



## Annual Broker-Dealer Regulatory Review and 2019 Outlook

With 2018 behind us and 2019 underway, we find ourselves in a position to look back on what transpired throughout last year to anticipate what this year may bring for Broker-Dealers. Here is our perspective on what the highlights were in 2018, as well as what will be at the center of regulatory development in 2019.

### 2018 Review

#### 2018 FINRA Initiatives

In its 2018 Exam priorities letter issued last January, FINRA indicated that it would focus on areas such as: technology governance, cybersecurity, ICOs and digital currency, Reg SHO, as well other more cyclical focus areas, including AML, suitability, and best execution. While the regulator paid attention to these subjects all year by issuing guidance, the topics at the core of the *Annual Exam Findings Report* issued in December 2018 were predominantly the “bread and butter” areas such as AML, liquidity, and investor protection across firm-wide functions and activities.

#### FINRA 2018 Exam Findings Report

In December 2018, FINRA released its second-ever Annual Exam Findings Report. The document focused on observations from recent exams that FINRA found to be worth highlighting due to their impact on the industry. This report is not a complete account of issues noted at member firms over the course of the year, nor does it serve to create any new regulatory requirements or interpretations of current ones. It is, however, an important tool for Member Firms to leverage when prioritizing their regulatory compliance and risk initiatives for 2019. CRC has reviewed this report and summarized key takeaways.

In the report, FINRA states, “[t]his report focuses on selected observations from recent examinations that FINRA considers worth highlighting because of their potential significance, frequency, and impact on investors and the markets.” As in years past, FINRA placed a priority on issues stemming from areas like AML, accuracy of net-capital calculations, liquidity, segregation of client accounts, and best execution. In keeping with the theme of previous reports from recent years, FINRA remains focused on customer protection.

In general, issues arose when dealing with products other than typical stocks and bonds. The report makes clear that FINRA equates less “mainstream” products with increased risk to consumers. Likely driven by increased activity and interest surrounding digital currency this year, the regulator focused on products that it considers to be “complex” or “high-risk,” primarily because they stray from the beaten path and therefore hold a greater potential to cause confusion and possible harm to investors. The list includes products such as leveraged and inverse ETFs and ETNs, variable annuities, UITs, REITs, volatility-linked products, and private placements.

FINRA's conservative solution to mitigating the risk of such products to a Member Firm's business or clients is to avoid them altogether. Although the report includes various instances in which Firms successfully implemented reasonably designed controls to mitigate the risks inherently present when dealing with lesser-known or understood products, they reference more frequently the notion that many firms are simply deciding to avoid these products altogether, further highlighting their point of view on the matter.

As noted above, FINRA's "bread and butter" issues were still at play in 2018- AML, liquidity, investor protection across firm-wide functions and activities- and they will be in 2019 as well. New to the list is the regulator's hyper-focus on complex products and the adequacy of controls surrounding them. Firms may choose to take the conservative path of avoidance championed (however subtly) by FINRA in the 2018 Exam Findings Report; for those who decide to continue or wish to begin offering such products, CRC recommends partnering with an experienced regulatory compliance partner to assist in navigating the ever-evolving regulatory landscape and implementing industry best practices and adequate policies and procedures to satisfy both regulators and clients.

### **2018 Notable FINRA Fines**

Although FINRA didn't hit the record-setting \$173.8 million in fines that it levied in 2016, the regulator did hand out some hefty, multi-million-dollar fines over the course of 2018. Most of the heavier fines imposed this year arose from issues surrounding areas such as AML, inadequate or inappropriate disclosures, and industry insiders abusing their knowledge or position.

In February, FINRA fined Wedbush Securities \$1.5 million for net capital deficiencies and for failing to accurately calculate its customer reserve requirement. In May, FINRA fined Fifth Third Securities Inc. \$4 million and required the firm to pay \$2 million in restitution for recommending variable annuity exchanges that were not suitable for its customers. FINRA fined Industrial and Commercial Bank of China Financial Services \$5.3 million for failing to implement an anti-money laundering program to detect suspicious transactions. In October, FINRA fined LPL Financial \$2.75 million for failing to report dozens of customer complaints on its brokers Form U4 and U5 disclosures, and for an inadequate anti-money laundering program. In December, FINRA imposed a \$4.5 million fine on UBS Financial Services and a \$500,000 levy on UBS Securities for failing to implement an AML system designed to flag high-risk transactions. The UBS Financial violations involved billions of dollars' worth of foreign currency wires, while the UBS Securities violations were issues surrounding the monitoring of penny stock transactions. The biggest fine announced by FINRA last year also involved anti-money laundering compliance. Also in December, FINRA slapped Morgan Stanley Smith Barney with a whopping \$10 million penalty for AML failures over the course of five years.

### **Looking Forward to 2019**

#### **Exam Priorities 2019**

FINRA recently published its annual [Regulatory and Examination Priorities Letter](#). FINRA encourages broker-dealers to use the 2018 Annual Exam Findings Report and the 2019 Exam Priorities Letter as resources to

enhance their compliance, supervisory, and risk management programs, and to prepare for FINRA examinations. Outlined below are the key points from the letter.

