concern. OCIE warns that its list is not exhaustive and will change as new risks and issues emerge from market and regulatory developments, examinations, complaints and tips.

Even more substantively, the introductory message tells readers that OCIE examinations are based upon the following four “pillars”: “promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy.” It also sets forth five principles that inform its execution of the priorities and that have been recently emphasized. Under Principle 1, its examinations have to be risk-based, which means targeting firms and areas of greatest risk, given OCIE’s limited resources. Related to this risk-based focus is Principle 2, the data-driven nature of its examinations: it uses data analysis to identify the firms and the kinds of conduct to examine. Under Principle 3, the OCIE hopes to be transparent in its examination priorities and findings so that firms and their compliance officers are aware of its areas of examination focus and the information on risks and problems that it has identified in the marketplace. The final two Principles are related to each other as well as to the first two Principles: OCIE makes an effort to put its limited resources to best use, by means of an expert staff and through its technology (Principle 4), and it embraces technological innovation in the industry and in its own work while overseeing the former (Principle 5).

Retail Investor Theme

OCIE explains that its priorities, which reflect its views of risks in financial practices, products and services, are organized around five “themes.” The first theme—which is most significant for compliance officers—involves issues of importance to retail investors, including seniors and those saving for retirement. This “theme” echoes the first one mentioned in the 2017 OCIE Priorities.2 Under this theme, OCIE plans to focus on certain retail-related areas. The first enumerated—which is new this year—is adequate disclosure of the costs of investing, i.e., fees, expenses and investment charges. In particular and among other things, it will examine whether the fees or charges assessed are those that have been disclosed to investors and calculated in accordance with that disclosure. For example, in advisory accounts it plans to check on whether account assets are properly valued where a fee is dependent on the value of these assets. In addition, it is concerned about practices and business models where investors risk paying inadequately disclosed fees or charges, such as where incentives exist for advisory personnel to put investors in mutual fund share classes with higher sales loads or distribution fees, where there is a lack of proper oversight of advisory accounts following the departure of investment adviser representatives, where advisers changed an account from a commission to an advisory one and where private fund advisers manage funds with a high concentration of retail investors, including from investments by not-for-profit organizations and pension plans.3

Many other areas under the retail investor theme are the same as in the 2017 OCIE Priorities. They include the provision of electronic investment advice or robo-advising, where the focus will be on examining whether the electronic advising works as advertised and how it protects investor data.4 Wrap-fee programs are again an area of focus, in particular and among other things the appropriateness of putting retail investors in the programs in the first place, the adequacy of disclosure of costs associated with a given program and any conflicts and the handling of these conflicts.5 And, as in the 2017 OCIE Priorities, OCIE is focusing on new investment advisers and those who have not been recently examined, albeit, in the latter case, if they are identified as having elevated risks.6

Senior investors and retirement accounts and products are also a significant area of focus under the retail investor theme. OCIE explains that its focus here will be on such matters as broker-dealer supervision of representatives’ dealing with seniors and the identification of financial exploitation of seniors.7 This is nearly identical to an OCIE priority from last year.8 Under this area and again echoing the 2017 OCIE Priorities, OCIE also promises to examine investment advisers and broker-dealers offering services and products to retail investors with retirement accounts, with attention to their investment recommendations, sales of variable insurance products and sales and management of target date funds.9 It will also examine investment adviser and broker-dealer involvement in retirement vehicles.
primarily serving state and local government, and non-profit, employees—again, a focus from the previous year.\(^5\)

The retail investor theme continues with attention to mutual funds and exchange traded funds (“ETFs”). In a new area of concern, OCIE explains that it will focus on certain problematic mutual funds: those performing poorly with respect to their peers, those managed by inexperienced advisers and those holding difficult-to-value securities (such as securitized auto, student or consumer loans or collateralized mortgage-backed securities).\(^6\) With respect to ETFs and mutual funds, it will examine those tracking “custom-built indices” for conflicts of interest arising from relationships or transactions between the adviser and the index provider: this, too, is a new area of focus.\(^7\) The OCIE’s proper ETF focus will be on illiquid ETFs, the resulting harm to investors from this illiquidity and the disclosure of these risks to investors—all new from the generic examination of ETF compliance listed in the 2017 OCIE Priorities.\(^8\)

