

January 5, 2016

Introduction

FINRA's 2016 Regulatory and Examination Priorities Letter identifies both new areas of focus as well as areas of recurring concern. We first address three broad issues—culture, conflicts of interest and ethics; supervision, risk management and controls; and liquidity—and then discuss more narrowly focused topics. As always, there is a tension between our desire to be brief with this letter while also addressing the many areas of potential concern that can arise across the breadth of the securities industry.

Broad Issues

Culture, Conflicts of Interest and Ethics

While firms may have their own definition of “firm culture,” we use it here to refer to the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm's business.

In 2016, FINRA will formalize our assessment of firm culture while continuing our focus on conflicts of interest and ethics. Firm culture has a profound influence on how a firm conducts its business and manages its conflicts of interest. FINRA does not seek to dictate firm culture, but rather to understand how it affects compliance and risk management practices at firms. That understanding will inform our evaluation of individual firms and the regulatory resources we devote to them. In our assessments, FINRA will focus on the frameworks that firms use to develop, communicate and evaluate conformance with their culture. We will assess five indicators of a firm's culture: whether control functions are valued within the organization; whether policy or control breaches are tolerated; whether the organization proactively seeks to identify risk and compliance events; whether supervisors are effective role models of firm culture; and whether sub-cultures (*e.g.*, at a branch office, a trading desk or an investment banking department) that may not conform to overall corporate culture are identified and addressed.

A firm's culture is both an input to and product of its supervisory system, including its approaches to identifying and managing conflicts of interest and ensuring the ethical treatment of customers. This means that firms should take visible actions that help mitigate conflicts of interest, and promote the fair and ethical treatment of customers. For example, material breaches of firm policies and procedures should not be tolerated, and compliance functions should be equipped with necessary resources to help firms navigate a complex and changing regulatory and market environment. In this regard,

FINRA's focus on firm culture is closely related to another area of focus for 2016: supervision. As discussed in our [2015 letter](#), a firm's supervisory, risk management, and control systems are essential safeguards to protect and reinforce a firm's culture.

Supervision, Risk Management and Controls

FINRA's rules create an obligation for firms to establish and maintain a system to supervise the activities of their associated persons that is designed to achieve compliance with securities laws and regulations, and with FINRA rules. In 2016, FINRA will focus on four areas where we have observed repeated concerns that affect firms' business conduct and the integrity of the markets: management of conflicts of interest, technology, outsourcing and anti-money laundering (AML).

Management of Conflicts of Interest

Incentive Structures

In 2016, FINRA will complete the targeted examination we launched in late 2015 regarding incentive structures and conflicts of interest in connection with firms' retail brokerage business. This review encompasses firms' conflict mitigation processes regarding compensation plans for registered representatives, and firms' approaches to mitigating conflicts of interest that arise through the sale of proprietary or affiliated products, or products for which a firm receives third-party payments (*e.g.*, revenue sharing). FINRA's reviews in this area will draw on our suitability and concentration focus discussed later in this letter, as well as our culture review.

On a related topic, FINRA reminds firms that we recently filed with the U.S. Securities and Exchange Commission (SEC) proposed Rule 2273, which would require firms to deliver educational communications in connection with firm recruitment practices. The communication would highlight key considerations in transferring assets to the recruiting firm—including whether financial incentives received by a registered representative may create a conflict of interest—and the direct and indirect impacts of transfers of those assets.

Investment Banking and Research Business Lines

FINRA previously fined 10 firms over \$43 million for violations of FINRA's research rules and the concerns that drove those actions remain present today. Firms may not use research analysts or the promise of offering favorable research to win investment banking business. FINRA will assess whether firms' research analysts are inappropriately involved in their investment banking activities and whether investment banking personnel exercise undue influence on analysts.

Information Leakage

One area of long-standing interest to FINRA is firms' controls to identify, minimize and mitigate information leakage within or outside a firm. This type of leakage could occur in a variety of different contexts, including inappropriate information leakage between different areas of a firm's trading activities, between a firm's trading activities and other parts of a firm, and through the front-running of pending rating changes. These and other situations raise conflicts of interest concerns that firms should manage with targeted controls and that we will examine for in 2016.