#### **I. Online Distribution Platforms**

Noted as the regulator's first "highlighted" item in the Exam Priorities Letter, FINRA lists its primary concerns in this area stem from the idea that some member firms are insisting that they are not selling or recommending securities when involved in online distribution platforms, despite contrary evidence. For instance, firms asserting that they are neither selling nor recommending securities but are receiving transaction-based compensation or are handling customer funds and/or accounts would likely fall on the regulatory radar. Firms should be aware of how they are communicating with the public, and carefully reviewing their AML procedures and offering documents to ensure that they meet AML and disclosure requirements. FINRA notes that they will be evaluating these areas, and additionally, offerings subject to Reg A and Reg D. CRC recommends that firms engaging in this space coordinate with a qualified compliance partner to ensure that they are appropriately disclosing their services and activities, and that offering language is not misleading or promissory, particularly due to how visible online distribution platforms are to the public.

#### **II. Fixed Income Mark-up Disclosures**

Another new item on the list this year, FINRA has expressed interest in firms' compliance with their mark-up or mark-down disclosure obligations on fixed income transactions with customers pursuant to amendments to FINRA Rule 2232 (Customer Confirmations) and MSRB Rule G-15, which became effective on May 14, 2018. To help firms evaluate their compliance with mark-up requirements, FINRA developed a Mark-up/Mark-down Analysis Report that is available to individual firms, as well as the publicly available Bond Facts Tool. FINRA will also assess any changes in a firm's activity which may have arisen from an attempt to avoid their obligations under Rules 2232 and G-15. CRC recommends that firms evaluate their obligations under these rules, and confirm that they have sufficient programs, policies, and procedures in place to ensure compliance.

#### **III. Regulatory Technology**

The last highlighted item in the report stems from firms' increased reliance on RegTech, which was on the regulator's radar last year as well. FINRA recognizes that, while many member firms are utilizing such technology to supplement and streamline their compliance efforts, there is inherent risk in using these tools. As such, FINRA is hoping to engage with firms to understand how they are using RegTech, and how they are addressing risks related to supervision and governance, third-party vendor management, cybersecurity, and safeguarding firm and client data. CRC recommends that firms utilizing or looking to utilize such technologies are cognizant of and evaluating risks, and are implementing appropriate controls and solutions to mitigate such risks.

## IV. Sales Practice Risks

### A. Suitability

Suitability is always one of FINRA's primary areas of focus. In 2019, some specific areas that FINRA may focus on include: (1) deficient quantitative suitability determinations or related supervisory controls; (2) overconcentration in illiquid securities, such as variable annuities, non-traded alternative investments and securities sold through private placements; and (3) recommendations to purchase share classes that are not in line with the customer's investment time horizon or hold for a period that is inconsistent with the security's performance characteristics (which could include, for example, a recommendation to purchase and hold a security that is intended for short-term trading or to engage in short-term trading in products designed primarily for long-term holding).

As indicated in their 2018 Exam Findings Report, FINRA emphasized again that the exchange-traded product (ETP) market is becoming increasingly complex. As such, the regulator will likely be focused on evaluating whether firms are meeting their suitability obligations and risk disclosure obligations when recommending such products, including: leveraged and inverse exchange-traded funds (ETFs), floating-rate loan ETFs (also known as bank-loan or leveraged loan funds) and mutual funds that invest in loans extended to highly indebted companies of lower credit quality.

In addition, FINRA remains concerned about securities products that package leveraged loans (e.g., collateralized loan obligations). Although these products are typically sold via private placement to qualified institutional buyers, FINRA is interested in the marketing of these products to retail clients and will review how firms are supervising such transactions to ensure their compliance with applicable sales restrictions.

CRC recommends that, regardless of complexity of investments or types of clients, member firms have consistent and conservative methods of ensuring that adequate disclosures are made to investors and potential investors. In addition, implementing stringent procedures with regard to suitability is a highly important aspect of the investment lifecycle, and should be considered and reviewed for accuracy and applicability on a consistent basis. Firms should pay particular attention to this area if they are dealing in complex or new product types, or marketing to retirement investors.

### B. Senior Investors

Protection of senior investors, as well as investors who are retired or approaching retirement, consistently remains a top priority for FINRA. The regulator will continue to focus on how firms are protecting these investors from fraud, sales practice abuses and financial exploitation. FINRA will pay particular attention to the supervision of accounts where registered representatives serve in a fiduciary capacity, including holding a power of attorney, acting as a trustee or co-trustee, or having some type of beneficiary relationship with a non-

familial customer account. FINRA will assess the supervisory systems firms employ to place heightened scrutiny over such accounts, as a primary concern is instances where representatives could authorize the transfer of funds to themselves, or in some other way take advantage of their relationship or position with a customer in this class.