The retail investor theme also includes last year’s attention to municipal advisors’ compliance with registration, recordkeeping, supervision and other requirements.\(^9\) The 2018 OCIE Priorities adds here particular attention to broker-dealers and municipal advisors acting as municipal underwriters.\(^10\) Fixed income order execution in municipal and corporate bonds is a new retail investor focus, where OCIE intends to ensure that broker-dealers are complying with their best execution obligations in this space.\(^11\) As a final, and new, retail investor area of focus, OCIE will examine the involvement of broker-dealers and investment advisers in the growing crypto-currency and initial coin offering markets. As is the case with FINRA below, OCIE understands that its jurisdiction will reach these markets only when the products involved are securities. In such cases, it will verify that financial professionals are providing adequate disclosure about the risks associated with them.\(^12\)

Market Infrastructure Theme

The next two “themes”—compliance and risks in critical market infrastructure and in self-regulatory organizations—are less of a concern to compliance professionals, unless they are working for firms involved in that infrastructure. As it did in the 2017 OCIE Priorities,\(^13\) OCIE promises to examine clearing agencies, national securities exchanges and transfer agents on various matters.\(^14\) More relevant is its continued focus on Regulation Systems Compliance and Integrity (“SCI”) entities, which includes alternative trading systems (“ATSs”) operated by broker-dealers, where OCIE will focus on firms’ overall compliance with Regulation SCI and their business continuity plans, risk management and ability to take corrective actions in response to identified problems.\(^15\)

The new areas cover such matters as the costs of investing, particularly as investors move (or are moved) to advisory accounts, financial professionals’ involvement in crypto-currencies and initial coin offerings, the ways in which business continuity plans address climate disasters and front-running in options transactions.

Technology and Anti-Money Laundering

The final two themes are relevant to compliance officers, even if they echo the 2017 OCIE Priorities. The first, cybersecurity, is now an important OCIE focus, as it is for FINRA. OCIE wants to see how firms manage cybersecurity risks, establish preventive measures, such as access rights and controls, vendor management and training, and how they deal with incidents, such as data loss.\(^16\) Second, again echoing the 2017 OCIE Priorities, OCIE promises to focus on anti-money laundering (“AML”) programs, particularly firms’ compliance with customer due diligence requirements, the timely filing of suspicious activity reports (“SARs”) and their testing of the AML program.\(^17\)
FINRA’s 2018 Examination Priorities Letter

Like OCIE, FINRA (the quality of whose examinations of broker-dealers is itself an OCIE examination priority!) has both old and new topics in its 2018 FINRA Priorities Letter. It tells firms that they should use the letter as a point of reference for their compliance, supervisory and risk management programs and as a source of preparation for FINRA examinations. As does OCIE, it observes that it may always adjust its priorities to respond to changing circumstances. From time to time it refers readers to its 2017 letter, which it regards as continuing to express its concerns in certain areas. FINRA alerts firms that it plans to focus on the following topics.

Fraud

As FINRA first observes, it always keeps its eye out for the “classic” fraudulent schemes, such as insider trading, microcap pump-and-dump plots, issuer fraud and Ponzi schemes. As was true last year and echoing the OCIE focus, it is particularly on the lookout for any fraudulent schemes involving senior investors. A related, and continuing, focus is on “high-risk firms and brokers,” a topic that it addressed at some length in the 2017 FINRA Priorities Letter. This subject is related because these firms and brokers are “high-risk” precisely because they are involved in fraudulent schemes and because their targets are often senior investors. As FINRA reminds firms, they have special supervisory obligations for these brokers, especially because certain of their activities often lead to investor abuse. These would include sales of speculative or complex products, their control of customer accounts, their involvement in rollovers of retirement plans, their engaging in private securities transactions and outside business activities with customers.

Operational and Financial Risks

FINRA highlights a number of subjects of perennial concern to it under the topic of “Operational and Financial Risks”; in the 2017 FINRA Priorities Letter it had a separate section for each of these kinds of risk. First among these, occasioned by the climate disasters over the summer, is a focus on firms’ business continuity plans, which should enable firms to continue to meet their obligations to customers in an emergency or extended business disruption. FINRA expects to see a detailed plan that would, among other things, describe how firms maintain and restore their business in these circumstances. Second would be customer protection, which includes verification and protection of customer assets; this was an operational risk in the 2017 FINRA Priorities Letter. FINRA promises to examine a firm’s compliance with financial responsibility rules, which have a customer protection purpose—a topic treated at length in the 2017 FINRA Priorities Letter. Firms can thus expect that their net capital and reserve computations will be checked, custodial banks will be contacted for verification of the reserve account and all custodians will be evaluated to see whether customer securities are properly secured and controlled. In particular, FINRA alerts firms that this year it will give special attention to foreign custodial arrangements.

