

# Client Alert

Business Litigation & Special Matters and Government Investigations Practice Groups

February 12, 2018

## Financial Industry Regulatory Priorities In 2018 *FINRA and OCIE Announce Examination Areas of Focus*

In early 2018 both the SEC's Office of Compliance Inspections and Examinations ("OCIE") and FINRA announced their examination priorities for 2018.<sup>1</sup>

As in previous years, both OCIE and FINRA share many examination priorities designed to protect retail investors (focusing on risks specific to senior investors) and managing market-wide risks. Although many of the identified priorities have been priorities in prior years, OCIE and FINRA have identified new foci worth noting. In 2017, OCIE announced that one of its priorities would include greater oversight of FINRA, which has taken on increasing responsibilities for conducting broker-dealer exams, and created a dedicated inspection team, FINRA and Securities Industry Oversight ("FISIO"). In 2018 OCIE will maintain its heightened oversight of FINRA and examine select operations, policies and procedures, and controls of the Municipal Securities Rulemaking Board ("MSRB"), a self-regulatory organization which has the responsibility of regulating broker-dealers and banks that buy, sell, and underwrite municipal securities, and municipal advisors. In 2018, FINRA has pledged to focus on certain operational risks that were highlighted by the events of 2017—with a particular focus on business continuity planning that will enable firms to weather disasters like Hurricanes Harvey and Maria. Further, given the expansion of the cryptocurrency market in 2017, both OCIE and FINRA have pledged to monitor cryptocurrencies and initial coin offerings in 2018. Of note, in 2017 the SEC National Exam Program completed 2,870 examinations—an 18% increase from 2016.

In FINRA's cover letter to its 2018 examination priorities letter, FINRA President and CEO Robert Cook reflected on changes expected at FINRA in the coming year, including operations enhancements resulting from FINRA360—a self-evaluation and improvement initiative completed in 2017. In 2018, FINRA's enforcement functions will be integrated into a single unit, additional changes will be made to FINRA Advisory Committees, and FINRA's examination program will implement a risk-based framework to better use resources.<sup>2</sup> Similarly, OCIE's leadership team released a cover letter to further explain its 2018 examination priorities. OCIE's leadership clarified that in executing the 2018 priorities OCIE will abide by five key principles: (1) conducting risk-based analyses; (2) using data analytics—

For more information, contact:

**Matthew H. Baughman**  
+ 404 572 4751  
mbaughman@kslaw.com

**Israel Dahan**  
+1 212 556 2114  
idaham@kslaw.com

**Peter Isajiw**  
+1 212 556 2235  
pisajiw@kslaw.com

**William Johnson**  
+1 212 556 2125  
wjohnson@kslaw.com

**Alec Koch**  
+1 202 626 8982  
akoch@kslaw.com

**Carmen Lawrence**  
+1 212 556 2193  
clawrence@kslaw.com

**Richard Walker**  
+ 1 212 556 2290  
rwalker@kslaw.com

**Chelsea J. Corey**  
+1 704 503 2575  
ccorey@kslaw.com

[www.kslaw.com](http://www.kslaw.com)

including the Qualitative Analytics Unit—to facilitate examinations; (3) maintaining transparency with its examination program and providing firms with Risk Alerts to promote compliance; (4) using resources efficiently; and (5) embracing innovation and technology to monitor risks and adapt examinations.

Both priority letters provide firms with a guide for evaluating their compliance programs and business operations in preparation for an exam in 2018. Firms are encouraged to use these letters to identify possible issues that could be proactively assessed to prevent possible future exposure.

## Shared Priorities

In the coming year, both FINRA and OCIE share concerns about (1) senior investors, (2) operational risks such as cybersecurity and anti-money laundering, and (3) cryptocurrency, initial coin offerings, and blockchain.

### *Senior Investors*

As in previous years, OCIE and FINRA remain concerned about the protection of senior investors and investors saving for retirement because they are more reliant on investment returns. OCIE will examine how firms interact with senior investors in an attempt to prevent exploitation with a focus on “investment recommendations, sales of variable insurance products, and sales and management of target date funds.”

