Agenda

CEFLI Compliance & Ethics Committee Meeting
Wednesday, October 30, 2019
2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Dial In: (800) 239-9838
Passcode: 3646069

I. Welcome and Introduction. **Donald J. Walters**

A. Antitrust Statement.

II. Approval of Minutes – September 25, 2019 Meeting. **The Committee**

III. Issues for Review. **The Committee**

A. Online Account Access Authentication Procedures.

Life insurance companies often establish customer portals that allow consumers of a life insurance company's products to gain access to their account information online.

As consumers register to establish online account access, questions arise concerning techniques used by life insurance companies to verify or authenticate the identity of the individual that may be seeking to establish an online account.

Given that there are potential AML/fraud issues associated with establishing online access, a question has been presented concerning the types of identifying "data points" that companies are using to verify the authenticity of a customer seeking to establish online access. For example, do companies permit the use of a Social Security number as one of the "data points" companies may use to verify the authenticity of the customer seeking to establish online access?

The Committee will be asked to discuss their practices with regard to verifying the authenticity of a customer seeking to establish online access to their accounts at a life insurance company; specifically, what "data points" do companies require for this purpose?

B. Use of CFP Designation by Advisers Who Sell Insurance Products.

During our July 31 Committee call, the Committee discussed strategies companies may be pursuing with respect to the use of the Certified Financial Planner ("CFP") Designation by advisers who may sell insurance products.

In one strategy, a company asked its advisors to drop their CFP designations if they were going to sell the company's products. Our further discussion of this issue indicated that several companies were reviewing their current strategies in light of recent changes by the Certified Financial Planner Board of Standards to expand their fiduciary standard applicable to CFP's.

In light of the evolving nature of this issue, we have been asked to revisit this question to determine the current status of compliance strategies associated with advisors who may hold the CFP designation and acting in a fiduciary capacity with respect to selling a life insurance company's products.

The Committee will be asked to discuss company practices with respect to allowing/prohibiting insurance producers from using the CFP designation in the sale of a life insurance company's products.

C. Funding of Single Premium Immediate Annuities.

Consumers who may be seeking lifetime income may elect to purchase a single premium immediate annuity ("SPIA") to meet this income goal. Typically, SPIA's are purchased with a single premium that is used to fund the SPIA's income stream.

In some instances, a consumer may choose to liquidate all or a portion of a securities account to fund a SPIA purchase.

However, in these instances, the securities account may have multiple securities which may liquidate in different time frames and, therefore, the life insurance company may receive additional proceeds from these liquidations after the SPIA has been issued.

Therefore, under this scenario, questions may arise with respect to:

- Whether the life insurance company may issue a new SPIA;
- Whether the additional proceeds may be returned to the transfer company from which they have been issued; or
- Whether the additional proceeds may be returned to the customer.

The Committee will be asked to discuss their company's operational practices with respect to funding a SPIA purchase through liquidation of a securities account that may have delayed liquidations associated with multiple securities within the broker-dealer account.

D. "Up Line" Licensing of Individuals Who May Be Receiving Compensation.

Life insurance companies rely upon a range of individuals to promote sales of the company's products. In addition to producers who work with consumers at the point of sale, there may be other "up line" contributors to the sales process (e.g., marketing and sales managers and other company executives) that may receive compensation related to a transaction or series of transactions.

It has been reported that some States insurance departments have focused their attention on these issues to determine whether "up line" individuals who may receive compensation related to sales transactions are licensed appropriately according to applicable laws and regulations.

The Committee will be asked to discuss their company's strategy with respect to analyzing the question of whether "up line" individuals who may be receiving compensation on sales transactions are licensed appropriately according to applicable laws and regulations.

E. Role of Compliance in Cybersecurity Matters.

As all organizations becoming increasingly concerned about potential cybersecurity risks, compliance and ethics professionals have been asked to participate in a variety of cybersecurity-related matters at life insurance companies.

Company strategies differ with respect to the role that compliance and ethics professionals play in various cybersecurity initiatives. For example, some companies may have their Chief Compliance Officer serve on a cybersecurity breach committee whereas other companies may have their Chief Compliance Officer only serve on a committee to develop the company's cybersecurity policies.

Interest has been expressed in determining the strategies companies may use to ensure that compliance has an appropriate "voice" in company cybersecurity matters.

Key questions include:

- *What role does compliance play in your company's cybersecurity breach strategy? and*
- *What role does compliance play in the development of your company's cybersecurity policies?*

The Committee will be asked to discuss their company's strategies with respect to the role that compliance plays in life insurance company cybersecurity matters.

F. Sales to Foreign Nationals.

Life insurance companies most commonly rely upon producers to sell their company's products. In soliciting potential prospects to purchase a company's products, producers may encounter foreign nationals (e.g., an individual who resides in the United States but may be a citizen of another country) who expresses interest in purchasing a company's life insurance and annuity products.

Sales to foreign nationals present unique compliance challenges. Therefore, company strategies differ with respect to their analysis of sales to foreign nationals.

In some cases, companies may prohibit sales to foreign nationals for business or other reasons. In other cases, sales to foreign nationals undergo a rigorous due diligence and operational analysis to determine whether the sale may be conducted in compliance with applicable laws and regulations.

The Committee will be asked to discuss their company's compliance strategies with respect to sales of their company's life insurance and annuity products to foreign nationals.

G. NYDFS Regulation 187.

As we move toward the February 1, 2020 effective date for compliance with the life insurance requirements of NYDFS Regulation 187, we will continue to include Regulation 187 issues on the Committee's agenda.

1. Annuities.

Compliance with the annuity requirements of Regulation 187 became effective on August 1, 2019. Companies and their producers have had an opportunity to implement appropriate compliance strategies to address the requirements of Regulation 187 for annuity transactions.

Now that companies' compliance strategies related to the annuity requirements of Regulation 187 have become operational, several questions arise:

- *What type of feedback are you receiving from producers regarding how Regulation 187 may be impacting their annuity sales practices?*
- *What key compliance issues have arisen (e.g., characterization of in-force transactions, etc.) related to the annuity requirements of Regulation 187?*
- *What type of training (i.e., company training or external provider training) has been provided to producers to enhance their understanding of the annuity requirements of Regulation 187?*

The Committee will be asked to discuss their company's experience with respect to implementing the annuity requirements of Regulation 187.

2. Life.

Compliance with the life insurance requirements of Regulation 187 becomes effective on February 1, 2020. Companies have been exploring a variety of strategies to address these requirements.

Key questions that have been presented previously include:

- *Will your company develop a separate suitability form for purposes of life insurance products?*
- *Who will conduct the suitability analysis for purposes of life insurance products at your company?*

The Committee will be asked to discuss the key issues they are exploring with respect to their company's development of appropriate compliance strategies to address the life insurance requirements of Regulation 187.

IV. Reporting Items. CEFLI Staff.

A. NAIC Annuity Suitability Working Group.

The NAIC Annuity Suitability Working Group continues to pursue an aggressive agenda with respect to attempting to develop a final draft of proposed revisions to the NAIC Suitability in Annuity Transactions Model Regulation by the NAIC Fall National Meeting in early December in Austin, Texas.

The Working Group has been holding conference calls over the past several weeks in an effort to achieve this goal.

CEFLI Staff will provide a brief report concerning the Working Group's efforts.

B. Highlights of the October 10 CEFLI Advisory Committee Meeting.

CEFLI held a meeting of its Advisory Committee on Thursday, October 10. The meeting included participation from representatives of the NAIC, the SEC, FINRA, AARP and NAIFA.

CEFLI staff will provide a brief summary of the highlights of the Advisory Committee discussions.

C. NYDFS Investigation of 403(b) Annuity Sales.

Recent media reports indicate that the New York Department of Financial Services is opening an investigation concerning selected insurers' practices associated with sales of 403(b) annuities to teachers.

The investigation is designed to determine "whether life insurers and their agents are taking advantage of teachers to sell them potentially high-cost and inappropriate investments in so-called 403(b) retirement-savings programs."

D. FINRA Publishes Regulation Best Interest and Form CRS Checklist.

FINRA recently published a Regulation Best Interest and Form CRS Checklist designed to assist firms in understanding their obligations under the SEC's Regulation Best Interest and Form CRS Relationship Summary. (See copy attached.)

The Checklist may help to inform life insurance industry compliance and ethics professionals of the obligations arising under Regulation Best Interest and Form CRS.

E. FINRA 2019 Report on Examination Findings and Observations.

FINRA has issued its 2019 Report on Examination Findings and Observations. (See copy attached.)

Areas identified in the Report include:

- Supervision;
- Suitability;
- Digital Communications;
- Anti-Money-Laundering; and
- Cybersecurity.

V. CEFLI Activities.

A. 2019 CEFLI Summit Meeting - The Future of Sales Standards in the Life Insurance Industry - November 20-21, 2019 - Washington, DC.

CEFLI will be conducting its 2019 CEFLI Summit Meeting to explore *The Future of Sales Standards in the Life Insurance Industry* at the Fairmont Hotel in Washington, DC on November 20-21. We have attached a copy of the Preliminary Program and a recent Announcement of the Summit Meeting for your review.

CEFLI has secured a discounted room rate at the Fairmont Hotel of $279. The discounted room rate is scheduled to expire TODAY, October 30. Act now to take advantage of this discounted rate.

