PUBLICATION

Recent FINRA Guidance on Supervisory Control Systems

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In the Financial Industry Regulatory Authority's (FINRA) "2012 Examination Priorities Letter," released on January 31, 2012 (the "Release"), FINRA outlined several areas of heightened concern it would focus on during future broker-dealer examinations. The Release, which FINRA has issued annually since 2006, was originally created to inform FINRA Member firms about FINRA's current examination-related focus areas so that broker-dealers (and investment advisors, as best practices) would be able to prospectively address issues subject to potentially heightened regulatory scrutiny before becoming subject to deficiency findings as a result of regulatory examinations.

The list FINRA released in January 2012 included several items raised in prior years' examinations, such as focuses on supervisory controls, suitability, product due diligence and the importance of client communications. Of interest, however, is that more than half of the issues raised in FINRA's 2012 Release were not included on its 2011 list. A review of recent Securities and Exchange Commission and FINRA enforcement actions indicates, however, that issues such as the use of foreign finders, high-frequency trading, and promoting the sale of mortgage-backed securities continue to remain at the forefront of regulators' scrutiny.

The Release, in addition to setting forth FINRA's current examination priorities, also set forth FINRA's latest efforts to strengthen its examination and enforcement programs. Through a new risk control assessment survey, FINRA is hoping to capture relevant information regarding its Member firms so as to better understand those firms' customer bases, product offerings and overall business activities.

With regard to supervisory control functions, FINRA's Release identified several priorities that stem, in large part, from deficiencies noted in recent Member examinations. These priorities can be classified into four broad categories, including business conduct and trading issues; product specific issues; supervisory control functions; and financial and operational controls. This Client Alert focuses specifically on supervisory control functions, but future Client Alerts issued by Baker Donelson will more fully address the other issues FINRA identified in its Release.

With regard to broker-dealer supervisory controls, FINRA's Release focused on the following items in particular:

- *Private Securities Transactions and Outside Business Activities.* The Release emphasized the importance of supervising registered representatives' outside business activities as well as registered representatives' inappropriate engagement of clients in private securities transactions;
- *Branch Examinations.* The Release re-addressed the importance of guidance previously offered through FINRA Notice 11-54 regarding regulators' expectations concerning branch office inspections. The Release indicated that both FINRA and the SEC would be evaluating the effectiveness of each broker-dealer's branch inspection program, as well as each broker-dealer's surveillance systems;
- *Cyber Security.* The Release further acknowledged FINRA's continued concerns over the security of Members' information technology, as well as potential threats to Members' cyber security. In its Release, FINRA recommended that Member firms reevaluate their IT policies and procedures in an

effort to determine whether those procedures are sufficient to adequately protect the privacy of customer account information and trading activity and to prevent unauthorized transactions in customer accounts as a result of breached customer email accounts or through other electronic means;

- *Outsourcing.* Further to that end, the Release also noted that Member firms are liable to their customers at all times, and that a Member firm's use of a third-party electronic service provider to perform reporting or retention functions on the Member's behalf will not relieve the Member's obligations to otherwise comply with applicable federal and state securities rules and regulations;
- *Foreign Finders.* FINRA's Release also addressed the use of foreign finders at length, strongly suggesting that the use of foreign finders may place a Member firm at greater risk for violating United States securities laws, as well as increasing the likelihood that Member firms may run afoul of compliance best practices (in particular, Member firms' anti-money laundering policies and procedures were noted). The Release reiterated the necessity for Member firms to evaluate the need for their foreign finders to register as associated persons in any situation where they (a) service non-U.S. customer accounts; (b) have trading authority over customer accounts; (c) enter customer orders directly to the clearing firm's online platform, or (d) process new account documents and funds transfers. The Release suggested that Member firms – prior to engaging in relationships with foreign finders – design policies and procedures reasonably designed to identify both the scope of permissible finders' activities, as well as the related potential anti-money laundering risks, and to carefully monitor all foreign finder-based activities; and
- *Rogue Trading.* Finally, and not surprisingly, the Release recommended that Member firms establish and enforce internal controls designed to prevent and detect unauthorized trading by registered representatives.

FINRA's new guidance on supervisory controls is both nuanced and complex. If you or your firm have any questions regarding the Release or its implications, or any other securities-related questions, please contact one of the attorneys in our Broker-Dealer/Registered Investment Adviser group.