Fraud targeting senior investors will continue to remain a focus of FINRA examinations. In 2017, FINRA adopted [Rule 2165](#) and amended [Rule 4512](#) specifically to protect senior investors from fraudulent investment schemes.<sup>3</sup> In 2018, FINRA will continue to identify high-risk firms and individual brokers to mitigate the risks posed to senior investors. Hiring and supervisory practices will be scrutinized, and FINRA reminds firms to implement heightened supervisory procedures under [Rule 3110](#) where required. High-risk practices involving senior investors are of particular concern, including: (1) recommendations for speculative or complex products; (2) situations where brokers have power-of-attorney or are beneficiaries of customer accounts; and (3) rollovers of qualified plans to non-qualified plans.

Both FINRA and OCIE express concern regarding fixed income order execution and best execution as an investor protection requirement. OCIE will examine firms to assess best execution policies, while FINRA will expand its equity best execution surveillance program “to assess the degree to which firms provide price improvement when routing customer orders for execution or when executing internalized customer orders.”

### *Operational Risks*

OCIE and FINRA share similar concerns about specific operational risks, including firms’ cybersecurity and anti-money laundering programs.

- *Cybersecurity:* Cybersecurity risk has increased dramatically with increased reliance on technology. OCIE’s 2018 examinations will particularly focus on risk assessment, access rights and controls, and incident response with respect to firms’ cybersecurity programs. These priorities were also the subject of OCIE’s Cybersecurity Initiatives 1 and 2 in 2015 and 2017, and OCIE’s Observations from those two prior Initiatives<sup>4</sup> are essential reading for insights into OCIE’s expectations in these areas and for exam preparation. FINRA intends to review firms’ preparedness, technical defenses, and reporting compliance.
- *Anti-Money Laundering:* As in previous years, both OCIE and FINRA will examine firms’ AML programs, with a particular focus on firms’ policies and procedures for detecting suspicious transactions and firms’ compliance with Suspicious Activity Report requirements. FINRA specifically encourages firms to review its

Examination Findings Report from 2017 to further understand areas of concern and effective practices for AML programs.

## *Cryptocurrency, Initial Coin Offerings, and Blockchain*

Given the rise of cryptocurrency, initial coin offerings, and blockchain in 2017 it is no surprise that both OCIE and FINRA have committed to monitoring these emerging digital assets and offerings in 2018. Due to their new and evolving nature, cryptocurrency, initial coin offerings, and blockchain pose increased risks to retail investors. OCIE and FINRA will monitor brokers dealing in these types of assets and offerings, with an eye toward ensuring maintenance of adequate controls and safeguards to prevent theft, misappropriation, and inadequate disclosure.<sup>5</sup>

## **OCIE-Specific Focus Areas**

Though OCIE and FINRA share some 2018 exam priorities, due to OCIE's broader jurisdiction, there are areas of divergence and OCIE-specific concerns that firms should be aware of.

### *OCIE's Focus on Investment Advisors Serving Retail Investors*

In 2018 OCIE will continue to prioritize protecting retail investors and will seek to examine firms that provide products to retail investors. Specific areas of focus include:

- *Disclosure of Investing Costs:* Proper disclosure and calculation of conflicts of interest, fees, expenses, and charges is a paramount protection for retail investors. OCIE examiners will review firms' retail customer disclosure practices and fee structures. OCIE intends to focus on firms with riskier business models for retail investors including those where advisory personnel receive financial incentives for investment recommendations and where private fund advisors manage funds with a high concentration of retail investors (including non-profit organizations and pension plans).
- *Electronic Investment Advice:* OCIE intends to continue its examination of investment advisors offering automated or digital investment advice, and will focus on firms' compliance programs (including oversight of computer algorithms).
- *Wrap Fee Programs:* OCIE will also continue to examine investment advisors and broker-dealers that charge investors a bundled fee for advisory and brokerage services, with a specific focus on adherence to fiduciary duties and contractual obligations.
- *Mutual Funds and Exchange Traded Funds:* OCIE will continue to review mutual funds and ETFs with a focus on mutual funds and ETFs that (1) have experienced poor performance or liquidity in terms of their subscriptions or redemptions, (2) are managed by inexperienced advisors, or (3) that hold difficult-to-value securities.
- *Municipal Advisors and Underwriters:* A new OCIE focus for 2018 includes monitoring of municipal advisors who provide advice to municipal entities regarding bonds and other financial products. Examinations will focus on compliance with MSRB rules regarding professional standards and education.