All CEFLI member company representatives may attend the Summit Meeting without any registration fee as part of your company's CEFLI membership benefits.

We hope you will be able to join us!

B. Webinar - Records Management - Deloitte.

CEFLI will be conducting the next webinar in its Educational Webinar Series on Tuesday, November 5 at 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT to explore the topic of *Records Management* in a joint CEFLI webinar presentation offered with CEFLI Affiliate Member firm Deloitte.

We hope you will be able to join us!

VI. Next Meeting.

The next meeting of the Committee is scheduled to take place:

November 13, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

The Committee will hold its remaining 2019 meetings as follows:

December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

Please mark your calendar and plan to join us!

VII. Other Business.

The Committee will be asked to identify and discuss any other business to be brought before the Committee.

DRAFT

Minutes
Meeting of the
CEFLI Compliance & Ethics Committee
September 25, 2019
2 PM EDT/1 PM CDT/11 AM PDT

A meeting of the CEFLI Compliance & Ethics Committee (the "Committee") was held via conference call on Wednesday, September 25, 2019 at 2 PM EDT/1 PM CDT/11 AM PDT.

The following CEFLI member company representatives participated in the meeting:

Ro Adebiyi, Thrivent
Marcie Allen, Texas Life
Jenna Austin, Guggenheim Life
Shannon Aussieker, Country Companies
Brendan Bakala, Catholic Order of Foresters
Lauren Barbaruolo. Oxford Life
John Baumgardner, II, Standard Insurance Company
Tom Birr, Thrivent
Alayna Cook, MassMutual
Steve Corbly, Cincinnati Life
Marvin Cox, Global Atlantic Financial Group
Jacquie Crader, CUNA Mutual
Nicholas Criscitelli, Voya Financial
Becky Criswell, Americo
Michele Kulish Danielson, American Enterprise
Tony Dowling, Jackson National
Jessica English, Thrivent
Bruce Eschbach, Texas Life
Jill Fiddler, Assurity Life
Paula Gentry, Cincinnati Life
Jennifer Gibb, Pacific Life
Jim Golembiewski, Sagicor Life
Andrea Golis, Thrivent
Rachel Gomez, State Farm Life
Dennis Herchel, SBLI MA

Belinda Howard, Principal Life
De Keimach, Delaware Life
Chris Kirby, Catholic Order of Foresters
Jennifer Knabe, Ohio National
Hannah Krone, Western &Southern
Mark Lasswell, RiverSource
Dan Leblanc, SBLI MA
Laurie Lewis, Amica Life
Genevieve Messina, Global Atlantic Financial Group
Morgan Milner, Modern Woodmen
Jim Odland, Thrivent
Monique Pascual, Pacific Guardian Life
Liza Perry, USAA Life
Megan Phillips, Principal Life
Tony Poole, AAA Life
Michelle Ross, Lombard International
Sally Roudebush, Lincoln Heritage
Scott Schabel, Jackson National
Zachary Simons, Global Atlantic Financial Group
Alison Soderberg, Lombard International
Joe Spada, Lincoln Financial
Carla Strauch, Thrivent
Kevin Sullivan, Protective Life
Jill Terry, Cincinnati Life
Bill Turner, American Fidelity Assurance
Chris Vellante, Delaware Life
Michelle Ward, Erie Life
Jaime Waters, Equitrust Life
Jennifer Wheeler, American Fidelity Assurance
John Vitou, Jackson National
Kim Yerigan, Cincinnati Life

Mallory Bennett, Nancy Perez and Donald Walters of CEFLI also participated in the meeting.

I. Welcome and Introduction.

The meeting began with a recitation of CEFLI's anti-trust statement.

II. Approval of Minutes – August 21, 2019 Meetings.

On motion, duly made and seconded and unanimously carried, the Committee: RESOLVED, that, the Minutes of the August 21, 2019 meeting are hereby approved.

III. Issues for Review.

A. Role of Compliance in Innovation Ventures.

The Committee was asked to discuss the extent to which compliance has been asked to be involved in the analysis of innovation opportunities at life insurance companies. If so, when does compliance become involved? The Committee was also asked to discuss whether the role of compliance may change in the event the life insurance company does not have a controlling interest in the innovation startup. Also, the Committee was asked to discuss any regulatory expectations with respect to the role of compliance in the evaluation of innovation opportunities.

A Committee member reported that Compliance is involved early in the process and sets guardrails to address well known challenges. Thereafter, Compliance is pulled in as necessary to address issues that arise.

Another Committee member indicated that Compliance gets involved when the innovation in question provides additional benefits (e.g., rebates) to consumers, or when there is a change in the way products are marketed (e.g., by text message). In such instances, Compliance will be engaged early in the process. Compliance may also be involved in reviewing InsureTech investment opportunities and may ask the outside party to provide a compliance report for senior management.

B. Senior Financial Exploitation Issues.

The Committee was asked to discuss how their companies address issues associated with suspected instances of financial exploitation of seniors. Specifically, the Committee was asked to discuss whether their company has established a separate team or department to address these issues. Also, the Committee was asked to discuss their experiences, as applicable, in working with a “trusted contact” identified through the new account opening or updating process. Lastly, the Committee was asked to discuss whether any state insurance regulators have raised questions during market regulation activities concerning how companies address suspected instances of financial exploitation of seniors.

A Committee member reported three years ago they established a small standalone team dedicated to issues related to senior financial exploitation. The

team has grown exponentially and works on educating and reaching senior consumers and will coordinate with social workers when it is determined in-home contact is necessary.

Another Committee member indicated they have a team within Compliance that deals with elder abuse and impaired elder issues and concerns.

Other Committee members reported that awareness of senior related issues is increasing within their organizations, but they have not yet decided to create a dedicated team or department.

C. Possible Interest in Establishing a "Fraud Alert" Group.

A suggestion has been offered to consider whether there may be interest in establishing an email distribution list that could serve as a "Fraud Alert" group for CEFLI member companies.

It has been suggested that this group could be comprised of representatives of each company's SIU or Antifraud Department and could meet on an ad hoc or timely basis to alert companies to new fraudulent techniques perpetrated against life insurance companies.

The Committee was asked to discuss whether there may be interest in establishing a "Fraud Alert" group among CEFLI member companies.
CEFLI is considering the possibility of establishing a Fraud Alert group which could meet on an ad hoc basis to the extent that issues arise in the marketplace of interest to companies.

A Committee member expressed interest in participating in a Fraud Alert group and suggested an email chain that would be used to provide informal, early warnings of potential fraud detected by members of the group.

Another Committee member suggested that such a Fraud Alert group would be helpful as a sounding board for life insurers to share case specific facts to determine if others would consider a given case to be fraud.

Several other Committee members voiced their support for CEFLI establishing a fraud alert group.

Committee members were encouraged to email Kelly Ireland (kelyireland@cefli.org) the names and email addresses of those they would like added to a CEFLI Fraud Alert group.

D. Regulation Best Interest.

The Committee was asked to discuss whether their company has determined that Regulation Best Interest will not apply to their variable product distribution practices because they provide education only to a customer and do not offer recommendations.

No comments were offered by Committee members at this time.

E. NYDFS Regulation 500 - Cybersecurity Examinations.

It has come to our attention that the New York Department of Financial Services ("NYDFS") has been undertaking a review of company's cybersecurity controls designed to comply with the requirements of NYDFS Regulation 500 as part of their examination process.

The Committee was asked to discuss whether their companies have been subject to a review of their cybersecurity controls related to NYDFS Regulation 500 as part of an examination conducted by the NYDFS.

No Committee member indicated being subjected to NYDFS Reg 500 cybersecurity examination activity to date.

F. Role of Compliance in Evaluating "New" Sales Strategies.

The Committee was asked to discuss the role that the compliance and ethics staff at their company plays in evaluating "new" sales techniques designed to encourage purchases of whole life or other types of life insurance products.

A Committee member indicated that Compliance has been asked to weigh in on the quoting tools made available for products. Specifically, the data points/information considered in developing a quote based on aggregated standards. While the engagement of Compliance used to come later, it has been deemed to be helpful to engage them at earlier stages in the sales process.

Another Committee member reported that Compliance is routinely involved in reviewing new advertising materials for whole life products. Additionally, there has been an increase in Compliance being asked to investigate cases where policies may have been marketed as an "infinite bank" where money is withdrawn soon after the purchase of a whole life product to "repay" the initial premium.

IV. Reporting Items.

A. NAIC Annuity Suitability Working Group.

CEFLI staff reported the NAIC Annuity Suitability Working Group continues to pursue an aggressive agenda with respect to attempting to develop a final draft of proposed revisions to the NAIC Suitability in Annuity Transactions Model Regulation by the NAIC Fall National Meeting in early December in Austin, Texas.

A new draft has been exposed for comment by September 30th. Subsequent to the close of the comment period, the Working Group will hold a series of calls (October 8, 15, 29 and November 5) to discuss comments received.

CEFLI will continue to monitor and report on any developments at the Working Group.

B. Comment Deadline: October 8 - FINRA Regulatory Notice 19-27.

CEFLI staff reported FINRA periodically conducts a retrospective review of its Rules to assess their effectiveness and efficiency as a means to consider possible updates or modifications to existing FINRA Rules.

FINRA recently issued Regulatory Notice 19-27 which is seeking comment on FINRA's retrospective review of its rules pertaining to helping protect seniors from possible financial exploitation. (See copy of FINRA Regulatory Notice 19-27.)