Position Valuation

A different type of conflict can arise when proprietary traders are permitted to provide valuations for proprietary positions they establish. This valuation can implicate both a firm's risk management processes, as well as the trader's performance assessment and compensation. FINRA will focus on assessing firms' supervision, control and validation of traders' pricing of illiquid, level 3 assets (assets or liabilities whose value is calculated based on unobservable inputs) to ensure that positions are fairly valued.¹ To the extent deficiencies are detected, we will expand the scope of examinations to determine whether traders or managers engaged in non-*bona fide* valuations to enhance compensation or other benefits.

Technology

Another focus for FINRA in 2016 is firms' supervision and risk management practices related to their technology infrastructure, including the hardware, software and personnel who develop and maintain a firm's information technology systems. Failures in this area can have widespread implications for firms, customers and the markets. FINRA will focus on firms' supervision and risk management related to cybersecurity, technology management, and data quality and governance.

Cybersecurity

FINRA remains focused on firms' cybersecurity preparedness given the persistence of threats and our observations on the continued need for firms to improve their cybersecurity defenses. Given the evolving nature of cyber threats, this issue requires firms' ongoing attention. While many firms have improved their cybersecurity defenses, others have not—or their enhancements have been inadequate. Firms face risks from unauthorized internal and external access to customer accounts, online trading systems and asset transfer systems, as well as in the management of their vendor relationships. FINRA will review firms' approaches to cybersecurity risk management, and depending on a firm's business and risk profile, we will examine one or more of the following topics: governance, risk assessment, technical controls, incident response, vendor management, data loss prevention and staff training.² As part of these reviews, FINRA will also consider examining firms' abilities to protect the confidentiality, integrity and availability of sensitive customer and other information, including compliance with SEC Regulation S-P and Securities Exchange Act (SEA) Rule 17a-4(f), the latter of which requires electronically stored records to be preserved in a non-rewriteable, non-erasable format. FINRA will also assess high-frequency and proprietary trading firms' ability to protect their systems from unauthorized access—*e.g.*, by a trader—that could be used to affect the market.

Technology Management

FINRA has observed shortcomings in firms' management of their technology systems. The implications of these shortcomings can be significant, as erroneous system and application changes to a firm's production environment may have widespread impacts, including causing market disrupting orders, system outages and adverse customer effects. Recent technology governance reviews have focused on firms' change management practices for algorithms, including both proprietary and customer order-routing algorithms. FINRA also reviewed firms' supervision of back office and vendor system changes. We have observed deficiencies in firms' risk management practices in these areas, for example through a lack of written procedures and evidence of supervision, insufficient segregation of duties

for personnel involved in the development and deployment of technology changes, as well as insufficient user acceptance testing and quality assurance. In 2016, FINRA will examine firms' technology governance and change management practices—*e.g.*, lifecycle development and testing of algorithms—and where applicable, incorporate new system implementation reviews.

FINRA is also seeing significant operational breakdowns at firms when there is a change from legacy to new compliance systems. These breakdowns can arise from coding issues, flaws that prevent the entry of information to facilitate proper implementation of controls and inadequate procedures leading to the suppression and override of automated alerts. This can lead to inadequate retention and supervision of email and other electronic communications, inaccurate position reports and problems with the identification of activity in customer accounts for review, among other things.

Data Quality and Governance

In 2016, FINRA will examine firms' data governance, quality controls and reporting practices to ensure the accuracy, completeness, consistency and timeliness of data reported to firm management and to firms' surveillance and supervisory systems. FINRA has observed that operational problems firms experience can originate from data quality and integrity issues, which can undermine a firm's ability to monitor or report key information that is needed to effectively manage its risk and business activities. For example, FINRA has observed problems with firms' automated AML surveillance systems not capturing complete and accurate data, which can result in missed or poor quality alerts.

