



## Risk Management Update February 2011

### REGULATORY UPDATE: FINRA'S ANNUAL REGULATORY AND EXAMINATIONS PRIORITIES LETTER

Each year FINRA publishes its Annual Regulatory and Examinations Priorities Letter ("Letter") with the goal of highlighting key areas of focus for firm's compliance, supervisory and ethics programs.<sup>1</sup> In issuing the 2011 Letter, FINRA identified numerous key issues facing today's financial industry, from rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), to priorities and expectations to be forthcoming with FINRA examinations of firms.

The Rulemaking portion of the letter reflects changes in the securities markets, touching on areas such as:

- Suitability (FINRA Rule 2111);
- Know your customer (FINRA Rule 2090); and
- Reporting Requirements (FINRA Rule 4530).

The lengthy Examinations portion of the Letter underscored familiar concerns for the regulatory body, with tones stemming from a recovering financial market. Examples of some of the key issues for Examiners thus include:

- Fraud Detection;
- Private Placements and Private Self-Offerings;
- Vulnerable Customers; and
- Electronic and Social Media.

The following summarizes the main focuses of these various areas. As a best practice, firms should review these areas and ensure robust policies and procedures are in place, as applicable to each firm's business model.

#### *Rulemaking Highlights*

##### **Suitability Requirements**

Under the new FINRA Rule 2111, to meet standards of suitability, brokers must have a reasonable belief that a recommended transaction or investment strategy meets the needs of the customer. Specific factors such as age, investment experience, time horizon, liquidity needs, and risk tolerance were added to the suitability analysis brokers had to

---

<sup>1</sup> FINRA, 2011 Annual Regulatory and Examination Priorities Letter (Feb. 8, 2011), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p122863.pdf> [hereinafter 2011 Annual Letter].

perform under the old rule. Rule 2111 also emphasizes the due diligence brokers must undertake in gaining an understanding of the risks and rewards of a recommended strategy. Rule 2111 becomes effective October 7, 2011. For more information about the suitability requirements please see Regulatory Notice 11-02.<sup>2</sup>

### **KYC - Know Your Customer**

Taking effect on October 7, 2011, FINRA Rule 2090 requires firms to use reasonable diligence when opening and maintaining accounts. Essential facts firms must gather are those that allow the firm to:

1. effectively service the customer's account;
2. act in accordance with any special handling instructions for the account;
3. understand the authority of each person acting on behalf on the customer;  
and
4. comply with applicable law, regulations and rule.

Importantly, FINRA reminds member firms that this diligence arises at the beginning of the relationship between the customer and broker, but is not dependant upon the broker making a recommendation. See Regulatory Notice 11-02 for more information.

### **Reporting Requirements**

FINRA Rule 4530, taking effect on July 1, 2011 will require all FINRA firms to report to FINRA within 30 days of engagement in certain violative conduct, including conduct that has widespread or potential widespread impact to the firm, its customers or the markets, or conduct that arises from a material failure of the firm's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts.<sup>3</sup>

### ***Examinations Priority Highlights***

#### **Fraud Detection**

FINRA issued a note of caution stating that its examiners "are trained to spot and investigate red flags that may indicate fraudulent behavior."<sup>4</sup> Examiners will narrow their focus on affiliate activity, as misconduct may be conducted with the material assistance of non-member firm. FINRA cautions that in accordance with Rule 4160 as effective February 1, 2011, examiners will seek written verification of assets held at a non-member financial institution. Inability to provide such records could potentially lead to prohibitive use of that institution for custodial purposes.

---

<sup>2</sup> FINRA Regulatory Notice 11-02, *Know Your Customer and Suitability* (Jan. 2011), available at <https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf>.

<sup>3</sup> See FINRA Rule 4530.01

<sup>4</sup> 2011 Annual Letter, *supra* note 1, at 4.

Additionally, FINRA reminds firms to implement and maintain supervisory systems and Anti-Money Laundering systems, in order to detect fraud on the customer level. Through use of such systems, firms will be more likely to identify, detect and report suspicious activity. Please see Regulatory Notice 10-61 for more information.<sup>5</sup>

### **Private Placements and Private Self-Offerings**

Recent FINRA examinations and investigations have noted substantial failures regarding firms' compliance with the suitability, supervision, and advertising rules involved in the retail sales of private placement interests. Firms are reminded to perform reasonable investigation into Regulation D offerings. Firms that lack essential pieces of information about an issuer or its securities when it making a recommendation, including recommendations of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from the lack of information. Further, in a Regulation D offering, firms should, at a minimum, conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made; and
- the intended use of proceeds of the offering.<sup>6</sup>

### **Vulnerable Customers**

Retired, elderly or ill customers may be more inclined to invest in products with higher yields which typically involve a higher risk of loss. FINRA reminds firms that adequate precautionary measure, such as proper suitability analyses must be conducted to ensure vulnerable customers are not placed into inappropriately risky investments. Several recent enforcement actions resulting in fines of up to \$1.44 million have resulted from inadequate supervisory responsibility on the part of noted firms.<sup>7</sup>

### **Electronic and Social Media**

Concern regarding the use of electronic communication continues to grow, with methods of such communication including text messages, blogs, bulletin boards, social networks and Skype messaging. Firms are required to implement and maintain adequate systems to

---

<sup>5</sup> FINRA Regulatory Notice 10-61, *Independent Verification of Assets* (Dec. 2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122525.pdf>.

<sup>6</sup> See also FINRA Regulatory Notice 10-22, *Regulation D Offerings* (Apr. 2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf>.

<sup>7</sup> See Press Release, FINRA Orders SunTrust Investment Services to Pay \$1.44 Million for Unsuitable UIT, Close-End Fund and Mutual Fund Transactions: Sanction Includes \$540,000 in Restitution to Disadvantaged Customers; Broker Barred in Separate Action, Former Branch Manager Suspended (July 22, 2010), available at <http://www.finra.org/Newsroom/NewsReleases/2010/P121754>.

retain and supervise communication pertaining to business. For more information see FINRA's [Guide to the Internet for Registered Representatives](#).<sup>8</sup>

### ***Conclusion***

To review the complete version of FINRA's Annual Regulatory and Examinations Priorities Letter please click on the following link: [2011 Regulatory and Examination Priorities Letter](#).

For more information, or to learn about how CCLS may be of assistance with your firm's compliance needs, please do not hesitate to contact us at (619) 278-0020.

**Author: Nicole Miller, Compliance Analyst; Editor: Zachary Rosenberg, Compliance Consultant, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, [info@corecls.com](mailto:info@corecls.com) or visit [www.corecls.com](http://www.corecls.com).**

*This article is for information purposes and does not contain or convey legal or tax advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer and/or tax professional.*

---

<sup>8</sup> See also FINRA Regulatory Notice 07-59, *Supervision of Electronic Communications* (Dec. 2007); FINRA Regulatory Notice 10-06, *Social Media Web Sites* (Jan. 2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf>.