The deadline to submit comments pertaining to Regulatory Notice 19-27 is October 8.

C. Regulation Best Interest Lawsuit.

CEFLI staff reported seven states and the District of Columbia have filed suit against the SEC challenging the legality of the issuance of Regulation Best Interest.

The lawsuit seeks to vacate Regulation Best Interest for three reasons:

- The SEC exceeded statutory authority to issue Regulation Best Interest;
- Regulation Best Interest does not apply the same standard as required for investment advisers as required under the Dodd Frank Act; and
- The rulemaking was arbitrary and capricious.

Also, member companies should be aware of the Regulation Best Interest blog that has been developed by CEFLI Affiliate Member law firm Drinker Biddle

which will provide updated information concerning developments pertaining to Regulation Best Interest over the months ahead.

The Drinker Biddle Regulation Best Interest blog can be found through the following link:

http://www.brokerdealerlawblog.com/

D. New DOL Fiduciary Rule Expected in Two Months.

CEFLI staff reported several recent media reports indicate that the DOL will be issuing a revised Fiduciary Rule within the next two months.

It is anticipated that the new DOL Fiduciary Rule will be aligned with the SEC's Regulation Best Interest.

There will be a public comment period before the rule becomes final.

V. CEFLI Activities.

A. 2019 CEFLI Summit Meeting - The Future of Sales Standards in the Life Insurance Industry - November 20-21, 2019 - Washington, DC.

Registration is now open for the 2019 CEFLI Summit Meeting to explore The Future of Sales Standards in the Life Insurance Industry at the Fairmont Hotel in Washington, DC on November 20-21.

All CEFLI member company representatives may attend the Summit Meeting without any registration fee as part of your company's CEFLI membership benefits.

A networking reception will take place the evening of November 20th and the business portion of the meeting will take place on November 21st.

B. Antifraud Issue Forum - Wednesday, October 9 - 2 PM EDT.

The next meeting of CEFLI's Antifraud Issue Form is scheduled to take place on Wednesday, October 9 at 2 PM EDT.

Members of the Issue Forum are asked to submit any discussion items for the Issue Forum agenda to Kelly Ireland by close of business on Friday, October 4.

Also, anyone who would like to be added to the distribution list for the Antifraud Issue Forum should contact Kelly Ireland to express their interest.

C. 2019 CEFLI Annual Conference and Compliance Leadership Forum.

CEFLI conducted its 2019 Annual Conference and Compliance Leadership Forum in Nashville, Tennessee on September 11-13.

The 2019 CEFLI Annual Conference, which was well attended and highly acclaimed, served to highlight the impacts data analytics and technological innovation are having on the life insurance industry.

The 2020 CEFLI Annual Conference and Compliance Leadership Forum. will be held at the Hotel del Coronado, San Diego, September 23-25. More information will be made available closer to the Conference date.

VI. Next Meeting.

The Committee will hold its next meeting on October 16, 2019 - 2 PM EDT/1 PM CDT/12 Noon MST/11 AM PDT.

The Committee will hold further 2019 meetings as follows:

November 13, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST
December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

VII. Other Business.

There being no additional business the meeting was adjourned.

Reg BI and Form CRS Firm Checklist

Compliance Date is June 30, 2020

FINRA is providing this checklist to help members assess their obligations under the SEC's Regulation Best Interest (Reg BI) and Form CRS Relationship Summary (Form CRS). This checklist explains key differences between FINRA rules and Reg BI and Form CRS. The checklist is not a substitute for any rule. Only the rule can provide definitive information regarding its requirements. Interpretive questions should be directed to the SEC, at *IABDQuestions@sec.gov*. You should carefully review the SEC's new rules and interpretations, related *Federal Register* notices and the SEC's Small Entity Compliance Guides, which provide important information on the new obligations.[1]

REG BI

1 Do you have procedures and training in place to assess recommendations using a **best interest** standard?

Status
Completed ✔

Securities recommendations must be in the retail customer's best interest. The firm and the associated person (AP) may not place their interests ahead of the retail customer's. This is a change from FINRA's suitability standard, which does not have an explicit best interest requirement. The best interest standard is an overarching obligation, which is satisfied only if you comply with four component obligations: Care, Disclosure, Conflict of Interest and Compliance.

2 Do you apply a best interest standard to recommendations of **types of accounts**?

Status
Completed ✔

Unlike FINRA's suitability rule, the best interest standard explicitly applies to recommendations of types of accounts. A broker-dealer (BD) or AP must have a reasonable basis to believe that a recommendation of a securities account type (*e.g.,* brokerage or advisory, or among the types of accounts offered by the firm, including IRAs) is in the retail customer's best interest at the time of the recommendation and does not place the financial or other interest of the BD or AP ahead of the interest of the retail customer.

In general, when considering recommendations of types of accounts, you should consider: (a) services and products provided in the account; (b) projected cost of the account; (c) alternative account types available; (d) services the retail customer requests; and (e) the retail customer's investment profile.

With regard to IRAs, in addition to the factors above, you should consider: (a) fees and expenses; (b) level of services available; (c) ability to take penalty-free withdrawals; (d) application of required minimum distributions; (e) protections from creditors and legal judgments; (f) holdings of employer stock; and (g) any special features of the existing account.

1 The SEC's *Federal Register* notices for *Reg BI, Form CRS, Interpretation of Solely Incidental and Interpretation of Investment Advisers' Obligations* are available at *https://www.sec.gov/rules/final.shtml*. The SEC's *Regulation Best Interest, A Small Entity Compliance Guide* is available at *https://www.sec.gov/info/smallbus/secg/regulation-best-interest*, and *Form CRS Relationship Summary; Amendments to Form ADV, A Small Entity Compliance Guide* is available at *https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary*.

3

If you agree to provide **account monitoring**, do you apply the best interest standard to both explicit and **implicit hold recommendations**?

Status
Completed
✔

Reg BI imposes no duty to monitor a customer's account following a recommendation. However, if you agree to perform account monitoring services, you are taking on an obligation to review and make recommendations regarding the account (*e.g.*, to buy, sell or hold) on the specified, periodic basis that you have agreed to with the retail customer. In such circumstances, Reg BI would apply even where you remain silent (*i.e.*, an implicit hold recommendation).

For example, if you agree to monitor a retail customer's account on a quarterly basis, the quarterly review and resulting recommendation will be subject to Reg BI, including an implicit recommendation to hold if you are silent as to the securities in the account. In addition, if you agree to monitor the customer's account, you are required to disclose the terms of such account monitoring services (including the scope and frequency of such services) pursuant to the Disclosure Obligation. IA registration requirements also might apply if a BD agrees to conduct ongoing monitoring in a manner not reasonably related to providing buy, sell or hold recommendations.

Importantly, you may voluntarily, and without any agreement with your customer, review the holdings in your retail customer's account for the purposes of determining whether to provide a recommendation to the customer. This voluntary review is not considered to be "account monitoring," and would not create an implied agreement with the customer to monitor the account.

4

Do you consider the elements of **care, skill** and **costs** when making recommendations to retail customers?

Status
Completed
✔

Reg BI incorporates FINRA's reasonable-basis (*i.e.* knowing the product and having a reasonable basis to believe it is appropriate for at least some investors) and customer-specific (*i.e.* knowing the customer and having a reasonable basis to believe a particular recommendation is appropriate for a specific customer based on that customer's investment profile) suitability obligations with important enhancements.

Care, skill and costs (in addition to applying a best interest standard) are new express elements for consideration when making recommendations to retail customers.

Cost must *always* be considered when making a recommendation. Moreover, consideration of cost includes not only the cost of purchase, but also any costs that may apply to the future sale or exchange of the security, such as deferred sales charges or liquidation costs. However, while cost must always be considered, it is not dispositive, and its inclusion in the rule text is not intended to limit or foreclose a recommendation of a more costly product if there is a reasonable basis to believe that product is in the best interest of a particular retail customer.

5

Do you guard against **excessive trading**, irrespective of whether the BD or AP "**controls**" the account?

Status
Completed
✔

Reg BI incorporates FINRA's quantitative suitability obligation (that a series of recommended transactions are appropriate and not excessive). However, in a change from FINRA's quantitative suitability obligation, Reg BI applies the best interest standard to a series of recommended transactions, irrespective of whether the BD exercises actual or de facto control over a customer's account.

6 Do you consider **reasonably available alternatives** to the recommendation?

Status Completed ✔

You should consider reasonably available alternatives, if any, offered by your BD in determining whether you have a reasonable basis for making the recommendation. An evaluation of reasonably available alternatives does not require an evaluation of every possible alternative (including those offered outside the firm) nor require BDs to recommend one "best" product.

A BD should have a reasonable process for establishing and understanding the scope of such "reasonably available alternatives" that would be considered by particular APs or groups of APs (*e.g.*, groups that specialize in particular product lines) in fulfilling the reasonable diligence, care and skill requirements under the Care Obligation.

7 Do you consider how to ensure that **high-risk** or **complex products** are in a retail customer's best interest?

Status Completed ✔

Although not a rule requirement, BDs should consider, as a best practice, applying heightened scrutiny as to whether high-risk or complex investments, such as inverse and leveraged ETFs, are in a retail customer's best interest.