Under the operational and financial risk topic are two related, perennial areas of focus but with a new orientation. The first, entitled “technology governance,” would examine a firm’s policies and procedures when a firm incorporates new technology into its systems or enhances existing technology, often through use of third-party vendors. FINRA will examine how firms plan for this incorporation or enhancement in order to prevent operational breakdowns that can threaten customer service or assets—a focus that has appeared in FINRA disciplinary actions. Another operational risk area covered here is cybersecurity, where FINRA, as discussed at length in the 2017 FINRA Priorities Letter and as was covered in the 2018 OCIE Priorities, focuses on a firm’s cybersecurity program to protect sensitive information, particularly customer personally identifiable information. Here FINRA reminds firms that they must file a SAR when they have a cybersecurity event.

Another familiar operational risk, also highlighted in the 2017 FINRA Priorities Letter (and in the 2018 OCIE Priorities), is a focus on the adequacy of a firm’s AML program. What is new is a more sustained warning to firms to be aware that their foreign affiliates may engage in high-risk transactions through accounts at the member firm (foreign currency transactions were highlighted in the 2017 FINRA Priorities Letter). FINRA will be examining whether AML programs sufficiently address these accounts, as well as

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accounts used in securities-backed lines of credit (“SBLOC”), noting, as to these latter, that, when multiple accounts are used to receive and to disburse funds from a given SBLOC, activity in all accounts must be aggregated for AML purposes.

The only financial risk that FINRA highlights this year comes in its warning that it will continue to focus on firms’ liquidity plans, including their use of liquidity stress tests—liquidity was a subject covered at length in the 2017 FINRA Priorities Letter. FINRA concludes its section on operational and financial risks by observing—and this is new—that it will focus on rates charged to customers in short sales because it has found abuses in these transactions, e.g., where a firm uses a conduit account to borrow securities, which then lends the security to a house account at a higher rate, which in turn lends the security to customers at a still higher rate. It promises to be on the lookout for such abusive practices in this area.

Sales Practice Risks

This topic also has the familiar with a bit of the new. Suitability is usually a focus of FINRA examinations because it is the primary duty that a broker owes the customer. This year, FINRA’s examination focus on suitability is similar to that of the 2017 FINRA Priorities Letter: that is, to see whether the firm has supervisory systems and controls in place to ensure that its sales staff meet their suitability obligations. In other words, do representatives properly understand the products (reasonable basis suitability), particularly complex products, and do they determine the products that are appropriate for customers (customer basis suitability), particularly unsophisticated investors? New this year are several suitability-related topics raised by the Department of Labor’s fiduciary rule: recommendations made to retirement plan participants, particularly IRA rollover recommendations involving securities transactions, and recommendations involving a switch of the customer from a brokerage account to an investment adviser account and related abuses. In the latter cases, FINRA is clearly concerned about situations where a customer has paid high commissions as a brokerage client and is then moved to an adviser account, where there is little trading in, but a regular assessment of fees on, the account.

A new focus of FINRA this year under sales practice risk, which echoes that in the 2018 OCIE Priorities, is on crypto-currencies and initial coin offerings, which have received a lot of recent publicity. Like OCIE, FINRA is watching developments, and broker-dealer involvement, in these transactions. Again, like OCIE, FINRA has jurisdiction only if these instruments can be considered to be securities or to involve securities transactions. The SEC is likely to take the lead in this area, but only where, under settled law, firms are raising capital through these currencies and offerings that would be deemed to be securities. At a minimum, firms should supervise the involvement of their representatives in these kinds of transactions (if they permit this involvement at all) as a prelude for the regulation of the transactions as securities or as outside business activities.

Another new sales risk focus involves broker-dealer disclosure and supervisory practices related to margin loans. FINRA is examining these practices because of abuses in this area, as, for example, where customers are solicited to purchase on margin without understanding the consequences (e.g., liquidation of securities collateral) and where representatives put customers into margin transactions without customer permission. FINRA will thus ask whether firms adequately disclose the risk of margin loans to customers and have controls to prevent excessive margin trading.

