

FINRA 2009 Field Examinations

Legal Alert
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Garvey Schubert Barer Legal Update, May 8, 2009.

In a letter recently released to member firms, FINRA discusses priorities being incorporated into its 2009 field examination program. A number of the identified priorities appear to have been prompted by uncertain financial markets and the current recession, while others reflect new regulatory developments or simply restate ongoing FINRA concerns about supervision, customer protection and other matters. Below is a summary highlighting some of the key points of the letter (the "Release.")

I. Priorities Related to Recent Financial Market and Economic Declines

Alternative Investments and Cash Products

Because investors may feel increased pressure to seek, and firms may be tempted to offer, alternative investment products with promised yields significantly higher than conventional bond and equity funds, the Release reminds each member firm that it must (i) exercise due care in understanding the terms, risks and rewards of any new products to be offered, (ii) perform a customer-specific suitability analysis, and (iii) present a fair and balanced explanation of the alternative product, including market, credit and other risk factors, to any customer considering the product. In addition, a separate portion of the Release emphasizes the need for firms to have these and additional procedures in place when targeting products and marketing efforts to senior investors.

Noting that money market funds and other cash alternatives have greater importance for customers during current market volatility, FINRA will be looking at how firms present these products to retail investors, particularly in advertising material which may incorrectly describe such products as "safe as cash" or as a "cash equivalent" with no indication of market or credit risk. As in the case of other alternative investments, each firm

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must be prepared to demonstrate that it has performed appropriate due diligence and suitability analyses for cash alternatives it markets to customers.

Unregistered Securities

With an eye to the use of restricted securities as revenue enhancers in difficult times, FINRA indicates that its examiners may be looking at member firm sales of unregistered securities, particularly penny and sub-penny issues sold at the instance of the firm or a customer. The concern will be whether a firm is following acceptable due diligence and other good practices (such as requiring legal opinions and Form 144 filings) in order to avoid violations of federal and state securities and criminal laws.

Outsourcing

FINRA has noticed a recent tendency, particularly by smaller broker-dealers, “to outsource key operational functions,” and is emphasizing that basic supervision and oversight functions may not be outsourced. As to those functions which can be outsourced, the Release indicates that examiners may check to see whether firms have monitoring and measurement procedures for determining whether vendors are performing their responsibilities, and whether firms have considered business and regulatory risks associated with outsourcing.

Marking the Close; Rumors as Manipulative Devices

Because of pronounced price declines and increased volatility in the trading markets, FINRA suggests that its examiners will be alert to evidence of attempts to affect the market close in particular securities. Accordingly, written supervisory procedures should include internal control and surveillance measures designed to alert supervisors to inconsistent share price movement and patterns of late order entry for a specific security.

Also, noting that circulation of negative rumors with respect to financial industry companies exacerbated price declines in their shares, FINRA notes that it and other securities industry regulators are heightening their surveillance efforts in this area. A firm should expect examiners to ask for evidence that it has reviewed its internal controls, procedures and surveillance practices to allow it to identify and review unsubstantiated statements that could affect specific securities or general market conditions.

Order Entry Controls

Due to recent market volatility, FINRA examiners will be looking into instances where a firm has an inordinate number of clearly erroneous trade filings which could produce market price distortion for a given security. Firms are urged to review their controls over order entry practices to ensure that systems and personnel are accurately entering and transmitting customer orders.

II. Priorities Related to Regulatory Changes

Consolidated Rulebook

Reminding firms of the consolidation of NYSE and NASD member regulation functions and of the development of a new FINRA Rulebook, FINRA states that it will expect firms to have in place procedures and schedules for reviewing and updating written supervisory procedures so that they will timely incorporate and reflect the new consolidated FINRA rules. As only a few recent examples, former NASD IM 2110-7 relating to interference with customer account transfers, NASD Rule 2315 relating to broker recommendations of higher risk securities without reviewing current issuer information, and NASD IM 2110-5 relating to improper coordination or influence as to prices and quotations issued by other firms, have each been revised and will now appear, respectively, as FINRA Rules 2140, 2114 and 5240, effective as of June 15, 2009. Since the process of revising, consolidating and re-issuing member regulation rules has been ongoing since last summer and is expected to continue for some time, examiners will be looking to see if firms have adjusted their procedures and practices to reflect the consolidated rules as they are issued.

Changes in Short Sale Procedures

Prompted in part by the capital markets crisis, the SEC last October adopted Regulation SHO Rule 204T to address abusive naked short selling practices and also extended its anti-fraud rules by concurrently adopting Rule 10b-21. The Release clearly states that certain member firms were specially examined in 2008 for compliance with the new rules and that FINRA “will continue to review firms’ compliance” with the new rules in 2009.

New Trade Reporting Procedures

Effective Monday, August 3, 2009, FINRA-designed trade reporting procedures for all OTC equities transactions will change from a market-maker based structure to a system in which the “executing party” (as defined in Regulatory Notice 09-08) will be required to report. The changes will also affect reporting for riskless principal trades and certain manually negotiated trades. Accordingly, FINRA field examination priorities for 2009 will include confirmation that a firm’s WSPs and actual practices reflect the new reporting procedures for periods after the effective date.

Identity Theft, Information Security and Customer Privacy

With authority from the Fair and Accurate Credit Transactions Act of 2003 (the “FACT Act”) the Federal Trade Commission has created a rule (known as the “Red Flags Rule”) which requires a defined “financial institutions” to develop and administer a written identity theft prevention program, effective from August 1, 2009. The Rule contemplates an assessment of risk of identity theft for customers and the use of reviews and other measures to detect unauthorized or aberrant activities in a customer account (the “red flags”), if a brokerage firm qualifies as a

“financial institution” holding “transaction accounts” which permit customers to write checks, make payments to third parties and obtain loans or credit. While many smaller and mid-sized brokerage firms may not qualify as a financial institution for purposes of the Red Flags Rule, those who do can expect FINRA examiners to ask for copies of the appropriate identity theft program.

Aside from the Red Flags Rule, the Release puts firms on notice that examiners will expect to see policies and procedures designed to protect against computer system invasions and other threats to the security and integrity of customer records under SEC Regulation S-P, particularly for firms which offer online customer access and trading through brokerage house computer systems which often rely on third-party vendors for support and other capabilities.

III. Priorities Related to Ongoing FINRA Concerns

In addition to the foregoing, the Release points up FINRA’s continuing emphasis on *supervisory systems*, particularly where high risk business activities would require customized oversight procedures designed to detect potential regulatory problems, and also comments on the need for “robust” inspection programs for both branch and non-branch locations. The Release also mentions, in this regard, the need for adequate procedures to detect and review private securities transactions and outside business activities. In a repetition of a FINRA theme, the Release notes that “examiners continue to focus” on *anti-money laundering* requirements and states that generic AML procedures not tailored to a firm’s particular business model “may not be appropriate.”

Conclusion

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.

[View the full text of the Release on \[www.finra.org\]\(http://www.finra.org\).](#) [PDF]