8 Prior to or at the time of the recommendation, do you provide retail customers with full and fair written disclosure of all material facts relating to the scope and terms of the relationship with the retail customer, including:

Status Completed ✔

○ The capacity in which you are acting (BD or IA)?

A standalone BD generally may satisfy this requirement by delivering the Form CRS to the retail customer.

For BDs who are dually registered, and APs who are either dually registered or who are not dually registered but only offer BD services through a firm that is dually registered, providing Form CRS will not be sufficient to disclose their capacity, and they must disclose if they are acting as a BD when making a recommendation.

In addition, an AP of a dual registrant who does not offer investment advisory services must disclose that fact as a material limitation. Similarly, an AP registered in a limited capacity (*e.g.*, a Series 6) must disclose that limitation (*i.e.*, she cannot recommend all available products).

○ Material fees and costs that apply to the retail customer's transactions, holdings, and accounts?

This should build upon the fees and costs disclosure in Form CRS, with more particularity, such as whether fees are deducted from the customer's account per transaction or quarterly. This obligation would not require individualized disclosure for each retail customer. Rather, the use of standardized numerical or other non-individualized disclosure (*e.g.*, reasonable dollar or percentage ranges) is permissible.

The type and scope of services – whether or not the BD will monitor the retail customer's account and, if so, the scope and frequency of those services?

Although Form CRS may disclose that the firm provides account monitoring services, Reg BI requires disclosure about whether or not account monitoring would occur for the particular retail customer and the scope and frequency of those services.

Any requirements for retail customers to open or maintain an account or establish a relationship (*e.g.*, minimum account size)?

This would include any requirements for retail customers to open or maintain an account, or to avoid additional fees when a threshold is crossed, such as a low account balance.

Any material limitations on the securities or investment strategies involving securities that may be recommended to the customer?

Material limitations include recommending only proprietary products or a specific asset class; products with third-party arrangements (revenue sharing, mutual fund service fees); products from a select group of issuers; the fact that IPOs are available only to certain clients; and that an AP of a dually registered firm does not offer investment advisory services or is registered in a limited capacity (*e.g.*, Series 6).

The general basis for the recommendation (*i.e.*, what might commonly be described as the firm's investment approach, philosophy, or strategy)?

This may be standardized or a summary; however, the disclosure should also address circumstances when a standardized basis does not apply, and how the BD will notify the customer when that is the case.

As a best practice, firms should encourage APs to discuss the basis for any particular recommendation with their retail customers and the associated risks, particularly when the recommendation is significant to the customer (*e.g.*, the decision to roll over a 401(k) into an IRA).

Risks associated with the recommendation?

Standardized disclosure is permitted.

9 At or prior to making a recommendation, do you make full and fair written disclosure of all material facts relating to conflicts of interest?

Status
Completed
✔

Material facts regarding conflicts of interest include, for example: conflicts associated with proprietary products, payments from third parties and compensation arrangements. BDs must disclose all material facts relating to conflicts of interest associated with the recommendation. This does not require that information regarding conflicts be disclosed on a recommendation-by-recommendation basis. Standardized written disclosure of this information may be made, provided that it sufficiently identifies the material facts relating to conflicts of interest associated with a particular recommendation.

REG BI

10	Do you ensure that you do not use the term "advisor" or "adviser" unless you are a registered investment adviser, a registered municipal advisor, a registered commodity trading advisor or an advisor to a special entity?
○ Status Completed ✔	Use of the terms "advisor" or "adviser" in a name or title by: (a) a BD that is not also an RIA; or (b) a financial professional that is not a supervised person of an RIA, would presumptively violate Reg BI. Exceptions would include a BD/AP that acts on behalf of a municipal advisor or commodity trading advisor, or an advisor to a special entity. In addition, an RR of a dually registered BD may use firm materials when the BD/IA firm has the term "advisor" or "adviser" in its title.
11	Do APs supplement written disclosures with subsequent oral disclosure?
○ Status Completed ✔	Oral disclosure of a material fact may be required to supplement, clarify or update written disclosure made previously. BDs must maintain a record that oral disclosure was provided to the retail customer (but not the substance of the disclosure). Although not required by Reg BI, the SEC encourages, as a best practice, following oral disclosures with timely, written disclosure summarizing the information conveyed orally.
12	Do you have policies and procedures to **identify** and **address** the firm's conflicts of interest?
○ Status Completed ✔	Firms must have written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate all conflicts of interest associated with recommendations covered by Reg BI. A conflict of interest is an interest that might incline a BD or AP – consciously or unconsciously – to make a recommendation that is not disinterested.
13	Do you have policies and procedures to **identify** and **mitigate** the AP's conflicts?
○ Status Completed ✔	Conflicts that create an incentive for the AP to place the BD's or AP's interest ahead of the retail customer's interest must be mitigated. Mitigation measures will depend on the nature and significance of the incentives and a variety of factors related to a BD's business model, such as its size and retail customer base, and the complexity of the security or investment strategy that is being recommended.
14	Do you have policies and procedures to **identify** and **disclose** material limitations on products recommended?
○ Status Completed ✔	Material limitations include, for example, recommending only proprietary products or a specific asset class; products with third-party arrangements; products from a select group of issuers; or making IPOs available only to certain clients.

15

Do you have policies and procedures to **prevent** material limitations from causing the BD or AP to make recommendations that place the BD's or AP's interest ahead of the retail customer's interest?

Status
Completed ✔

Policies and procedures to prevent harm from material limitations could consist of establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where you cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from the product menu.

As part of this process, firms may consider: evaluating the use of "preferred lists"; restricting the retail customers to whom a product may be sold; prescribing minimum knowledge requirements for APs who may recommend certain products; and conducting periodic product reviews to identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the mitigation measures or product selection accordingly.

16

Do you have policies and procedures to **identify** and **eliminate** sales contests, bonuses, non-cash compensation and quotas based on the sale of specific securities or specific types of securities within a limited time?

Status
Completed ✔

Reg BI bans these practices. This requirement does not apply to compensation practices based on, for example, total products sold, or asset growth or accumulation, and customer satisfaction.

This requirement would not prevent a BD from offering only proprietary products, placing material limitations on the menu of products, or incentivizing the sale of such products through its compensation practices, so long as the incentive is not based on the sale of specific securities or types of securities within a limited period of time.

The requirement also is not intended to prohibit: training or education meetings, provided that these meetings are not based on the sale of specific securities or types of securities within a limited period of time; or receipt of certain employee benefits by statutory employees, as these benefits would not be considered to be non-cash compensation for purposes of Reg BI.

17

Have you updated your policies and procedures to ensure **compliance** with Reg BI?

Status
Completed ✔

Reg BI's Compliance Obligation requires that BDs establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.

In addition to the required policies and procedures, depending on the BD's size and complexity, a reasonably designed compliance program generally would also include: controls, remediation of non-compliance, training, and periodic review and testing.

Firms may be able to satisfy the Compliance Obligation by adjusting their current systems of supervision and compliance, rather than creating new ones.

18 Have you updated your policies and procedures and systems to ensure Reg BI's **recordkeeping** obligations are satisfied?

Status Completed ✔

SEA Rules 17a-3(a)(35) and 17a-4(e)(5) codify the recordkeeping requirements associated with Reg BI.

Current recordkeeping practices will not fully satisfy Reg BI. For example, BDs must provide retail customers with additional disclosures that require records. Firms may use a risk-based approach to documenting compliance with Reg BI.

19 Have you implemented **training** to ensure that APs are aware of Reg BI's requirements?

Status Completed ✔

The SEC noted that training generally is an important vehicle to communicate firm culture, specific requirements of a firm's code of conduct and its conflicts management framework.

20 Have you aligned your policies and procedures to the **definitions** in Reg BI?

Status Completed ✔

Retail Customer

Reg BI only applies to recommendations to "retail customers." Reg BI defines a "retail customer" as a natural person, or the **legal representative** of such person, who: (a) receives a **recommendation** for any securities transaction or **investment strategy** from a BD or AP; and (b) **uses** the recommendation primarily for **personal, family or household purposes**.

Legal Representative

"Legal representative" includes the non-professional legal representatives of such a natural person, *e.g.*, a non-professional trustee that represents the assets of a natural person. Reg BI would not apply when the legal representative is acting in a professional capacity as a regulated financial services industry professional retained to exercise independent professional judgment. Therefore, recommendations to registered IAs and BDs or corporate fiduciaries would not trigger Reg BI. On the other hand, recommendations to non-professional trustees, executors, conservators and persons holding power of attorney that represent natural persons are covered.

Recommendation

The final rule release for Reg BI states that this is keyed off of the guidance for FINRA's suitability rule.

Investment Strategy

The final rule release for Reg BI states that this is keyed off of the guidance for the FINRA's suitability rule; however, this will include recommendations of types of accounts.

Receives and Uses

The SEC has stated that "use" means when, as a result of the recommendation:

- the retail customer opens a brokerage account with the BD, regardless of whether the BD receives compensation;
- the retail customer has an existing account with the BD and receives a recommendation from the BD, regardless of whether the BD receives or will receive compensation, directly or indirectly, as a result of the recommendation; or
- the BD receives or will receive compensation, directly or indirectly, as a result of that recommendation, even if that retail customer does not have an account at the firm.

Personal, Family, or Household Purposes

The phrase "primarily for personal, family, or household purposes" covers any recommendation to a natural person for his or her account, other than recommendations to a natural person seeking these services for commercial or business purposes. Reg BI would not cover, for example, an employee seeking services for an employer or an individual seeking services for a small business or on behalf of another non-natural person entity, such as a charitable trust.