In 2018, OCIE has specifically pledged a continued focus on newly registered or never-before-examined investment advisors with elevated risk profiles.

## *OCIE's Focus on Market Infrastructure and Compliance Risk*

OCIE highlighted additional exam priorities regarding compliance risks and general market infrastructure monitoring. To this end, OCIE promises to: (1) continue its annual examinations of clearing agencies that the Financial Stability Oversight Council has identified as important to overall trading integrity; (2) monitor the more than 20 national exchanges with a focus on the self-conducted internal audits and governance issues; (3) examine transfer agents in light of their critical role in the efficient operation of the secondary securities market; and (4) examine Regulation Systems Compliance and Integrity Entities, with a focus on adoption and implementation of relevant policies and reporting procedures.

In its oversight role, OCIE will continue to monitor FINRA's operations and regulatory programs, including the quality of FINRA examinations. This focus is in line with OCIE's recent effort to direct more resources towards examining investment advisors and rely more on FINRA to conduct examinations of broker-dealers. For the first time since OCIE began publishing exam priorities in 2013, it identified oversight of the MSRB as a stated priority for 2018. OCIE will focus its oversight of the MSRB by examining the effectiveness of its operational and internal policies and procedures. It is possible that OCIE's decision to prioritize MSRB oversight could have been prompted by the results of the SEC's Municipalities Continuing Disclosure Initiative, which between 2014 and 2016 resulted in enforcement actions against 72 underwriters of municipal securities offerings.

## **FINRA-Specific Focus Areas**

In its priorities letter FINRA identified a number of unique 2018 examination priorities that touch nearly every aspect of a broker-dealer's business.

### *FINRA's Focus on Operational and Sales Risks*

FINRA identified a number of operational and financial risks for firms including:

- *Business continuity planning:* In light of the spate of natural disasters to strike the United States in 2017, FINRA will examine firms' business continuity planning, with a focus on whether firms have adequately planned for continued access to critical systems and physical locations. FINRA will also review firms' plans for restoring systems, procedures, and records once normal business operations are returned.
- *Customer protection and verification of assets and liabilities:* FINRA will examine the accuracy of firms' net capital and reserve computations, and will review firms' processes for verifying customer assets. These examinations will include a review of firms' foreign depositories, clearing agencies, and custodial banks to ensure that customer assets are being adequately controlled and transferred.

FINRA also noted that it intends to review firms' information and technology management policies as well as liquidity risk policies to ensure that firms have adequately protected against operational breakdowns or liquidity crises. In addition to the operational and financial risks discussed above, FINRA also identified specific sales practice risks for firms including:

- *Suitability:* FINRA will continue to examine firms' controls regarding the introduction of new products and personnel training on suitability of these products for retail investors. FINRA pledged to pay particular attention to suitability determinations for products that are recommended to unsophisticated or vulnerable investors.

- *Use of margin:* In light of 2017 examination observations, FINRA will assess firms' disclosure and supervisory practices related to margin loans, with a focus on firms' disclosure of the risks of margin trading.
- *Securities backed lines of credit:* As the use of SBLOCs continues to increase, FINRA will continue to review firms' compliance with sales and operational obligations relating to SBLOCs, with a focus on the adequacy of disclosures.

## ***FINRA's Focus on Market Integrity***

Market integrity remains a concern for FINRA, with a specific focus on market manipulation, Regulation SHO compliance, options products, Market Access Rule compliance, and alternative trading systems.

