

FINRA Facts and Trends: January 2023

Newsletter

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Welcome to the latest issue of Bracewell's FINRA Facts and Trends, a monthly newsletter devoted to condensing and digesting recent FINRA developments in the areas of enforcement, regulation and dispute resolution. This month, we examine the 2023 Report on FINRA's Examination and Risk Monitoring Program.

On January 10, 2023, FINRA published its [2023 Report on FINRA's Examination and Risk Monitoring Program](#) (the "Report"). As in past years, the Report is intended to offer insights and observations on key regulatory topics and emerging risks that firms should consider when evaluating their compliance programs and procedures. Broadly speaking, the Report identifies relevant rules, summarizes noteworthy findings, highlights key considerations for member firms' compliance programs, and provides helpful and practical considerations as member firms analyze their existing procedures and controls.

The 2023 Report discusses 24 topics relevant to the securities industry. While many of these are "perennially important topics," the Report also includes a new section on financial crimes and four newly identified priorities: manipulative trading, fixed income, fractional shares, and Regulation SHO. Below, we provide an overview of the Report's four new priorities, together with certain continuing priorities highlighted in the Report. A recent episode of the FINRA Unscripted podcast, titled "[2023's Must-Read, Report on FINRA's Examination and Risk Monitoring Program](#)," also provides key insights and observations from FINRA leadership on several of the principal findings in the Report.

Newly Identified Priorities

- **Manipulative Trading:** The Report's new "Financial Crimes" section includes one new topic (Manipulative Trading) and two topics (Cybersecurity

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and Technology Governance) that were included in prior reports. FINRA determined that this new section was necessary to properly focus member firms on the need to protect investors against these threats. As it relates to the new manipulative trading topic, the Report reminds member firms of their obligations to implement written supervisory procedures that identify firm personnel tasked with monitoring manipulative conduct; to implement surveillance controls that can capture manipulative trading; and to monitor customer activity to detect patterns of manipulative trading schemes.

- **Fixed Income and Fair Pricing:** The Report reminds member firms that fair pricing obligations under FINRA Rule 2121 apply to transactions in all securities, including fixed income securities. These rules generally require a dealer that is acting in a principal capacity to mark-up or mark-down from the prevailing market price. The Report found that, during its review period, member firms had violated this Rule by incorrectly determining the prevailing price, using outdated mark-up/mark-down grids, failing to consider the impact of mark-up on yield to maturity, and failing to implement reasonable supervision in setting fair pricing in fixed income securities. FINRA recommends that member firms document the prevailing market price for each transaction—even if it does not require a mark-up disclosure—and use exception reports or outside vendor software to ensure compliance with FINRA Rule 2121.
- **Fractional Shares-Reporting and Order Handling:** The Report reminds member firms that although FINRA's trade reporting facilities and over-the-counter trade reporting facilities do not currently support the entry of fractional share quantities, FINRA guidance requires that, if the trade is less than one share, it should be rounded up to one, and if more than one share, it should be reported with the fractional quantity removed (i.e., for a trade of 100.5 shares, the reported quantity would be 100). Firms are required to report order, route and trade events in NMS stocks and OTC equity securities to the CAT Central Repository, including fractional shares.
- **Regulation SHO:** Bona Fide Market Making Exemptions and Reuse of Locates for Intraday Buy- to-Cover Trades: Rules 203(b) (Short Sales) and 204 (Close-Out Requirement) of Regulation SHO provide exceptions for bona fide market-making activity. The Report highlights FINRA's concern that firms have relied on Regulation SHO's bona fide market-making exceptions with respect to trading activity that is not eligible for these exceptions. The Report offers examples of how firms should establish supervisory systems and policies and procedures to properly comply with these rules.