Conflict of Interest

A conflict of interest is an interest that might incline a BD or AP – consciously or unconsciously – to make a recommendation that is not disinterested.

Full and Fair

Sufficient information to enable a retail customer to make an informed decision with regard to a recommendation.

FORM CRS

1 Have you developed a two-page (four for dual registrants) **relationship summary known as Form CRS**?

Status Completed ✔

This applies to both IAs and BDs. Firms must write their relationship summaries in plain language, taking into consideration retail investors' level of financial experience. Firms are encouraged, but not required, to use electronic and graphical formatting.

2 Does your **relationship summary** include:

Status Completed ✔

- **An introduction to the firm?**

  This must include: (a) the name of the BD or IA, and whether the firm is registered with the SEC as a BD, IA or both; (b) an indication that BD and IA services and fees differ and that it is important for the retail investor to understand the differences; and (c) a statement that free and simple tools are available to research firms and financial professionals on the SEC's investment education website (Investor.gov/sec), which provides educational materials about BDs, IAs and investors.

- **A description of services and advice that can be provided?**

  The relationship summary must describe all relationships and services offered to retail investors, even if the investor at issue does not qualify for or is not being offered a particular service currently.

- **A description of fees and costs, applicable standard of conduct, and examples of how the firm makes money and conflicts of interest?**

  Firms must summarize the principal fees and costs that retail investors incur with respect to their BD and IA accounts, and the conflicts they create.

- **Relevant disciplinary history?**

  The relationship summary must include a separate section about whether a firm and its financial professionals have reportable disciplinary history and where investors can conduct further research on these events.

- **How additional information may be obtained?**

  Firms must state where retail investors can find additional information about their BD and IA services.

- **Prescribed "conversation starters" for investors to ask?**

  If a required disclosure or conversation starter is inapplicable to your business, or specific wording required by the Form's instructions is inaccurate, you may omit or modify that disclosure or conversation starter.

FORM CRS

3	Do you have a process in place to **file** the Form CRS?
○ Status Completed ✔	Firms must file the relationship summary through Web CRD® (dual registrants will be required to file their relationship summaries using both IARD™ and Web CRD®).
4	Do you have a process in place to **update** the Form CRS?
○ Status Completed ✔	Firms must update Form CRS and file it within 30 days whenever any information becomes materially inaccurate. Firms must communicate any changes in the updated relationship summary to retail investors who are existing clients or customers within 60 days after the updates are required to be made and without charge. Firms can make the communication by delivering the amended relationship summary or by communicating the information through another disclosure that is delivered to the retail investor. Form CRS General Instruction 8 sets forth requirements for updating the relationship summary, including filing and delivering an exhibit that highlights changes to an updated relationship summary.
5	Are you **delivering** Form CRS to each **new or prospective customer** who is a retail investor before or at the earliest of:
○ Status Completed ✔	(a) a recommendation of an account type, a securities transaction or an investment strategy involving securities; (b) placing an order for the retail customer; or (c) the opening of a brokerage account for the retail customer? If included in a packet of information, the relationship summary must be placed first. If the relationship summary is delivered electronically, it must be presented prominently in the electronic medium, for example, as a direct link or in the body of an email or message, and must be easily accessible for retail investors.
6	Do you have a process in place to **deliver** the relationship summary to **existing retail customers**?
○ Status Completed ✔	Firms must deliver the relationship summary to existing retail investor customers before or at the time firms open a new account that is different from the retail investor's existing account. In addition, firms must deliver the relationship summary when they recommend that the retail investor roll over assets from a retirement account, or when they recommend or provide a new service or investment outside of a formal account (*e.g.*, variable annuities or a first-time purchase of a direct-sold mutual fund through a "check and application" process). With respect to existing customers, firms should deliver the relationship summary in a manner consistent with the firm's existing arrangement with that customer and with the SEC's electronic delivery guidance.

FORM CRS

7	Are you posting the relationship summary on your **public website**?

Status
Completed ✔

Firms must post the current version of the relationship summary prominently on your public website, if you have one. The instructions set forth requirements, including design requirements, for a relationship summary that is posted on your website.

8	Have you adjusted your **recordkeeping procedures** to reflect the relationship summary?

Status
Completed ✔

BDs must make and keep current a record of the date that each relationship summary was provided to each retail investor, including any relationship summary that was provided before such retail investor opens an account.

BDs must maintain and preserve, in an easily accessible place, the following records until at least six years after such record or relationship summary is created: (a) all records of the dates that each relationship summary was provided to each retail investor, including any relationship summary that was provided before such retail investor opens an account, as well as (b) a copy of each relationship summary.

2019 Report on FINRA Examination Findings and Observations

INTRODUCTION

In both 2017 and 2018, FINRA issued Reports on Examination Findings in response to firms' requests that we make publicly available a summary of key findings from FINRA's examinations of member firms. Firms use this information, as well as effective practices observed by FINRA at certain firms, to anticipate potential areas of concern and improve their procedures and controls. (We subsequently refer to the two prior years' documents as the "2017 Report" and the "2018 Report.")

The name of this year's report—the "2019 Report on Examination Findings and Observations"—reflects FINRA's recent decision to distinguish more clearly between examination findings and observations. Findings constitute a determination that a firm or registered person has violated U.S. Securities and Exchange Commission (SEC), FINRA or other relevant rules. By contrast, observations (formerly known as recommendations) are suggestions to a firm about how it could improve its control environment in order to address perceived weaknesses that elevate risk, but do not typically rise to the level of a rule violation or cannot be tied to an existing rule, and are communicated to firms separately from the formal examination report. This report reflects key findings and observations identified in recent examinations, and contains effective practices, where noted, that could help firms improve their compliance and risk management programs. Where a matter is rule-based, the applicable regulatory sources ("Regulatory Obligations") are identified under the topic heading.

As a reminder, this report does not represent a complete inventory of findings, observations or effective practices. In fact, an individual firm may not have any deficiencies identified in this report, or may have other deficiencies that were not included. Similarly, we recognize that firms may employ effective practices that are not described in this report.

Further, this report does not create new legal or regulatory requirements or new interpretations of existing requirements. There should be no inference that FINRA requires firms to implement any specific effective practices described in this report or those that extend beyond the requirements of existing securities rules and regulations.

FINRA always welcomes feedback on how we can improve the content, structure, format or other elements of future reports on examination findings and observations. If you have suggestions, please contact Steven Polansky, Senior Director, Member Supervision, at (202) 728-8331 or by email, or Elena Schlickenmaier, Principal Research Analyst, Member Supervision, at (202) 728-6920 or by email.

Supervision

Regulatory Obligations

FINRA Rule 3110 (Supervision) requires firms to establish, maintain and enforce a system to supervise their activities and the activities of their associated persons that is reasonably designed to achieve compliance with federal securities laws and regulations, as well as FINRA rules. This includes updating supervisory processes and written supervisory procedures (WSPs) to address new or amended rules, as well as products and services.

Customer account and trading supervision includes complying with other obligations, such as FINRA Rule 4512 (Customer Account Information), which specifies the categories of customer account information firms must maintain. Further, FINRA Rule 2231 (Customer Account Statements) generally requires firms to send customers account statements containing their securities positions, money balances and account activity at least once each calendar quarter. Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (Exchange Act), as well as the FINRA Rule Series 4510 (Books and Records Requirements) prescribe recordkeeping obligations relating to customer account records, trading records and related documentation.

Noteworthy Examination Findings

FINRA noted the following issues relating to supervision and documentation requirements.

- **Insufficient WSPs for New or Amended Rules –** Some firms did not adequately address newly adopted or amended rules by developing controls to address the new requirements applicable to their business and updating their WSPs accordingly, for example: new fixed income mark-up disclosure requirements under FINRA Rule 2232 (Customer Confirmations); new trusted contact person information requirements pursuant to Rule 4512 (Customer Account Information); temporary holds, supervision and record retention requirements under new Rule 2165 (Financial Exploitation of Specified Adults) (if they intended to use the rule); and compliance with amended Rule 3310 (Anti-Money Laundering Compliance Program), which incorporates FinCen's new Customer Due Diligence (CDD) rule obligations. Firms are expected to evaluate which new and amended laws and regulations apply to their business, and review whether their supervisory systems, WSPs and training programs need to be amended to comply with any new or amended requirement(s).
- **Limited Supervision and Internal Inspections –** Some firms did not have reasonably designed branch supervision and inspection programs. In particular, some firms did not adequately understand the activities being conducted through their branch offices, including products and services that were offered only at certain branch locations, which could prevent such firms from effectively supervising and addressing the unique risks of each branch location. Many firms also did not conduct periodic inspections of non-branch locations as required by FINRA Rule 3110(c) (Internal Inspections); did not determine relevant areas of review at branch offices or non-branch locations, taking into consideration the nature and complexity of the products and services offered or any indicators of irregularities or misconduct; failed to reduce the inspections and reviews to a written report; or did not follow through on corrective action determined to be necessary through their branch inspections.
- **Inadequate Supervision of Account Statements, Consolidated Account Reports and Other Forms –** FINRA found that some firms did not consistently maintain accurate information in account documents, which impacted their ability to reasonably supervise account activity.
    - *Consolidated Account Reports (CARs)*[1] – In certain instances, firms did not have supervisory systems to evaluate whether and when registered representatives used CARs, did not know

when CARs included manual entries by representatives or customers, and did not require review of relevant customer documents to confirm that CARs accurately represented customers' assets and values that were held outside the broker-dealer. FINRA notes that firms with stronger supervisory systems maintained comprehensive WSPs and training addressing the use and supervision of CARs; had strict limits on the use of CARs, including around manual entries; and determined whether they accurately reflected customer holdings outside of the broker-dealer.