In 2017, FINRA launched various market surveillance programs to identify and manage potentially manipulative trading activity (including programs designed to identify dominant trading surrounding the open or close and programs designed to identify layering), which will be further enhanced in 2018 through the use of machine learning techniques. Likewise, in 2017, FINRA developed surveillance patterns to detect front running in correlated options products and will continue to remain focused on options surveillance (particularly with respect to "marking the close" activity) in 2018. This year FINRA expects to implement surveillance patterns focusing on fair pricing and best execution in Treasury securities transactions.

Firms' compliance with Rule 201 of Regulation SHO will be evaluated in 2018, with a specific focus on compliance procedures that include automated, rules-based controls to ensure compliance. Likewise, compliance with the Market Access Rule (SEA Rule 15c3-5) will continue to be assessed. FINRA encourages firms to review its [Examination Findings Report from 2017](#) for additional guidance on possible compliance issues.

## ***FINRA Compliance Tools and Changes***

As in previous years, FINRA will continue to provide firms with compliance tools. New report cards to assist compliance efforts will be launched in 2018, including report cards to help supervise and identify manipulation techniques. Also with respect to broader compliance, FINRA highlighted the applicability of new rules in 2018. The new rules and their general subject matter are:

- [Rule 2165](#) (effective February 5, 2018), regarding financial exploitation of specified adults and permitting members to place temporary holds on disbursements from accounts of specified customers when there is a reasonable belief of exploitation;
- [Rule 4512](#) amendments (effective February 5, 2018), requiring members to make reasonable efforts to obtain contact information for a trusted contact person for a non-institutional customer's account;
- [Rule 2232](#) amendments (effective May 14, 2018), requiring members to disclose, among other things, the amount of mark-up or mark-down applied to trades with retail customers in debt securities if the member executes offsetting trades in the same security on the same trading day;
- [Rule 4210](#) amendments (effective June 25, 2018), regarding FINRA's new margin requirements for Covered Agency Transactions (which include TBA transactions, Specified Pool Transactions, and agency CMO transactions); and
- [Rules 1210 through 1240](#) (effective October 1, 2018), are the consolidated FINRA registration rules that are designed to streamline registration requirements.

Further, FINRA reminded that firms have until May 11, 2018 to comply with the Financial Crimes Enforcement Network's Customer Due Diligence Rule. FINRA noted that "FinCEN identifies four components of customer due diligence: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information."

\* \* \*

The annual examination priority letters from OCIE and FINRA provide firms with a useful guide for assessing risk management protocols and compliance programs. Firms are encouraged to act proactively to tackle the priorities that OCIE and FINRA announced for 2018.

*Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,000 lawyers in 20 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at [www.kslaw.com](http://www.kslaw.com).*

*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."*

---

<sup>1</sup> See 2018 Annual Regulatory and Examination Priorities Letter, FINRA, January 2018, available at <http://www.finra.org/sites/default/files/2018-regulatory-and-examination-priorities-letter.pdf>; 2018 National Exam Program Examination Priorities, U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, February 7, 2018, available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf>.

<sup>2</sup> Cook, Robert, "Cover Letter From FINRA President and CEO," Jan. 8, 2018, available at <http://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter>.

<sup>3</sup> Rule 2165, titled "Financial Exploitation of Specified Adults," puts protections in place—including disbursement restrictions and supervision requirements—for persons aged 65 and older or persons with mental or physical impairments. Rule 4512, titled "Customer Account Information," requires FINRA members to maintain customer personal information, including a trusted contact person to address possible financial exploitation.

<sup>4</sup> See OCIE, "OCIE's 2016 Cybersecurity Examination Initiative," Sept. 15, 2015, available at <https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf>; OCIE, "Observations From Cybersecurity Examinations," Aug. 7, 2017, available at <https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf>.

<sup>5</sup> For additional information regarding cryptocurrency enforcement please consult King & Spalding's latest Client Alert: "Dividing Up the Sandbox: Recent Actions and Public Statements Demonstrate How the SEC and CFTC Are Dividing Up the Cryptocurrency and Crypto-Token Enforcement Landscape," Feb. 7, 2018, available at <https://www.kslaw.com/attachments/000/005/636/original/ca020718.pdf?1518102898>.