Continuing Priorities

In addition to the Report's new topics, the Report places special emphasis on certain continuing priorities that will remain key focus areas for FINRA in 2023:

- **Anti-Money Laundering (“AML”):** FINRA Rule 3310 requires that each member firm develop and implement a written AML program that is approved in writing by senior management and is reasonably designed to achieve and monitor the firm’s compliance with the Bank Secrecy Act and its implementing regulations. One of the concerns raised in the Report is new account fraud—where accounts are opened using synthetic or stolen identities, and are then used for a range of suspicious activities, including fraudulent transfers to ACATS. Effective practices here include reviewing alerts, advisories, significant cases and other updates from the SEC, FinCEN, FINRA, and other regulators; verifying customers’ identities when establishing online accounts; and sending notifications to account owners when an ACATS transfer is initiated.
- **Regulation Best Interest (“Reg BI”) and Form CRS:** As we’ve reported previously, Reg BI became effective on June 30, 2020. Reg BI and Form CRS remain areas of focus for FINRA. The Report details a number of observations and effective practices. The observations generally concern firms issuing recommendations that comply with Reg BI’s Care Obligation, identifying and addressing conflicts of interest, and monitoring associated persons’ compliance with Reg BI (including by conducting monthly reviews and monitoring communication channels). Going forward, Reg BI examinations will focus on the intersection of Reg BI and complex products, whether a brokerage or fee-based product or other account types are in the client’s best interest, and how firms determine what is a recommendation and the accuracy of that determination.
- **Cybersecurity and Technology Governance:** Cybersecurity remains one of the principal operational risks facing broker-dealers and customers. In August 2022, FINRA established the Cyber and Analytics Unit (CAU) to examine member firms’ cybersecurity risk management through reviews of their controls. The Report highlights instances where firms did not have reasonably designed procedures to investigate cyber events and whether a suspicious activity report (“SAR”) filing should be made. The Report also provides an update on effective cybersecurity practices, including specific risks associated with ransomware.
- **Complex Products and Options:** The Report confirms that FINRA will continue to review member firms’ communications and disclosures made to customers in relation to complex products. FINRA will also review customer account activity to determine whether recommendations regarding complex products are in the best interest of the customer in light of the customer’s investment profile and the risks and rewards associated with the recommendation. FINRA reiterated that firms should review Regulatory Notice 22-08 to focus their compliance obligations for complex products and options. From FINRA’s perspective, it remains critical that firms ensure that their brokers have some training on the products that are being offered and understand the core components. As Bill St. Louis, FINRA’s Executive Vice

President of the National Cause and Financial Crimes Detection Programs noted on the FINRA Unscripted podcast, the first thing FINRA does when it sees an issue with complex products is ask the broker, “Tell me how this product works.

- Cryptocurrency: In addition to noting FINRA’s overall role in reviewing member firms’ communications and disclosures related to complex products, the Report highlighted FINRA’s targeted examination of firms’ crypto asset retail communications (as noted in a previous issue). FINRA promised to share its findings from this exam at a future date
- **Order Handling, Best Execution and Conflicts of Interest:** FINRA continues to evaluate member firms’ compliance with their best execution obligations under Rule 5310, including whether firms are fully and promptly executing marketable customer orders, adequately conducting periodic “regular and rigorous reviews,” and clearly and completely disclosing the specific terms of any profit-sharing relationships—such as payment for order flow (PFOF)—with venues to which they route orders. The Report also includes findings and observations from targeted regulatory reviews FINRA conducted in 2020. Those targeted exams evaluated the impact of not charging commissions on member firms’ order routing practices and decisions, as well as other aspects of member firms’ businesses.
- **Mobile Apps:** As detailed in the Report—and as we’ve discussed in a previous issue—FINRA remains concerned that mobile apps are encouraging retail investors to engage in trading activities and strategies that may be inconsistent with their investment goals or risk tolerance, and how the apps’ interface designs and functionality could influence investor behavior. FINRA observed that these apps were not properly distinguishing between the products and services of the broker-dealer and those of affiliates or other third parties (such as transactions involving crypto assets). FINRA will continue to monitor how mobile apps disclose and explain risks of higher-risk products or services. The Report also highlights the approximate \$2 billion in fines the SEC obtained from many of the largest brokerage firms arising out of employees communicating internally and externally away from compliant firm channels.

The Report’s findings and observations are intended to serve as a guide for member firms to assess their current compliance, supervisory, and risk management programs and note any perceived deficiencies that could result in scrutiny by FINRA. Member firms are encouraged to focus on the findings, observations, and effective practices relevant to their respective business models.