- *Falsifying Documents* – Some firms did not have reasonable processes to detect or prevent various forms of forgeries, including "accommodation forgery," where registered representatives and associated persons asked customers to sign blank, partial or incomplete documents. Some firms expanded risk-based reviews of associated persons' communications to cover requests for customer signatures or enhanced firm reviews of customer complaints for issues relating to forgery or falsification of documents. In addition, some firms did not follow their protocols relating to notarization and medallion stamp guarantees, or did not have any supervisory procedures for supervising the use of such stamps.

- **Insufficient Supervision for Specific Types of Accounts –** FINRA noted the following supervisory issues.
  - *Restricted and Insider Accounts* – Some firms failed to update timely their watch and restricted lists, or reasonably identify and restrict account activity susceptible to insider trading. Other firms did not have surveillance systems or procedures to review and approve restricted trading because they relied on clearing firms to conduct the review. Both introducing and correspondent firms are required to have supervisory systems reasonably designed to detect and prevent insider trading.
  - *Margin Accounts* – Some firms allowed customers to open margin accounts even though the customers did not meet the firms' standards for such accounts. FINRA also identified that some firms' systems of supervision were not reasonably designed to detect recommended margin account activity that appeared to be unsuitable and inconsistent with the cost and expense of margin use. Many firms' supervisory systems could not identify situations where the firm failed to accurately disclose their own—as well as their clearing firms'—fees, costs and charges relating to customers' use of margin.
  - *Options Accounts* – FINRA noted instances where some firms did not identify or prevent registered representatives from creating and canceling fictitious orders to circumvent sales limits; mismarking opening options transactions as "closing"; listing inaccurate receipt time, execution time and origin codes on tickets; failing to record purchases and time of order transmission for routed options orders in the firms' order management systems; and failing to show the terms or conditions of the order on tickets.

Additional Resources

- *Regulatory Notice* 10-19 (FINRA Reminds Firms of Responsibilities When Providing Customers with Consolidated Financial Account Reports)
- New Account Application Template
- Supervision Topic Page
- Books and Records Topic Page
- Broker-Dealer – Written Supervisory Procedures Checklist
- Supervision category of the Peer-2-Peer Compliance Library
- Customer Information category of the Peer-2-Peer Compliance Library

Suitability[2]

Regulatory Obligations

Currently, FINRA's suitability rule establishes obligations that are central to promoting ethical sales practices and high standards of professional conduct. FINRA Rule 2111 (Suitability) establishes three primary obligations for firms and their associated persons: (1) reasonable-basis suitability, (2) customer-specific suitability and (3) quantitative suitability.[3]

Noteworthy Examination Findings

Some firms did not have adequate systems of supervision to review that recommendations were suitable in light of a customer's individual financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs and other investment profile factors. This report shares some new suitability-related findings, as well as additional nuances on prior years' findings.

- **Inadequate Supervision of Product Exchanges –** Some firms did not maintain a supervisory system reasonably designed to assess the suitability of recommendations that customers exchange certain products, such as mutual funds, variable annuities or unit investment trusts (UITs). In particular, some firms did not maintain blotters or other processes to identify patterns of unsuitable recommendations of exchanges involving long-term products.[4] Additionally, some firms did not reasonably supervise exchanges because they could not verify the information provided by registered representatives in their rationales to justify a recommended exchange, such as inaccurate descriptions of product fees, costs and existing product values. In other instances, firm supervision did not detect that the source of funds for a purchase was misrepresented (*i.e.*, as "new" money), when other account information revealed another likely source of funds (*e.g.*, funds from a liquidation of another financial product at the firm).
- **Limited Supervision to Identify "Red Flags" for Suitability –** Some firms' supervisory systems were not reasonably designed or used to detect red flags of possible unsuitable transactions. For example, some firms did not identify or question patterns of similar recommendations by representatives or branch offices across many customers with different risk profiles, time horizons and investment objectives. In some instances, several customers of a representative or branch office appeared to have made "unsolicited" transactions in identical securities, which could raise questions around whether the transactions were actually "unsolicited."
- **Inadequate Supervision of Changes to Customer Account Information –** As discussed further in the Supervision section of this report, FINRA noted instances where registered representatives unilaterally changed account information, such as customers' income, net worth or account objectives. In many instances, the changes preceded or were contemporaneous with one or more transactions that, but for the account change, would have been subject to heightened supervisory scrutiny, raised suitability concerns or would not have been approved.
- **Limited Supervision of Trading Activity for Excessive Trading or Churning –** FINRA identified a variety of situations where supervisors failed to recognize when a pattern of transactions rendered the series of recommendations unsuitable. FINRA also noted that some firms did not adequately train supervisors how to use exception reports to identify red flags indicative of excessive trading. In other cases, some firms did not appropriately respond to and address red flags indicating excessive trading identified through their exception reports.[5]

- **Unsuitable Options Strategy Recommendations –** FINRA identified registered representatives recommending complex options strategies to customers who did not have the sophistication to understand the features of an option or the associated strategy, or without adequately considering the customers' individual financial situations and needs, as well as other investment profile factors. Further, some firms did not implement trade limits and controls to identify and prevent options trading that exceeded customer pre-approved investment levels.

Additional Resources

- 2017 Report – Product Suitability
- 2018 Report – Suitability for Retail Customers
- *Regulatory Notice 18-13* (FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111)
- Supervision Topic Page
- Suitability Topic Page
- Customer Information category of the Peer-2-Peer Compliance Library

Digital Communication

Regulatory Obligations

Exchange Act Rules 17a-3 and 17a-4, as well as FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) and FINRA Rule Series 4510 (Books and Records Requirements) require a firm to, among other things, create and preserve, in an easily accessible place, originals of all communications received and sent relating to its "business as such." If a firm permits its associated persons to use a particular application—for example, an app-based messaging service or a collaboration platform—the firm must preserve records of business-related communications and supervise the activities and communications of those persons on the application. Firms remain responsible for conducting due diligence to comply with the securities laws and FINRA rules and follow up on red flags of potentially violative activity and may, in some cases, use services provided by the relevant digital channel or third-party vendors.

Noteworthy Examination Findings

FINRA has noted that some firms encountered challenges complying with supervision and recordkeeping requirements for various digital communications tools, technologies and services (collectively, "digital channels").

- **Use of Prohibited Digital Channels –** In some instances, firms prohibited the use of texting, messaging, social media or collaboration applications (*e.g.*, WhatsApp, WeChat, Facebook, Slack or HipChat) for business-related communication with customers, but did not maintain a process to reasonably identify and respond to red flags that registered representatives were using impermissible personal digital channel communications in connection with firm business. Red flags could be detected through, for example, customer complaints, representatives' email, outside business activity reviews or advertising reviews.
- **Prohibited Electronic Sales Seminars –** Some registered representatives conducted "electronic sales seminars" in a chatroom or on digital channels that were not permitted by their firms and were outside of supervision or recordkeeping programs.

Effective Practices

Firms implemented a number of effective practices to manage registered representatives' use of digital channels.

- **Establishing Comprehensive Governance –** Some firms maintained governance processes to manage firm decisions and develop compliance processes for each new digital channel, as well as new features of existing channels. Such firms worked closely with their marketing, compliance and information technology departments, as well as their third-party vendors, to monitor the rapidly evolving array of communication methods available to their associated persons and customers.
- **Defining and Controlling Permissible Digital Channels –** Firms with holistic supervision and record retention programs and policies clearly defined permissible (as well as prohibited) digital channels; blocked prohibited digital channels (or prohibited features of permitted channels); restricted the use of messaging and collaboration apps that limit the firm's ability to comply with its recordkeeping requirements (such as apps with end-to-end encryption or self-destructing messages); established how permitted communications will be stored in a compliant manner; and implemented supervisory review procedures for communication and recordkeeping that are appropriate for the firm's business model and tailored to each digital channel.

- **Managing Video Content –** Some firms implemented WSPs to manage the lifecycle of video content, which could include, for example, live-streamed public appearances, scripted commercials or video blogs.
- **Training –** Some firms implemented mandatory training programs prior to providing registered representatives access to firm-approved digital channels. The training clarified the firms' expectations for business and personal digital communications, and assisted personnel with using all permitted features of each channel in a compliant manner.
- **Disciplining Misuse of Digital Communications –** Some firms temporarily suspended or permanently blocked from certain digital channels those registered representatives who did not comply with the firm's digital channel policies and required additional digital communications training.