As mentioned above, in a related new area of focus FINRA will also examine the use of SBLOCs. These lines of credit, offered by either a broker-dealer affiliate or a third party, are secured by securities collateral, but their proceeds cannot be used for securities purchases. Noting that their use has recently increased, FINRA wants to ensure that firms comply with sales practice and operational requirements in their use. Chief among its concerns are whether customer disclosures are adequate: do they disclose the impact of market downturns on the SBLOC (e.g., a liquidation of the collateral) and the tax implications of the liquidation? In addition, a firm must ensure that the collateral securing the SBLOC is not pledged for another extension of credit and that the proceeds are not being used for securities purchases, which would mean that they would constitute a margin loan that is not subject to margin regulations. This kind of abuse, we
might remember, occurred, notoriously, in some broker-dealers operating in Puerto Rico.

Market Integrity
Under this topic, FINRA will focus on its traditional concerns in ways similar to those enumerated in the 2017 FINRA Priorities Letter. With respect to manipulation, it simply explains the development of its surveillance programs, some of which use machine learning, that seek to identify suspicious and potentially abusive trading patterns (e.g., the Cross Market Auction Ramping surveillance pattern). As with respect to the discussion of this subject in the 2017 FINRA Priorities Letter, these programs are intended to provide information to firms that will supplement, but not replace, the firms’ own surveillance and supervision in this area.42

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Best execution is a traditional market integrity focus of FINRA. This year, in addition to concerns identified generally in the 2017 FINRA Priorities Letter, FINRA will be examining, through its surveillance pattern, how much firms provide price improvement when routing customer orders or internalizing them.43 In addition, following on a recent sweep examination on this subject, it will focus on how firms meet their best execution obligation when they receive inducements for routing orders to particular venues. It reminds broker-dealers that these inducements (or their own proprietary interests in the case of internalization) cannot interfere with their best execution duty. Finally, FINRA will continue to explore fixed income execution practices for execution quality and fair pricing in fixed income securities, including Treasury securities.

A new focus this year is on firms’ compliance with Rule 201 of Regulation SHO, particularly on their testing and supervision of automated controls in this area.44 In addition, FINRA warns firms that they should be sure that any order they believe is exempt from that Rule in fact qualifies for the exemption and that they mark and report the order as short exempt. Continuing a focus from last year, FINRA will continue to monitor through its own surveillance firms’ transaction reporting in Treasury securities.45 As it notes, this surveillance could pick up late reporting, failure to report inter-dealer trades, misreporting of such trades and inaccurate execution time reporting. These failures could reveal abuses of customers. An additional source of FINRA review will be electronic communications with customers on these transactions and discrepancies between the transaction information that customers receive and that in firm records and reports to the Trade Reporting and Compliance Engine.

A new market integrity focus for this year is on front running and other abusive practices in options, a focus developed from a FINRA surveillance pattern in 2017.46 Among other things, FINRA will look at transactions in options while participants have knowledge of pending transactions in the underlying product. It will also look at whether firms supervise “marking the close” activity in options that may have an impact on the national best bid or offer (“NBBO”) for the underlying securities. In addition, it will conduct reviews of option-related violations of Exchange Act Rule 14e-4, which governs partial tender offers and requires that participants tender no greater than their “net long position.” In this latter case, FINRA is focusing on an abuse whereby a participant does not subtract from its long position, as the rule requires, call options that it sells with a strike price less than the tender offer price (presumably, to hedge the participant’s position).

Several additional focus areas of market integrity simply echo those in the 2017 FINRA Priorities Letter.47 FINRA will continue to review broker-dealer compliance with Exchange Act Rule 15c3-5, known as the Market Access Rule,
when firms give customers access to their trading systems. Continuing on from a focus on broker-dealers’ disclosures to customers about the operations of their ATSs, FINRA plans to review the supervisory systems for these ATSs and, in particular, their response to manipulative activity occurring in an ATS.

In the context of market integrity, FINRA announces that it will provide firms with the following new “report cards” to assist in their compliance and will then review how firms use those cards. The “Auto Execution Manipulation Report Card” deals with a firm’s supervision to identify instances when a market participant uses non-bona fide orders to move the NBBO (see, for example, the discussion of options above). Another is the Alternative Trading System Cross Manipulation Report Card that identifies instances where a participant manipulates the NBBO resulting in modification of a security’s prevailing midpoint price on an ATS crossing venue. The “Fixed Income Mark-up Report Card” provides information to firms and the industry about median and mean percentage mark-ups for each firm with respect to certain criteria (e.g., investment rating, product (corporate or agency), length of time to maturity).

