

## Back to Basics: FINRA Issues 2009 Examination Priorities

March 18, 2009

On March 9, the Financial Industry Regulatory Authority (FINRA) issued its annual communication to member firms outlining its 2009 Examination Priorities. FINRA's 2009 letter highlights a number of issues that have gained significance in the current market environment. Not surprisingly, this year's letter tackles almost twice as many topics as did last year's letter. Although some topics appear every year—supervision, seniors—and others make their debut or are substantially expanded upon—alternative investments, cash alternatives, protection of customer information, Exchange Act Rule 15c3-3 (the customer protection rule)—the key theme is that member firms should get back to basics: know your business, know your products, know your customers, and create supervisory systems and controls tailored to your firm's business mix and the current market environment.

At the outset, FINRA's letter stresses the importance of strong compliance, supervision, and risk management, and advises member firms to carefully consider the impact of headcount reductions in non-income-producing areas such as compliance, finance, operations, and other control functions to determine whether they are proportionate to reductions in the relevant business areas. Also, as member firms look for new income streams, the letter reminds them to review new products and business activities in terms of both supervisory procedures and communications made to customers.

Additionally, FINRA describes its expectations for member firms with respect to updating written supervisory procedures (WSPs) to reflect the consolidated FINRA rulebook resulting from the consolidation of the NASD and NYSE member regulatory functions. The letter states that as a priority, member firms should keep abreast of consolidated rules and periodically review and update their WSPs to reflect the new rule requirements. Changes to rule citations in WSPs may wait until the member firm's next scheduled update.

The topics addressed in FINRA's 2009 letter can be classified into three broad categories: sales practice issues, enterprise control functions, and financial and operational controls. We highlight several of the most significant issues in each category below.

### Sales Practice Issues

- **Cash Alternatives.** The 2009 letter expands on a key issue raised by both the SEC and FINRA in the wake of the failure of the auction rate securities market: the representation of such securities as cash alternatives or equivalents. Thus, FINRA advises member firms that they should have a reasonable basis for characterizing an investment as a cash alternative, as inappropriate representations may implicate FINRA's advertising rules. FINRA also advises firms to have procedures in place to continually monitor developments to ensure that the investment retains its characterization as a cash alternative. FINRA also reminds firms to perform a suitability analysis before recommending cash alternatives to particular customers.
- **Bank Sweeps.** FINRA observes that in 2008 it saw member firms increase use of bank deposit programs as sweep vehicles for free credit balances. This increase has caused FINRA to continue to focus on sales practice issues associated with sweep vehicles, including disclosures made to customers of the terms and conditions of bank sweep programs, the differences between SIPC protection and FDIC insurance, and the methodology for calculating interest rates on swept balances. FINRA also indicates that it will review disclosure of compensation earned by broker-dealers and banks operating the sweep programs, as well as

the registered representatives who may offer these programs to customers. FINRA also notes that its examiners will focus on documentation and reconciliation issues relating to the bank where the account is held and any intermediary banks involved in the bank sweep arrangement.

## Enterprise Control Functions

- **Anti-Money Laundering (AML).** FINRA's approach in the letter mirrors allegations in a recent enforcement action against a member firm<sup>1</sup> in that it cautions firms to focus broadly on suspicious activities related to securities transactions rather than solely on money movements. One size does not fit all as far as AML compliance programs are concerned; instead, each firm should tailor these programs to its own business model, risk profile, and volume of transactions, as well as the allocation of AML responsibilities between introducing and clearing firms.
- **Foreign Corrupt Practices Act (FCPA).** FCPA has been a significant area of SEC enforcement, with recent announcements of settlements in the hundreds of millions of dollars. Additionally, the New York State Banking Department has indicated that it may make FCPA a new area of compliance focus. FINRA reminds members of their obligation to comply with the FCPA, to maintain accurate books and records, and to implement internal controls to properly record transactions that may implicate FCPA.
- **Protection of Customer Information and IT Security.** Following in the wake of several SEC enforcement actions arising from online account intrusions, including one action against a firm for allegedly failing to implement safeguards despite its awareness that it had insufficient controls to protect customer information,<sup>2</sup> FINRA advises members offering online customer access to assess their internal surveillance and institute methods for dealing with account intrusions. Firms should also review account activity to monitor for any indications of suspicious activity. On a related topic, FINRA reminds firms to develop and implement a written identity theft program pursuant to the FTC's Red Flags Rule, which the FTC will begin to enforce on May 1, 2009. (See *Regulatory Notice 08-69* ([www.finra.org/notices/08-69](http://www.finra.org/notices/08-69))).
- **Outsourcing.** FINRA previously stated in *Notice to Members 05-48* ([www.finra.org/ntm/05-48](http://www.finra.org/ntm/05-48)) that while broker-dealers may outsource certain functions, they may not outsource supervision and oversight. In the 2009 letter, FINRA provides illustrations of how member firms may satisfy their supervision and due diligence obligations for outsourcing arrangements by (1) requiring vendors to meet measurable performance standards, (2) meeting frequently with vendor personnel, and (3) assigning qualified personnel to monitor, review, and supervise the service provider's activities. Additionally, FINRA reminds members to consider the risks of activities outsourced to vendors that operate in foreign jurisdictions to determine the impact that outsourcing arrangements may have on business continuity plans. Member firms should expect FINRA examiners to look for written procedures addressing these issues.
- **Information Barriers.** FINRA has been conducting an ongoing enforcement sweep with respect to the control of the flow of nonpublic material information within member firms. In the 2009 letter, FINRA reminds members that they must have information barrier procedures that are tailored to their business activities and organizational structures, as well as procedures addressing the use of restricted and watch lists, monitoring systems, supervision, review of proprietary and employee trading, review of questionable activities, and recordkeeping requirements.
- **Rumors.** Both the SEC and FINRA have undertaken enforcement sweeps relating to the circulation of rumors, and the SEC has recently sent out a sweep letter to broker-dealers that asks about controls relating to the prevention of rumors, including monitoring electronic communications such as employees' Internet access, including access to chat rooms and other websites. In the 2009 letter, FINRA again reminds member firms to review their internal controls, procedures, and surveillance practices with respect to rumors in order to promptly discover and review any misconduct. Although FINRA has warned about spreading false rumors through public statements, its proposed a new rule on the topic (see *Regulatory Notice 08-68*