Additional Resources

- *Regulatory Notice* 19-31 (Disclosure Innovations in Advertising and Other Communications with the Public)
- *Regulatory Notice* 17-18 (Guidance on Social Networking Websites and Business Communications)
- Broker-Dealer Books and Records: New and Amended Recordkeeping Requirements Checklist
- Social Media Topic Page
- Books and Records Topic Page

Anti-Money Laundering (AML)

Regulatory Obligations

The Bank Secrecy Act (BSA) requires firms to monitor for, detect and report suspicious activity to the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN). Further, FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires that members develop and implement a written AML program reasonably designed to comply with the requirements of the BSA and regulations promulgated thereunder. FINRA also notes that FinCEN's CDD rule requires that firms identify beneficial owners of legal entity customers, understand the nature and purpose of customer accounts, conduct ongoing monitoring of customer accounts to identify and report suspicious transactions, and—on a risk basis—update customer information.[6]

Noteworthy Examination Findings

FINRA identified the following issues relating to firms' AML programs, including challenges with transaction monitoring systems.

- **Inadequate AML Transaction Monitoring –** FINRA noted deficiencies in the design and implementation of systems and processes to detect and report suspicious activity:
  - Some firms did not tailor their transaction monitoring to address the risk(s) relating to the firms' business (for example, some firms did not adjust their AML programs for new sources of revenue or higher-risk customers with increased levels of activity, and other firms relied on FINRA's AML resources without tailoring them to the firms' business);[7]
  - Deficient transaction monitoring for suspicious trading and possible related money-laundering activity, which may have been due to an ongoing misconception that securities trading does not need to be monitored for suspicious activity reporting purposes, or inadequate delegation of duties to a group outside of the AML department (*e.g.*, the securities trading desk). As a result, some firms failed to detect red flags such as market dominance, prearranged trading or instances where groups of seemingly unrelated accounts were working in concert to manipulate stock prices; and
  - Transaction monitoring processes that were not reasonably designed to identify and investigate red flags associated with third-party wire transfers, where such red flags might include transfer requests that are out of the ordinary for the customer or appear designed to deter verification of the transfer instructions.
- **Overreliance on Clearing Firms –** FINRA found that some introducing firms continued to rely primarily or entirely on their clearing firm for transaction monitoring and suspicious activity reporting. While clearing firm inquiries about certain customers or activities can be triggers for further review by introducing firms, introducing firms are required to monitor for suspicious activity attempted or conducted through the firm.[8]

Additional Resources

- *Regulatory Notice* 19-18 (Guidance Regarding Suspicious Activity Monitoring and Reporting Obligations)
- 2017 Report – Anti-Money Laundering (AML) Compliance Program
- 2018 Report – Anti-Money Laundering
- Anti-Money Laundering (AML) Template for Small Firms
- Frequently Asked Questions (FAQ) Regarding Anti-Money Laundering (AML)
- Anti-Money Laundering (AML) Topic Page

Uniform Transfers to Minors Act (UTMA) and Uniform Grants to Minors Act (UGMA) Accounts

Regulatory Obligations

FINRA Rule 2090 (Know Your Customer) requires member firms and their associated persons to use reasonable diligence to determine the "essential facts" about every customer and "the authority of each person acting on behalf of such customer." *Regulatory Notice 11-02* (SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations) advised that firms verify the essential facts about a customer "at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances."

Noteworthy Examination Findings

Generally, when UTMA or UGMA accounts (UTMA/UGMA Accounts) are established, the beneficiary (a minor) becomes the owner of the property at the time of the gift; however, the custodian manages and invests the property on the beneficiary's behalf until the beneficiary reaches the age of majority, at which point the custodian is required to transfer the custodial property to the beneficiary.

FINRA noted that some firms did not establish, maintain or enforce a supervisory system reasonably designed to achieve compliance with their continuing obligation to know the essential facts of their UTMA/UGMA Account customers. Specifically, the circumstances concerning the authority of a person acting on behalf of a customer will change in UTMA/UGMA Accounts when the account beneficiary reaches the age of majority.

FINRA found that many firms were aware of the need to transfer responsibility for the account at a future date because they had policies and procedures addressing this topic, such as noting the date of majority when setting up the account. However, even though they were aware of the need to transfer the account at a future date, some firms did not take any steps to track or monitor when beneficiaries would reach the age of majority, while other firms had procedures for their registered representatives to follow, but did not require any supervisory oversight. Further, in some instances, firms permitted custodians to effect transactions in, and withdraw, journal and transfer money from UTMA/UGMA Accounts months, or even years, after the beneficiaries reached the age of majority, and ignored red flags of such activity (*e.g.*, customer complaints relating to such transactions).

Effective Practices

Some firms implemented a number of effective practices for verifying the authority of custodians of UTMA/UGMA Accounts.

- **Age of Majority –** Some firms maintained supervisory systems and used automated tools to track when each UTMA/UGMA Account beneficiary reached the age of majority.
- **Notification to Custodians –** Some firms issued letters or provided notifications to custodians to advise them that beneficiaries were approaching the age of majority and informed them about upcoming transfers of custodial property in their UTMA/UGMA Accounts, as well as any restrictions to the custodians' trading authority after the beneficiaries reached the age of majority.
- **Notification to Registered Representatives –** Some firms maintained systems to provide registered representatives with automated alerts when beneficiaries reached the age of majority and required them to communicate with the custodian about the transfer of custodial property.

Observations on Cybersecurity

While many firms have made significant improvements in their cybersecurity programs, cybersecurity attacks continue to increase in both number and level of sophistication. FINRA notes that such attacks often take advantage of and highlight weaknesses in a firm's cybersecurity program. The observations and effective practices we share below can help firms strengthen their cybersecurity programs and may support compliance with the SEC's Regulation S-P, which requires firms to have policies and procedures addressing the protection of customer records and information.[9]

We encourage firms to strengthen their cybersecurity programs by taking advantage of FINRA publications and other resources identified below. FINRA recognizes that there is no one-size-fits-all approach to cybersecurity, and reminds firms to evaluate each of the controls described in this report and other FINRA resources in the context of their business model and risk profile.

Highlighted below are effective practices some firms have implemented to strengthen their cybersecurity risk-management programs.

- **Branch Controls –** Firms maintained branch-level written cybersecurity policies to protect confidential data. In addition, they implemented procedures to verify that branch office controls were implemented and functioning adequately, either via automated monitoring tools or during in-person branch inspections.
- **Documented Policies on Vendor and Third-Party Management –** Firms using third-party vendors that provide critical firm services or handle sensitive client information adopted, implemented, and documented formal policies and procedures to manage the lifecycle of the firm's engagement with the vendor (*i.e.*, from onboarding, to ongoing monitoring, through off-boarding, including defining how vendors will dispose of sensitive client information).
- **Incident Response Planning –** Firms established and regularly tested written formal incident response plans that outlined procedures they would follow when responding to cybersecurity and information security incidents. Firms also developed procedures relating to incident response plans, which included a mechanism to appropriately identify, classify, prioritize, track and close cybersecurity-related incidents.
- **Data Protection Controls –** Firms encrypted all confidential data, including sensitive customer information and firm information, whether stored internally or at vendors' locations.
- **System Patching –** Firms adopted procedures to implement timely application of system security patches to critical firm resources (*e.g.*, servers, network routers, desktops, laptops and software systems) to protect sensitive client or firm information.
- **Access Controls –** Firms implemented or maintained policies and procedures to grant system and data access only when required (often referred to as "Policy of Least Privilege") and removed such access when it was no longer needed (such as when individuals departed or changed roles at the firm). In addition, firms tracked (and monitored the activities of) individuals granted administrator access to data or systems. Further, firms implemented multi-factor or two-factor authentication controls for registered representatives, employees, vendors and contractors accessing firm systems and data from outside the organization.
- **Management of Asset Inventory –** Some firms created and kept current an inventory of critical information technology assets—including hardware, software and data—in home and branch offices. These inventories also included legacy assets that vendors no longer supported, as well as corresponding cybersecurity controls to protect those assets.

- **Data Loss Prevention Controls –** Certain firms implemented data loss prevention controls to protect a broad range of sensitive customer information in addition to Social Security numbers, such as other account profile information (*e.g.*, account numbers, dates of birth, bank information and driver's license numbers).
- **Training and Awareness –** Firms provided robust cybersecurity training for registered representatives, personnel, third-party providers and consultants. This training addressed key topics relevant to individuals' roles and responsibilities (*e.g.*, training on the various types of phishing emails that might be directed towards registered representatives' associates or home office staff in the human resources or finance departments, or training on secure software development practices for developers). Some firms determined the appropriate frequency of such training based on the cybersecurity risk exposure associated with the firm, as well as individuals' roles and responsibilities.
- **Change Management Processes –** Some firms implemented change management procedures to document, review, prioritize, test, approve, and manage hardware and software changes in order to protect sensitive information and firm services.

Additional Resources

- Report on Cybersecurity Practices – 2015
- Report on Selected Cybersecurity Practices – 2018
- 2017 Report – Cybersecurity
- Small Firm Cybersecurity Checklist
- Core Cybersecurity Controls for Small Firms
- Customer Information Protection Topic Page
- Cybersecurity Topic Page
- Cybersecurity category of the Peer-2-Peer Compliance Library
- Non-FINRA Cybersecurity Resources

Business Continuity Plans (BCPs)

Regulatory Obligations

FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information) requires firms to create and maintain a written BCP with procedures that are reasonably designed to enable firms to meet their obligations to customers, counterparties and other broker-dealers during an emergency or significant business disruption.[10] The rule also requires firms to review and update their BCPs, if necessary, in light of changes to firms' operations, structure, business or location. Further, although most introducing firms rely, to some extent, on their clearing firms to allow customers to access their accounts and enter transactions, they are responsible for compliance with the BCP rule.