Outsourcing

Firms continue to look for opportunities to reduce costs by outsourcing key operational functions. FINRA will review firms' due diligence and risk assessment of providers of outsourced services and their supervision of those services.³ FINRA reminds firms that while certain tasks can be performed by a third-party provider, the responsibility to supervise covered activities for compliance with applicable federal securities laws and regulations, as well as self-regulatory organization rules, remains with the broker-dealer. Moreover, firms must avoid outsourcing functions that are required to be performed by qualified registered persons. It is essential that broker-dealers appropriately supervise outsourced activities and that firms conduct adequate initial and ongoing due diligence of outsourced providers. This concern is also applicable to employees of affiliates conducting certain functions on behalf of the broker-dealer.

AML Controls

Suspicious Activity Monitoring

FINRA continues to assess the adequacy of firms' monitoring for suspicious activity, including surveillance of both money movements and trading activity. (See Transmittal of Customer Funds discussion below for money transfer issues beyond AML.) Firms should routinely test systems and verify the accuracy of data sources to ensure that all types of customer accounts and customer activity, particularly higher-risk accounts and activity, are properly identified and reviewed in a manner designed to detect and report potentially suspicious activity. In situations where a risk-based decision is made to exclude certain customer transactions from one or more aspects of AML surveillance, the rationale for the decisions should be documented and will be checked.

FINRA makes it a priority to assess the adequacy of firms' monitoring of high-risk customer accounts and transactions (see Microcap Securities discussion below), including activity that occurs in cash management accounts where banking services are offered to brokerage customers. When monitoring customer money movement activity, firms should ensure that the business purpose of higher risk transactions is understood to enable the firm to assess whether the transactions are suspicious, considering what the firm knows or should know about the customer and the customer's anticipated activity. FINRA also reminds firms to consider reviewing customers' activity over a period of time sufficient to identify patterns and ensure they assess the full picture of activity. When firms delegate the monitoring of suspicious trading activity to personnel outside of the AML function, firms should ensure that appropriate delegation has been made, and that the AML function has an open line of communication with the personnel conducting reviews of trading activity.

Microcap Securities

FINRA remains focused on high-risk activity involving microcap securities. Firms should assess whether their process for conducting due diligence on deposits of large blocks of microcap securities is appropriate to ensure compliance with the registration provisions of the Securities Act of 1933 as FINRA continues to identify deficiencies in this space. FINRA reminds firms to review deposits of microcap securities to determine compliance with or exemptions from registration requirements. This includes physical deposits as well as electronic deposits through Deposit/Withdraw at Custodian (DWAC) transfers, Depository Trust & Clearing Corporation (DTCC) transactions, and transfers into Delivery Versus Payment/Receive Versus Payment (DVP/RVP) accounts. With respect to customer trading activity in microcap securities, firms should have processes in place to identify suspicious trading activity, with a particular focus on securities that exhibit "red flags" of "pump-and-dump" schemes, such as news of stock promotion campaigns, and significant price and volume spikes. Firms should also focus on red flags of potentially manipulative trading, like pre-arranged trades and marking the close, particularly when securities are thinly traded.

Liquidity

Firm Funding

Failures to manage liquidity have contributed to both individual firm failures and systemic crises. For this reason, firms' practices to manage funding and liquidity risk have long been an area of interest to FINRA⁴ and will remain so in 2016. FINRA will review the adequacy of firms' contingency funding plans in light of their business models. The framework for these reviews will consider many of the effective practices contained in [Regulatory Notice 15-33](#), e.g., that firms rigorously evaluate their liquidity needs related to both marketwide and idiosyncratic stresses, develop contingency plans so that they have sufficient liquidity to weather those stresses, and conduct stress tests and other reviews to evaluate the effectiveness of their contingency plans.

In addition, FINRA will focus on the adequacy of high-frequency trading (HFT) firms' liquidity planning and controls. Given the number of orders HFT firms have in the market at one time, sudden changes in a firm's execution rate—whether triggered by a market event or other factors—could create liquidity challenges for a firm.