FINRA will also review firms' controls regarding their obligations under amendments to FINRA Rule 4512 (Customer Account Information) requiring firms to make reasonable efforts to obtain information about trusted contacts for non-institutional accounts and new FINRA Rule 2165 (Financial Exploitation of Specified Adults), to the extent that firms anticipate placing temporary holds on disbursements pursuant to the Rule 2165 safe harbor, including whether firms have clearly defined policies and procedures or practices.

CRC recommends that firms divert significant effort to this area in the event that senior investors make up a significant portion of their customers. Regulatory trends for the past several years have indicated an across-the-board interest in protecting the "average joe" or "main street" investor; senior investors are no exception and are perhaps the most likely to fall prey to fraud. In addition, they have the most at stake due to the fact that, as they are in or approaching retirement, they would not have time or means to recover financial losses incurred from inappropriate investments or theft and misappropriation of assets due to encounters with unscrupulous financial institutions or individuals. Demonstrating dedication to protecting investors' assets and information, particularly in instances when registered representatives are in a position of authority over such assets will satisfy clients and regulators alike.

## V. Operational Risks

### A. Supervision of Digital Assets Business

Throughout 2018, some firms have demonstrated significant interest in participating in activities related to digital assets. FINRA stated in their Exam Priorities letter that they encourage firms to notify FINRA if they plan to engage in such activities before they start, and even in instances where a membership application is not required. In the coming year, FINRA plans to review firms' activities through its membership and examination processes related to digital assets and assess such firms' compliance with applicable securities laws and regulations. FINRA also noted that they will be coordinating with the SEC in a joint effort to consider how firms determine whether a particular digital asset is a security and whether firms have implemented adequate controls and supervision over compliance with rules related to the marketing, sale, execution, control, clearance, recordkeeping and valuation of digital assets, as well as AML/Bank Secrecy Act rules and regulations. CRC recommends that any firm looking to enter or continue operating in this space consult with an experienced compliance professional who is aware of changing regulatory expectations and evolving risks impacting this area. Digital currency will remain a regulatory focus as it continues to gain traction with retail investors.

## B. Customer Due Diligence and Suspicious Activity Reviews

During their examination processes, FINRA will assess firms' compliance with FinCEN's Customer Due Diligence (CDD) rule, which became effective on May 11, 2018. FINRA will focus on the data integrity of those suspicious activity monitoring systems, as well as the decisions associated with changes to those systems. CRC recommends that firms ensure that they have not only implemented CDD compliant procedures, but that they test and refine them as well. Firms should have procedures in place to identify beneficial owners of legal entity customers, understand the nature and purpose of customer accounts, conduct ongoing monitoring of customer accounts to identify and report suspicious transactions, and, on a risk-basis, update customer information. CRC recommends that firms consider engaging a third-party vendor to continually monitor and verify information provided, run OFAC checks, etc., as a best practice.

This list is not exhaustive; FINRA noted in the introductory portion of the Exam Priorities Letter that this year, the regulator was using the letter to focus on materially new priorities and then discuss ongoing concern areas, with particular emphasis on facets of those topics that have not been previously addressed in prior years' letters. In addition to the "bread and butter issues" (AML, disclosures, suitability, etc.), other focus areas include protecting investors from fraud, high risk firms and brokers, business continuity planning, cybersecurity, insider trading and market manipulation, best execution, data quality and governance, protection of customer assets, recordkeeping, accuracy of firm financial data, and risk management across all business areas.

### Conclusion

As always, CRC's position is that the best compliance program is a proactive and conscientious one. Methodically assessing risks and adequacy of mitigating controls, combined with an ongoing effort to uphold investor rights and best interest are the keys to operating successfully in today's regulatory climate. CRC offers a full suite of risk and regulatory compliance services to support initiatives and ongoing procedures related to the contents of FINRA's Exam Findings and Priorities for 2018 and 2019, as well as a host of firm-specific functions such as (but not limited to): ongoing compliance support, project management, annual reviews, document and WSP review, gap analyses, etc. Partnering with a team of compliance professionals with the depth to support your operational and regulatory needs is the next step in augmenting your compliance program to meet the standards of the constantly evolving regulatory landscape.

*Sources: FINRA 2018 Exam Findings Report, FINRA 2019 Exam Priorities Letter*





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Kaitlyn Gibbs joined CRC in 2017. She is a regulatory compliance professional with 7 years of experience in the financial services industry. Kaitlyn has extensive knowledge of the rules of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. She previously managed compliance processes and performed forensic testing in her role as Compliance Analyst at Welch & Forbes LLC.

She has experience performing annual reviews and risk analyses, regulatory research, as well as Code of Ethics administration. Her primary focus areas include, process implementation and enhancement, cybersecurity, marketing materials review, private equity investment compliance, and investment portfolio compliance.

Most recently at CRC, Kaitlyn has performed regulatory research, evaluated compliance programs, and performed annual reviews and risk assessments for investment advisors.

Kaitlyn holds a Bachelor's Degree in English from Boston University.





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