New Rules Implementation

Finally, FINRA lists several significant new rules that will (or by now have) become applicable in 2018 and alerts firms that it may discuss with them how they are implementing their obligations under the rules. They are the following:

- Rule 2165 (effective as of Feb. 5) permitting broker-dealers to put a temporary hold on disbursements of funds or securities from accounts of specific customers where there is a reasonable belief of financial exploitation of the customers.

- Amended Rule 4512 (also effective as of Feb. 5) requiring a firm to make reasonable efforts to obtain the name and the contact information for a trusted contact person for a non-institutional customer account.

- FinCEN’s Customer Due Diligence Rule (compliance date of May 11), which strengthens customer due diligence, particularly as to (1) customer identification and verification, (2) beneficial ownership and verification, (3) the understanding of the nature and purpose of customer relationships and (4) the ongoing monitoring for reporting suspicious transactions and, on a risk basis, the maintaining and updating of customer information.

- Amended Rule 2232 on customer confirmations (effective on May 14) requiring a broker-dealer to disclose the amount of mark-up and mark-down for trades with retail customers in corporate or agency debt securities if it also executes an offsetting principal trade in the same security on the same trading day, and requiring disclosure in retail customer confirmations for corporate or agency debt security trades by (1) a reference or hyperlink to a FINRA web page with publicly available trading data on the specific security and (2) the execution time of the transaction, expressed to the second.

- Amended Rule 4210 (effective on June 25) dealing with new margin requirements for covered agency transactions listed in the rule.

- Consolidated FINRA registration rules, Rules 1210 through 1240 (effective on Oct. 1), which streamline and bring consistency and uniformity to the qualification and registration requirements.

Conclusion

While compliance officers have a lot to digest from a reading of the 2018 OCIE Priorities and the 2018 FINRA Priorities Letter, they are likely to be prepared for an examination in many of the topic areas highlighted in them because they echo those of recent OCIE and FINRA focus. Even the new areas generally come from ongoing regulatory attention to particular subjects (e.g., trading and best execution in the fixed income space, initial coin offerings). One “takeaway” from the above is that compliance officers have to be ready for an examination of all aspects of their firms’ technology: the uses of technology in the firms’ business, the controls on and testing of this technology, the use of technology in compliance and risk management and products with a technology-based component (relating to execution, valuation, crypto-currencies, to name just a few). And, as discussed above and as every compliance officer knows, new examination priorities can suddenly surface, often because of a well-publicized scandal or systems breakdown in one or more financial firms. So, once again, it is business as usual; the sheer number of priorities suggests that this will be a busy year for compliance officers.
ENDNOTES


3 See 2018 OCIE Priorities, at 5.

4 See 2018 OCIE Priorities, at 5; 2017 OCIE Priorities, at 2.


7 See 2018 OCIE Priorities, at 6.

8 See 2017 OCIE Priorities, at 3.

9 See 2018 OCIE Priorities, at 6. 2017 OCIE Priorities, at 3. The focus on investment recommendations is new this year.

10 See 2018 OCIE Priorities, at 6; 2017 OCIE Priorities, at 3. The reference to non-profit employee protection in the retirement space is new.

11 See 2018 OCIE Priorities, at 6.

12 See id.

13 See 2018 OCIE Priorities, at 6; 2017 OCIE Priorities, at 2.

14 See 2018 OCIE Priorities, at 6; 2017 OCIE Priorities, at 5.

15 See 2018 OCIE Priorities, at 7.

16 See id.

17 See id.

18 See 2017 OCIE Priorities, at 4-5.

19 See 2018 OCIE Priorities, at 7-8.


21 See 2018 OCIE Priorities, at 9. The 2017 OCIE Priorities’ discussion of cybersecurity, at 4, was less expansive.

22 See 2018 OCIE Priorities, at 10; 2017 OCIE Priorities, at 4-5. The 2018 specific focus on customer due diligence is new.


26 See 2018 FINRA Priorities Letter, at 1; 2017 FINRA Priorities Letter, at 3.


33 See id.


39 See 2018 FINRA Priorities Letter, at 5.

40 See id.

41 See id., at 5.


47 See 2018 FINRA Priorities Letter, at 8.


50 See id., at 9-10.