Other Areas of Focus in 2016

Sales Practice

Suitability and Concentration

Effectively discharging suitability obligations is a fundamental obligation and one that can become more challenging in the context of recommendations regarding complex, speculative or longer-duration interest-rate sensitive and alternative products. By their nature, the essential characteristics of these products and their heightened risks may make them more difficult for retail investors to understand and often require additional scrutiny to arrive at a suitable recommendation.⁵ While many firms have established robust systems to support such recommendations, others have not—and FINRA has observed firms failing to tailor their systems to the specifics of their product offerings. Examples of products and services where one or more of these concerns may be more pronounced include high-yield and speculative bonds, unlisted equities, alternative mutual funds, emerging market funds, structured products, non-traditional exchange-traded products (ETPs) and securities-backed lines of credit (SBLOCs).

In addition, FINRA has observed shortcomings in some firms' new product review committees and training programs to educate registered representatives and supervisors about products. In some cases, firms are deficient in their due diligence obligations and rely too heavily on incomplete or inaccurate issuer or third-party information. This has led to examination findings that firms, registered representatives and supervisors do not adequately understand products they recommend to customers.

A related area where FINRA has observed deficiencies is firms' failure to adequately monitor for excess concentration. This includes situations where firms—or branches—focus on more risky products without attendant measures to ensure suitable recommendations and avoid excess concentration. Firms' approaches to monitoring concentration should be dynamic, taking into account changing market, issuer financial condition or other factors that may increase concerns about concentration in a particular product. For example, increases in short-term volatility in high-yield and speculative bonds, or financial challenges with a municipal issuer may alter a product's risk-return profile, possibly making concentration a riskier proposition for certain investors and one that is at odds with the investor's profile.

FINRA will focus on these concerns in 2016 by assessing firms' policies and processes that govern monitoring for excessive concentrations, as well as suitability determinations for recommended transactions or investment strategies. This means that FINRA will assess whether registered representatives adequately consider, for example, such factors as credit risk, duration and leverage as relevant to specific fixed-income, complex and alternative products.

Seniors and Vulnerable Investors

FINRA's focus on senior and vulnerable investors has steadily increased over the years, and we underscore the importance of protecting these investors from fraud, sales practice abuse and financial exploitation. Through our examination program, the FINRA Securities Helpline for Seniors™ (see December 2015 [Report on the FINRA Securities Helpline for Seniors](#)) and other sources, FINRA has observed repeated situations where

seniors have been victims of fraud and abuse, for example by individuals operating both within and outside of the securities industry who have exploited a position of trust to gain control over an elderly person's assets. In some instances, registered representatives have borrowed large sums of money from elderly clients, and in other situations have taken control of assets through Powers of Attorney and other mechanisms. We have seen products recommended that are not suitable for an elderly investor but provide high commissions and payouts to the salesperson. FINRA urges firms to monitor investors' accounts for red flags of possible abuse, such as overly aggressive investments or unusual asset movements, including to recipients outside of the country.

FINRA will make the treatment of senior and other vulnerable investors a priority in 2016. The scope of our examinations in this area will include the suitability and concentration concerns referenced above, as well as recommendations regarding higher-cost products that may drive unsuitable recommendations and affect product performance to the detriment of the investor.

Sales Charge Discounts and Waivers

FINRA reiterates the concern we expressed in our 2015 letter regarding firms' failures to provide appropriate volume discounts (breakpoints) or sales charge waivers for products such as mutual funds, unit investment trusts (UIT), non-traded Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs). Multiple enforcement actions in 2015 resulted in millions of dollars in fines and restitution to customers.⁶ In particular, FINRA levied large fines against firms that systemically failed to apply eligible sales charge waivers to mutual fund transactions made by charitable institutions and retirement plans. FINRA also imposed significant sanctions against firms that systemically failed to apply eligible volume, rollover and exchange discounts to UIT transactions. This underscores the need for firms to establish and maintain controls to ensure that customers receive the volume discounts and fee waivers they are due.

