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FINRA 2010 Field Examinations

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In keeping with our practice of providing information on FINRA-announced priorities for its annual cycles of field examinations of member firms, the following summary of FINRA's March 1, 2010 release (the "Release") describes the concerns and areas of concentration which FINRA intends to incorporate in this year's field examinations. Not surprisingly, a number of the concerns appear to be prompted by recent financial services industry scandals such as the Bernard Madoff and Allen Stanford frauds, while the increased number of topics seems intended to demonstrate a more rigorous regulatory oversight of the financial services industry.

I. Structural and Financial Concerns.

- ***Mergers and Acquisitions of Securities Firms.***
  Noting that recessionary and economic pressures on securities firms have resulted in an increasing number of consolidations, FINRA expects that entities resulting from mergers or acquisitions will properly integrate and update their supervisory procedures and systems, trading platforms, reporting functions, electronic record surveillance and retention, and will perform post-merger reviews to determine if business and compliance goals are being met. The Release also refers member firms to discussions of FINRA Rule 1017 which requires notifications and approvals by FINRA for material changes in business operations and ownership brought about by merger or acquisition.

- ***Equity Capital Withdrawals.***
  Because FINRA Rule 4110 limiting equity capital withdrawals from member firms became effective in February 2010, FINRA is serving notice that it will be checking to see that stockholders and partners have obtained FINRA withdrawal consents when withdrawals exceed 10% of excess net capital or where stockholder loans or advances in clearing firms exceed prescribed thresholds.

II. Transactions in Products and Services.

- ***Direct Market Access.***
  Echoing recent SEC releases on the same subject, FINRA is voicing its concerns over the increased use of electronic systems, which permit both broker-dealers and non-broker dealers to have direct access to trading markets (including exchanges and electronic trading systems), in many cases without any meaningful participation or supervision by the broker-dealer charged with the responsibility of filtering orders, monitoring trading patterns and making risk assessments of customer order flows. As the SEC weighs in later this year on pending proposals to regulate direct market access, member firms can expect FINRA examiners to review procedures and supervisory controls on both sponsored and "naked" direct access arrangements offered by member firms.

- ***Private Placements.***
  The Release warns that, when a member firm conducts a private placement offering to raise capital for itself through the sale of its own securities, FINRA examiners will want to confirm that the offering was conducted in accordance with Rule 5122, that the proper conflict disclosures and commitments were made to customer / investors, and that the offering documents were filed with FINRA for review. In addition, the Release voices concern about "an increase in the number of investor complaints involving the sale of private placements in general," citing serious failures to conduct due diligence reviews and suitability determinations before the sale of private offering investments to customers.

- ***Municipal Securities.***
  Citing the impact of the recession on many issuers of municipal securities, FINRA reminds underwriters and dealers in municipal securities of their obligations under SEC and MSRB rules to make certain that procedures are in place to supply customers with an Official Statement with disclosures on a muni issue and with notifications on material events affecting a particular municipal security.

- ***Fixed Income Transactions.***
  In light of increased market volatility and greater interest by the public in the purchase and sale of debt securities, FINRA is indicating that it will intensify its examination focus on the execution of fixed income securities transactions, both as to fair and reasonable mark-ups and mark-downs and as to best execution, using existing automated surveillance techniques. In addition, FINRA reminds fixed income brokerages that debt securities issued or guaranteed by a government or government-sponsored agency are becoming TRACE-eligible for reporting purposes.

- ***Short Sales and Regulation SHO.***
  The Release states specifically that FINRA "will continue to focus on short sale rule compliance in 2010" due to ongoing concerns about the impact of short selling on market integrity and the extent to which firms are following changes in Regulation SHO. Firms can expect that examiners will check to see if

short sale orders are being properly marked, if locate and close-out procedures are included in WSP manuals and are being consistently followed, if short sale reporting for both customer and proprietary accounts is proper and up-to-to date, and if WSPs are being revised to incorporate the new alternative uptick rule restricting shorts when a stock has dropped 10% or more in a trading day. Firms engaged in equity sales, whether as introducing brokers, proprietary traders or clearing agents, may also anticipate that their short-sale close-out history will be checked to see if stock required to be delivered against a short sale was actually borrowed or purchased within the prescribed settlement time frames.

III. General Supervisory Issues.

- ***Branch Office Supervision.***
  The Release suggests that FINRA will target for examination any branch office of a member firm in which a registered representative with multiple customer complaints is employed, on the theory that multiple sales practice violations at a single location is an indicator that branch office supervision, including visits and internal inspections are not sufficiently rigorous.

- ***Outsourcing.***
  For the second consecutive year, FINRA has voiced a concern about outsourcing of certain broker-dealer service functions, noting that use of outside vendors to perform important functions has been increasing as firms reduce overhead in the difficult times. FINRA continues to emphasize that (i) firms must perform due diligence and risk assessment in evaluating the ability and reliability of service providers to perform key functions, (ii) establish controls and procedures "to ensure that vendors are fulfilling their duties responsibly and in compliance" with regulatory requirements, and (iii) the outsourcing can in no way diminish the responsibility of a firm or its senior management for supervisory, compliance and financial obligations in the operation of its business.

- ***Customer Information and Cyber-Security.***
  An awareness of well-publicized and more frequent incidences of hacking, identity theft, and customer and operational data intrusions in financial firms, and within the vendors who service them, is mentioned in the Release, along with a reminder that the supervisory and technical systems for protecting customer and other firm confidential information will be reviewed for adequacy during the 2010 examination cycle.

- ***PIPE Offerings and Information Barriers.***
  FINRA indicates that it has found numerous instances of firms engaged in PIPE (private investment in public entities) placements where inadequate information barriers exist between those with access to non-public issuer information and personnel involved in actual offerings. Accordingly, firms engaged in

these activities may expect a close review of the related supervisory procedures and increased examiner concerns about potential insider trading abuses.

- ***Anti-Money Laundering.***
  Both the Release and other information we have received suggest that FINRA will continue and may well increase it's the level of reviews of anti-money laundering (AML) compliance programs this year. More intensive scrutiny appears to be driven by (i) a change in the existing AML rule (now FINRA Rule 3310) effective January 1, 2010 which eliminates the prior small-firm exception for independent testing, and (ii) an apparent regulatory view that better AML procedures by firms could and should help identify a broader range of suspicious activities. In particular, FINRA now seems to be suggesting that a proper AML program should be designed, not solely to detect suspicious transfers of funds, but to "red flag" other activities warranting further inquiry, such as unauthorized trading in penny stocks, manipulative activities, and unauthorized transfers of assets among the accounts of firm customers and employees.

- ***Investment Advisor Oversight.***
  In a preamble to its Release, FINRA suggests that firms which have persons registered as both brokerage representatives with FINRA and as investment advisers with the SEC should be "advised that FINRA examiners may review their investment advisory activities" to ascertain that such firms are properly supervising RIA personnel to ensure that they comply with applicable FINRA rules, including best execution and the general business conduct provisions of FINRA Rule 2010. Since the SEC and not FINRA has historically been responsible for registered investment advisor activity, it is unclear to what extent FINRA, through its carefully worded message, will now seek to expand its regulatory role for brokerage firms to encompass activities associated with the Investment Advisers Act of 1940.

While the Release is intended as general guidance for firms preparing for this year's field examination cycle, there is no assurance that all firms will be examined on all of the items mentioned or that FINRA examiners will not seek to review areas not covered in the Release.

The full text of the Release, which covers a few topics in addition to those mentioned above, is available on the FINRA website by browsing to:
http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/index.htm
and then clicking on the highlighted March 1, 2010 examination priorities entry.