



Risk Management Update May 2010

FINRA 2010 EXAMINATION HIGHLIGHTS – PART II

Introduction

In last month's Risk Management Update, CCLS provided guidance regarding FINRA's examination priorities. This month we are continuing our discussion of the 2010 FINRA Examination Highlights, focusing on FINRA's guidance on compliance efforts for dealing with new financial products, mergers and acquisitions, life settlements, municipal securities, capital liquidity and other areas.

Selling New Financial Products

In its March 1, 2010 letter to member firm Executive Representatives, FINRA continues to emphasize the need for broker-dealers to develop compliance safeguards for new financial products. As an example, market trends show increased retail sales of principal-protected notes ("PPNs"), which combine a desirable relative safety of a bond, with a growth potential not typically found in fixed income debt instruments. Consequently, given this product's unique characteristics, firms ensure that clients receive appropriate disclosures at the point of sale as outlined by FINRA.¹ This includes explaining to clients that PPNs are not risk free, often contain complex terms and may have intricate fee structures. Advertising and marketing for the product must not overstate the level of protection offered with the investment or inflate the product's potential returns.

Prior to selling a new financial product (including PPNs), firms and their Registered Representatives should take into consideration the following guidelines provided by FINRA²:

1. Perform a reasonable-basis suitability analysis to determine whether the instrument meets the needs of firm clients or customers;
2. Perform a client specific suitability analysis taking into account the customer's specific needs; and
3. Provide adequate disclosures of the risks associated with the instruments.

In addition, Firms must evaluate their internal controls and assess existing surveillance capabilities in order to ensure adequate supervision of the new product.

¹ See *Regulatory Notices 09-73*, available at www.finra.org/notices/09-73.

² See 2010 Annual Examination Priorities Letter, FINRA Letter to Executive Representatives (March 1, 2010) at 3.

Merger and Acquisitions of Firms

Stemming from present economic conditions and events, the financial and securities industry has seen an increase of mergers and acquisitions amongst firms. FINRA's primary concern in regards to combining entities is the increase in opportunity for operational regulatory risk. Often the integration of operational systems can pose a myriad of compliance risks that should be anticipated and timely addressed.

To assist in this process, FINRA has imposed certain guidelines for new successor entities. This includes carefully designed written supervisory procedures and control systems, monitoring of personnel, updating of system entitlements, potential physical access restrictions and strong record retention protocols. Moreover, FINRA has articulated the need for a single business continuity plan, among other things. For more information, please visit www.finra.org/industry/issues/mergers.

Life Settlements

Another instrument which continues to grow in the marketplace is life settlements. Due to the increase in sales of existing life insurance policies to third parties, FINRA is issuing reminders to its members regarding firm obligations and responsibilities to customers. For example, it is important for the broker-dealer and its representatives to remember that life settlements have unique characteristics compared to other securities instruments. Moreover, variable life settlements, which are primarily marketed to persons of retirement age, have certain associated costs and risks that may not be fully appreciated by the end-customer.

As these instruments pose unique risks, FINRA urges firms to take note of the following:

1. All variable life settlements are considered securities, which are subject to federal securities laws and FINRA rules;
2. Any firm applying to sell life settlements must file an application for a material change in business under NASD Rule 2210;
3. Any and all advertising material must be presently in a balanced and fair manner; and
4. FINRA member firms must adhere to all suitability and reasonableness standards as addressed in NASD Rules 2110 and 2310.³

Municipal Securities

Municipal Securities continue to be a central focus in FINRA examinations in light of the financial crisis. Municipal securities, which typically represent bonds issued by states, cities and counties to fund capital projects, are regulated by the SEC, FINRA and the Municipal Securities Rulemaking Board ("MSRB"). MSRB requires continual

³ See *Regulatory Notice 09-42*, available at www.finra.org/notices/09-42.

disclosures of municipal issuers including annual financial information and any material event notifications.

Under the Securities Exchange Act of 1934, municipal securities brokers or dealers are required to have procedures in place to notify parties of material events and to disclose prior to or at the time of sale, all material facts about the transaction. Firms also must ensure that such disclosures include a complete description of the security, as well as any information obtained from industry sources. For more information, please visit www.emma.msrb.org.

Capital Liquidity

As financial challenges over the past two years have shown the importance of liquidity and management practices that measure liquidity risk, firm's are reminded to maintain sufficient collateral to meet both expected and unexpected borrowing needs. FINRA urges firms to:

1. Actively manage collateral positions using risk management strategies;
2. Promptly revalue collateral after market movements;
3. Understand the physical location of positions and how those positions could be timely mobilized if needed; and
4. Conduct "stress-tests" on the potential strains on collateral liquidity.

In addition to these procedures, diversification of lending in the event of adverse market movement is recommended.

Conclusion

As member firms will notice, much of FINRA's attention continues to focus those underlying areas which may have impacted the overall financial crisis. To address such concerns, firms must assign primary persons responsible for assessing FINRA's latest guidelines and releases to ensure that recommended internal safeguards are implemented and risk controls employed for dealing with these compliance issues.

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

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