529 College Savings Plans (529 Plans)

529 Plans can have three or more different share classes—*e.g.*, A, B, C—each with a different fee and expense structure. FINRA expects firms that recommend a specific share class to conduct an analysis to determine that fee and expense structures are appropriate for a customer, given their investment time horizon and liquidity needs.⁷ FINRA has observed relatively large C share purchases by customers of 529 Plans. In general, A shares may be more economical for investors with a long investment time horizon—and they offer breakpoints that C shares do not.

Private Placements, the JOBS Act and Public Offerings

Private Placements

FINRA's focus on private placements in 2016 will address concerns with respect to suitability, disclosure and due diligence.⁸ These concerns are relevant regardless of the underlying industry of the issuer or the type of investment (*e.g.*, notes offerings, pre-initial public offering investment funds, real estate programs, EB-5 investment funds or start-up companies). FINRA's focus will reflect recent regulatory developments, including the ability to conduct general solicitations under SEC Rule 506(c) of Regulation D and the crowdfunding rules which will become effective in 2016. FINRA notes that some communications used by firms concerning private placements have not reflected the

significant risks of loss of principal and lack of liquidity associated with these investments. Where a communication addresses a specific investment benefit associated with a private placement offering, a firm must ensure that the key risks associated with such benefit are disclosed. FINRA will continue to evaluate firms' compliance with respect to their communications, including general solicitation advertisements and materials posted on the Internet.

Public Offerings

In 2015, the SEC's Regulation A+ amendments, pursuant to the Jumpstart Our Business Startups (JOBS) Act went into effect. Under Regulation A+, securities are offered publicly and firms that participate in such offerings must file with FINRA and receive clearance before they commence sales. In reviewing these filings, FINRA will consider possible red flags that deserve a deeper inquiry, such as a broker-dealer or insiders of the issuer with a problematic regulatory history, conflicts of interest among parties, non-compliance with escrow requirements and disclosures that indicate inadequate due diligence by the underwriter. FINRA also will track the Regulation A+ filings to gauge how this market is developing.

Non-Traded REITs and Direct Participation Programs (DPPs)

FINRA has recently observed that in anticipation of amendments to the Customer Account Statement Rule and the DPP Rule, which become effective in April 2016, sponsors of unlisted REITs and DPPs were in the process of restructuring and repositioning their product lines. New share classes may provide greater transparency on fees and expenses and more timely appraisals that are reflected in share valuations. In addition, lower front-end commissions increase the percentage of an investor's funds available for investment. While the changes in these products should increase the information and choices available to investors, they may add complexity to these illiquid investments, which are sold primarily to retail investors.

Unlisted BDCs must also follow the new rules. Some BDCs are blind pools, while others have portfolio assets when they begin their offerings. BDCs generally lend money to small and medium-sized businesses, and thus follow the credit cycle and trends in high-yield markets and the economy. A growing number of REIT and DPP sponsors have added BDCs to the product lines they offer. This may increase their availability to retail investors, exposing them to high commissions and fees, illiquidity risks and uncertainty regarding the time-period BDCs will hold funds before they are invested. FINRA will subject all of these products to rigorous reviews.

Excessive Charges to Customers in New Bond Sales

Municipal bond underwriters are required to offer new bonds to their customers at the initial offering price, which is negotiated with the issuer of the bonds. FINRA is aware of instances in which firms have taken new issues into inventory and then improperly offered them to customers at higher prices. In such instances, a firm may entirely refrain from offering the bonds to its customers until after trading commences in the secondary market, and then sell the bonds at prices higher than the initial offering price. The SEC recently levied significant sanctions against a municipal underwriter for this type of misconduct.⁹ Current customer confirmation rules do not require dealers to disclose markups on municipal or corporate bonds and, as such, investors generally do not receive information about their dealer's compensation for transactions in fixed income securities.¹⁰

In 2016, FINRA will review whether firms have processes in place to ensure that investors are treated fairly, that firms are complying with fair pricing obligations and that they conduct *bona fide* public offerings. Using transaction data reported to the Trade Reporting and Compliance Engine® (TRACE®) and the MSRB, FINRA will monitor the primary market sales reported by syndicate participants relative to issuance size. FINRA will also assess secondary market trading, particularly by syndicate participants, subsequent to the completion of the offering to ensure customers are receiving fair and reasonable prices.