---

1 *E\*Trade Securities, LLC*, Hearing Panel Decision, 20006004297301 (Dec. 17, 2008).

2 *LPL Financial Corp.*, Exchange Act Release No. 58515 (Sept. 11, 2008) (<http://www.sec.gov/litigation/admin/2008/34-58515.pdf>).

([www.finra.org/notices/08-68](http://www.finra.org/notices/08-68)) raised many questions, including how to distinguish “rumors” from market commentary.

## Financial and Operational Controls

Noting that the “failure and /or merger of several large firms in 2008 reinforces the significance of the customer protection rules,” member firms can expect FINRA to take a deeper dive in the Financial and Operations Principal (FINOP) exams. In general, when firms are reviewing compliance and supervisory structures, they should focus on areas where they have noted material weaknesses or where they have had past compliance issues. The requirements that FINRA mentions in the letter include the following:

- **Customer Protection Rule.** FINRA reminds members of multiple factors to consider when computing their reserve formula under Exchange Act Rule 15c3-3. FINRA also reiterates several steps that clearing firms should take to maintain possession and control of customer funds and securities and that introducing firms should review procedures to ensure that they generally are not receiving customer funds and securities.
- **Excess SIPC Protection.** FINRA states that it will review firms’ disclosures to customers with respect to excess SIPC insurance. Firms should make sure that they accurately describe to customers how any excess SIPC protection functions.
- **Inventory and Collateral Valuations.** Concern about valuations has been an area of high importance for FINRA for the past year. According to FINRA, firms should have adequate controls to independently value inventory and collateral positions, especially with respect to complex and less liquid positions. Specifically, FINRA expresses concern about relying on traders’ valuation and the valuation of collateral for reverse repo and securities borrowed transactions and cautions firms and senior management to maintain resources and support for product controllers and other independent valuation groups.
- **Funding and Liquidity.** FINRA reminds firms to evaluate the quality and reliability of funding sources, liquidity stress tests, and contingency funding plans, in order to address lessons learned from recent market events.
- **Counterparty Credit Risk.** According to FINRA, firms are expected to evaluate and manage counterparty credit risk emanating from their trading activities, including with respect to derivative transactions, especially factoring in stressed market conditions.

## Conclusion

In examinations, member firms should be prepared to address the topics identified in FINRA’s 2009 letter, as well as any issues raised in prior examinations.

To view the entire FINRA letter outlining its 2009 Examination Priorities, please go to <http://morganlewis.com/documents/FINRA2009ExamPriorities.pdf>.

For more information on the issues discussed in this FYI Alert, please contact any of the following Morgan Lewis attorneys:

### New York

Jennifer L. Klass	212.309.7105	<a href="mailto:jklass@morganlewis.com">jklass@morganlewis.com</a>
Ben A. Indek	212.309.6109	<a href="mailto:bindek@morganlewis.com">bindek@morganlewis.com</a>
Adrienne Marie Ward	212.309.6794	<a href="mailto:award@morganlewis.com">award@morganlewis.com</a>

### Washington, D.C.

John V. Ayanian	202.739.5946	<a href="mailto:jayanian@morganlewis.com">jayanian@morganlewis.com</a>
Theodore R. Lazo	202.739.5250	<a href="mailto:tlazo@morganlewis.com">tlazo@morganlewis.com</a>
Mark D. Fitterman	202.739.5019	<a href="mailto:mfitterman@morganlewis.com">mfitterman@morganlewis.com</a>

**About Morgan, Lewis & Bockius LLP**

Morgan Lewis is an international law firm with more than 1,400 lawyers in 22 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis, please visit [www.morganlewis.com](http://www.morganlewis.com).

This FYI Alert is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2009 Morgan, Lewis & Bockius LLP. All Rights Reserved.