Outside Business Activities (OBA)

In 2016, FINRA will evaluate firms' procedures to review OBAs as required by FINRA Rule 3270. Activities encompassed by this rule can create conflicts of interest that firms should be aware of and mitigate. In fact, one of FINRA's most common examination findings is that firms have not, or have not adequately, assessed registered representatives' written notifications of proposed outside business activities. In reviewing these notifications, firms must, among other things, determine whether the proposed activities might interfere with or otherwise compromise the registered person's responsibilities to the firm or the firm's customers, or be viewed by customers or the public as part of the firm's business. In addition, firms must determine whether the OBA should be treated as a private securities transaction under FINRA Rule 3280. FINRA will focus on these areas and determine whether customers have been harmed due to failures to follow the provisions of Rule 3270 (or Rule 3280 where applicable).

Financial and Operational Controls

Market-Maker Net Capital Exemptions

SEA Rule 15c3-1 establishes net capital requirements for broker-dealers, including certain exemptions for firms operating as market-makers. Subsection (b)(1) exempts options market-makers from the net capital rule if the firm, among other things, is engaged primarily in options market-making and does not engage in more than an occasional investment transaction unrelated to its options market-making business. FINRA will focus on whether firms have properly claimed an exemption under and operated consistent with subsection (b)(1) of the net capital rule. FINRA will also assess whether firms are engaged in *bona fide* market-making and permissible hedging transactions pursuant to the requirements of subsection (a)(6) of the net capital rule.

Exchange-Traded Funds (ETFs)

In 2016, FINRA will review broker-dealers' role as Authorized Participants (APs) in the ETF creation and redemption process. In the primary market for ETFs, broker-dealers acting as APs serve as ETF liquidity providers through a process of creating and redeeming ETF shares. The creation and redemption function undertaken by APs is critical to maintaining ETF market structure integrity and efficiency; however, AP activities may also result in pressure on the financial integrity of broker-dealers in some conditions and this, in turn, could impair the liquidity provision function the broker-dealer plays when acting as an AP. FINRA will review the processes firms use to measure and monitor the impact of overnight counterparty credit risk, and to reflect this accurately in their net capital computations pursuant to SEA Rule 15c3-1. FINRA has observed that ETF creation and redemption can expose APs to substantial counterparty credit risk on an intra-day or overnight basis. For instance, redemptions of international ETFs may require the AP to deliver the ETF shares to the custodian bank of the fund on T+1. This exposes the AP to the credit risk of the fund until the underlying shares are received on settlement date.

Fixed Income Prime Brokerage

Prime brokerage involves credit and operational risk from settling and financing trades for hedge fund clients. Due to capital and leverage constraints placed on bank holding companies, many firms are reducing the amounts of assets that they are willing to carry on a financial basis for clients. In some cases, clients will need to find new or additional prime brokers. This will create opportunities for other firms to enter into or expand their prime brokerage business. As firms pursue this type of business, it is imperative that they implement controls commensurate with the risks. For 2016, we will focus on settlement practices for fixed income trades to understand how the operational and credit risks are managed when large trades are executed away from the prime broker. We will explore industry practices with respect to disaffirming trades and the legal documentation that supports the settlement process. We will also consider financing practices for fixed income where extensive leverage is offered.

Internal Audit

An effective internal audit framework contributes to strong internal controls and a robust corporate governance structure, which can address significant risks to a broker-dealer. Given its importance, in 2016 FINRA will focus on the organization and governance of the Internal Audit function. Our reviews will focus on Internal Audit's process for identifying and prioritizing risks, the interaction between the audit committee and the board of directors, the involvement of Internal Audit in committees and major projects, and the execution of the audit plan specific to coverage of select business and control functions. FINRA will look at how issues are tracked through resolution and evaluate how Internal Audit deficiencies are incorporated into business risks.

Client Onboarding

FINRA will assess firms' policies and controls related to onboarding clients and correspondents. FINRA has observed that firms encountering capital and liquidity problems or shortfalls generally have not employed good practices to onboard professional clients, *e.g.*, institutional, trading, hedge fund and broker-dealer clients. FINRA will select some medium and small firms to understand how they assess credit, liquidity and operational risks associated with onboarding new clients. FINRA will review firms' practices to determine, for example, a client's credit worthiness and the impact of its trading strategy on that credit worthiness; projected liquidity usage arising from client trading practices; and estimated margin lending requirements, and the impact of that lending on a firm's capital and liquidity. In addition to reviewing firms' practices with respect to such individual assessments, FINRA will also review how firms aggregate this information to develop an overall risk assessment.

Transmittal of Customer Funds

FINRA has observed a number of instances where firms failed to supervise the transmittal of customer funds to third-party accounts. Recently, FINRA brought several enforcement actions in this area. These transfers create risks for customers and the firm. FINRA reminds firms of their responsibilities related to the transmittal of customer funds pursuant to FINRA Rule 3110 (Supervision). In 2016, FINRA will assess whether firms implement adequate supervisory controls to test and verify systems to prevent the improper transmittal of customer funds. This will include firms' controls to review and monitor transmittals of funds (*e.g.*, wires¹¹ or checks) or securities from customer accounts to: third-party accounts that would result in a change of beneficial ownership; outside entities

(e.g., banks, investment companies); locations other than a customer's primary residence (e.g., post office box, "in care of" accounts or alternate address); and firms' registered representatives (including the hand-delivery of checks).

Market Integrity

Vendor Display Rule

On December 9, 2015, FINRA issued [Regulatory Notice 15-52](#) to remind firms and registered representatives of their obligations under SEC Rule 603(c) of Regulation NMS (Vendor Display Rule) when providing quotation information to customers. FINRA expects firms to review their compliance with the requirement that broker-dealers provide a consolidated display of market data when they are providing quotation information to customers. SEC staff recently stated that registered representatives' reliance on non-consolidated market information as the source of quotations used to assess the current market or the quality of trade execution is inconsistent with the Vendor Display Rule.

Market Access

In early 2016, FINRA plans to deliver compliance report cards to firms derived from our cross-market equity manipulation surveillance program. FINRA will begin with the publication of monthly report cards focused on layering¹² and spoofing.¹³ The report cards will provide information both with respect to instances where all of the potentially manipulative activity is occurring through the firm and where at least one portion of the activity is occurring through the firm while the remainder is effected outside the firm. FINRA will examine how firms use this new information to take steps to identify and address the potential misconduct.

Fixed Income

FINRA will continue to review fixed income order handling, markups and related controls. FINRA notes that the fixed income market has evolved significantly in recent years with increased transparency, the introduction of new technology and communications channels as well as the proliferation of electronic systems that facilitate trading. As a result of these and other changes, what constitutes reasonable diligence has evolved as more information has generally become available to assist firms in meeting their best execution obligation.¹⁴ FINRA will augment our best execution surveillance by implementing spread-based surveillance patterns in 2016. Other areas of increased focus include wash sales, marking the close and trading ahead. In addition, FINRA will continue to review fixed income alternative trading systems (ATs).

Regulation SHO

In 2016, FINRA will assess firms' compliance with SEC Regulation SHO. Firms should ensure that they appropriately close out fails to deliver by the designated close out date pursuant to Rule 204 of Regulation SHO. FINRA surveillance and examinations continues to uncover deficiencies with firms' compliance with the requirement to be net flat or net long on the Rule 204 close-out date. If a firm has a failure to deliver in an equity security that must be closed out pursuant to Rule 204, the firm must borrow or purchase shares on the close out date and have a net-flat or net-long position on its books and records on that close out date in order to meet the requirements of Rule 204. FINRA will assess whether firms are implementing supervisory processes to ensure compliance with the net-flat or net-long position requirement of Rule 204, and whether they are correcting deficiencies.

In addition, FINRA will evaluate the adequacy of APs' controls on ETP redemption orders. FINRA is particularly concerned that APs ensure that they—and their customers to the degree required by each specific AP agreement—have sufficient shares in their possession to prevent over redemptions and potential violations of Rule 204 for failures to deliver shares.

Cross-Market and Cross-Product Manipulation

FINRA conducts surveillance to detect market participants that attempt to disguise misconduct by trading in multiple markets. FINRA will focus on coordinated equity and options market activity designed to create momentary, artificial prices intended to affect the settlement prices of related products. In addition, FINRA is adding a new surveillance approach to address equity layering to influence options trading, either through newly established or existing positions.

Audit Trail Integrity

In 2016, FINRA will focus on identifying potential audit trail issues not typically detected through routine compliance sweeps. This topic includes a continuing focus on late reporting of TRACE-eligible and municipal securities, as well as errors in the equity audit trail.

Conclusion

FINRA urges compliance staff, supervisors and senior business leaders to consider the broad issues and the targeted topics addressed in this letter. Using the information as part of firms' risk management can better protect investors, the markets and firms themselves. For our part, we will periodically provide insights into the topics addressed in this letter as well as evolving priorities. FINRA's website (www.finra.org), conferences, *Regulatory Notices*, alerts and Weekly Update emails are all excellent sources of timely information and guidance. FINRA regulatory coordinators remain, of course, a key point of contact for firms. Finally, comments regarding this letter or suggestions on how we can improve it may be sent to Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, at dan.sibears@finra.org.

Endnotes

- 1 Statement of Financial Accounting Standards (FAS) 157.
- 2 In 2015, FINRA released the [Report on Cybersecurity Practices](#) to highlight effective practices that firms should consider to strengthen their cybersecurity programs.
- 3 See [Notice to Members 05-48](#).
- 4 In [Notice to Members 99-92](#), FINRA sets forth effective risk management practices and described shortcomings at firms. Later, FINRA published [Regulatory Notice 10-57](#) outlining a number of steps that firms should consider in managing liquidity and funding risks.
- 5 For further discussion of complex products, see [Notice to Members 05-26](#) and [Regulatory Notice 12-03](#).
- 6 <https://www.finra.org/newsroom/2015/finra-sanctions-12-firms-67-million-failing-apply-sales-charge-discounts-uits> and <https://www.finra.org/newsroom/2015/finra-orders-5-firms-pay-18-million-failing-waive-fund-sales-charges>.
- 7 529 College Savings Plans typically have a long-term investment horizon due to the beneficiary's young age with the goal of the account to assist in paying for college expenses. Due to the long-term nature, the fee structure is an important factor in determining which class of the mutual fund best fits the needs of the customer.
- 8 See [Regulatory Notice 10-22](#) for a historical perspective on this topic.
- 9 <http://www.sec.gov/news/pressrelease/2015-166.html>
- 10 Investors can obtain information about municipal bonds through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) [website](#). In addition, FINRA and the MSRB have solicited comment on proposals to provide additional pricing information to customers on the confirmation. See FINRA [Regulatory Notice 15-36](#) and MSRB [Regulatory Notice 2015-16](#).
- 11 See [Notice to Members 04-71](#).
- 12 Layering involves a trading pattern in which multiple, non-*bona fide*, limit orders are entered on one side of the market at various price levels away from the National Best Bid or Offer (NBBO) in order to create the appearance of a change in the levels of supply and demand, thereby artificially moving the price of the security; an order is then executed on the opposite side of the market at the artificially created price, and the non-*bona fide* orders are immediately cancelled.
- 13 Spoofing involves a trading pattern in which multiple, non-*bona fide* limit orders are entered generally inside the existing NBBO, with the intention of briefly triggering some type of market movement and/or response from another market participant, followed by cancellation of the non-*bona fide* orders, and the entry of an order on the opposite side of the market.
- 14 See [Regulatory Notice 15-46](#).