Noteworthy Examination Findings

FINRA found some firms encountering challenges where their BCPs did not reflect certain market conditions, business models or other circumstances.

- **Incomplete Mission-Critical Systems –** Some firms' BCPs did not identify all of their mission-critical systems. Omitted systems included those used for order management for trading desks, or vendor systems that processed and managed financing transactions, such as securities lending and repurchase agreements.
- **Insufficient Capacity –** Some larger firms did not have sufficient capacity to handle substantially increased call volumes and online activity during a business disruption, which affected customers' ability to access their accounts.
- **No Updates for Operational Changes –** Some firms did not update their BCPs after significant operational changes, such as outsourcing critical operational functions, relocating data centers or replacing other key systems, including trading desk order management systems or other systems that are critical to firms' business lines.
- **Outdated Contact Information –** Some firms' BCPs contained outdated emergency contact information and did not identify how customers could access their funds and securities during a business disruption.
- **Local Document Storage –** Some firms allowed employees to maintain critical working documents on their computers' local drives rather than requiring that they be stored on the firms' network. Firms should review their controls to test whether these files would be secure and readily accessible.
- **No Registered Principal Registrations –** Some senior management personnel, who were responsible for performing the annual BCP review, did not maintain the required registered principal registration.[11]

Effective Practices

Firms implement a number of effective practices to fulfill their obligations under the rule, especially those relating to testing of their BCP plans.

- **Engaging in Annual Testing –** Firms tested their BCPs as part of their annual review to confirm that the BCP was updated, and to evaluate its effectiveness, especially with respect to the functioning of mission-critical systems and processes, availability of key personnel and access to physical contingency site location(s). As part of these tests, some firms assessed their remote access capabilities to such systems, as well as evaluated and documented their ability to failover from one server to another. Firms also included key vendors in their BCP tests and documented results from those tests.

- **Incorporating Test Results into Firm Training –** Firms found these tests can be a valuable tool, not only to identify weaknesses in their BCPs, but also to train staff on how to implement the program, should that become necessary.

Additional Resources

- *Regulatory Notice* 19-06 (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rule on Business Continuity Plans and Emergency Contact Information)
- *Regulatory Notice* 19-15 (FINRA Publishes Consolidated Criteria to Designate Firms for Mandatory Participation in FINRA's Business Continuity/Disaster Recovery Testing)
- Business Continuity Plan FAQs
- Small Firm Business Continuity Plan Template
- Business Continuity Planning Topic Page

Fixed Income Mark-up Disclosure

Regulatory Obligations

FINRA's and the Municipal Securities Rulemaking Board's (MSRB) amendments to FINRA Rule 2232 (Customer Confirmations) and MSRB Rule G-15 require firms to provide additional transaction-related pricing information to retail customers for certain trades in corporate, agency and municipal debt securities (other than municipal fund securities).[12]

Noteworthy Examination Findings

FINRA identified many of the issues previously discussed in the Fixed Income Mark-up Disclosure section of the 2018 Report, as well as the following additional issues.

- **Excluding Charges from Mark-Up/Mark-Down Disclosure –** Some firms disclosed additional charges separately from disclosed mark-ups or mark-downs, even when such charges reflected firm compensation. Firm compensation should not be mischaracterized, for example, as miscellaneous or fixed transaction fees; it should instead be included in the reported price of the transaction and accounted for when calculating mark-ups and mark-downs, consistent with applicable rules and guidance.[13]
- **Unclear or Inaccurate Labels for Sales Credits or Concessions –** Some firms disclosed registered representatives' sales credits or concessions as separate line items on confirmations, in addition to the mark-up or mark-down, without clear and accurate labeling, creating confusion about the actual disclosed mark-up and therefore diminishing its utility.[14] Similarly, some firms inaccurately labeled only the sales credits or concessions portion as the total mark-up or mark-down.
- **Incorrect Prevailing Market Price (PMP) Determinations –** Some firms did not determine the PMP as set forth in FINRA Rule 2121.02(b) (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities) for their fixed income transactions. Some firms' PMP determinations did not presumptively rely on the dealer's contemporaneous cost or proceeds, as required by Rule 2121. Other firms decided that their cost or proceeds were no longer "contemporaneous" without sufficient evidence as required by Rule 2121.02(b)(4) and used other pricing information to determine the PMP.
- **Inaccurate Time of Execution –** Some firms disclosed times of execution on customer confirmations that did not match the times of execution disseminated by the Electronic Municipal Market Access system (EMMA) or Trade Reporting and Compliance Engine (TRACE).[15] The time of execution on confirmations must match the trade times disseminated by EMMA and TRACE to allow customers to identify their specific transactions, consistent with the intent of the disclosure requirement.

Additional Resources

- *Regulatory Notice 17-24* (FINRA Issues Guidance on the Enhanced Confirmation Disclosure Requirements in Rule 2232 for Corporate and Agency Securities)
- Report Center – FINRA's MSRB Markup/Markdown Analysis Report
- Report Center – FINRA's TRACE Markup/Markdown Analysis Report
- Fixed Income Confirmation Disclosure: Frequently Asked Questions (FAQ)
- Municipal Securities Topic Page
- Fixed Income Topic Page

Best Execution

Regulatory Obligations

FINRA Rule 5310 (Best Execution and Interpositioning) requires firms to conduct a "regular and rigorous" review of the execution quality of customer orders if the firm does not conduct an order-by-order review.[16] Where "regular and rigorous" reviews are used instead of order-by-order reviews, the reviews must be performed at a minimum on a quarterly basis and on a security-by-security, type-of-order basis (*e.g.*, limit order, market order and market on open order). If a firm identifies any material differences in execution quality among the markets that trade the securities under review, it must modify its routing arrangements or justify why it is not doing so.

Noteworthy Examination Findings

FINRA continued to identify issues with some firms' execution quality reviews, as well as conflicts of interest and related disclosures.

- **No Execution Quality Assessment of Competing Markets –** Some firms did not compare the quality of the execution of their existing order routing and execution arrangements against the quality of executions that the firm could have obtained from competing venues.
- **No Review of Certain Order Types –** In some instances, firms did not conduct adequate reviews on a type-of-order basis, including, for example, on market, marketable limit or non-marketable limit orders.
- **No Evaluation of Required Factors –** Some firms did not consider factors set forth in FINRA Rule 5310 (Best Execution and Interpositioning) when conducting their execution quality reviews, including, among other things, the speed of execution, price improvement opportunities and the likelihood of execution of limit orders.
- **Conflicts of Interest –** Some firms did not adequately consider and address potential conflicts of interest relating to their routing of orders to affiliated alternative trading systems (ATSs) or market centers that provide payment for order flow or other routing inducements. In addition, some firms continue to route significant portions of their order flow to such venues without conducting an adequate "regular and rigorous" review to support such routing decisions.
- **Inadequate SEC Rule 606 Disclosures –** Some firms did not provide adequate information in the material disclosures section of their order routing reports required by Rule 606 of Regulation NMS. For example, certain firms did not disclose, when required, the specific, material aspects of the non-directed order flow routed to their own trading desk, including that the firm stands to share in 100 percent of the profits generated by the firm's trading as principal with its customers' orders.[17] Other firms did not disclose material aspects of their relationships with each of the significant venues identified on their reports, including descriptions and terms of all arrangements for payment for order flow (including the amounts of payment for order flow on a per share or per order basis)[18] and profit-sharing relationships that may have influenced the firms' order routing decisions.

Additional Resources

- 2017 Report – Best Execution
- 2018 Report – Best Execution
- *Regulatory Notice 15-46* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets)
- Report Center, Equity Report Cards section – FINRA's Best Execution Outside-of-the-Inside Report Card

Direct Market Access Controls

Regulatory Obligations

Compliance with Exchange Act Rule 15c3-5 (Market Access Rule) requires firms that provide access to trading in securities on an exchange or ATS to incorporate appropriate controls to mitigate key risks. The Market Access Rule is particularly important with the continued increase in automated and high-speed trading.

Noteworthy Examination Findings

FINRA continued to find many of the same issues identified in the Market Access Controls sections of the 2017 and 2018 Reports, as well as additional challenges with certain other market access controls, especially those related to fixed income transactions.

- **Insufficient Controls and WSPs –** Some firms' risk management controls and WSPs did not include pre-trade order limits, pre-set capital thresholds and duplicative and erroneous order controls for accessing ATSs, especially for fixed income transactions.
- **Inadequate Financial Risk Management Controls –** In some instances, firms with market access, or those that provide it, did not establish appropriate capital thresholds for trading desks, aggregate daily limits, or credit limits on institutional customers and counterparties. In some instances, firms with market access, or those that provide it, did not have reasonably designed risk-management controls or WSPs to manage the financial, regulatory or other risks associated with this business activity. Firms should regularly assess the appropriateness of their capital thresholds and pre-set credit limits for each customer.
- **Inadequate Basis for CEO Certification –** Some firms did not maintain reasonably designed risk-management controls that could support the CEO's certification pursuant to the requirements of Exchange Act Rule 15c3-5(e)(2).
- **Inaccurate Intra-day (Ad Hoc) Adjustments –** FINRA identified weaknesses in some firms' processes for requesting, approving, reviewing and documenting ad hoc credit threshold increases. For example, institutional clients requested ad hoc (daily) adjustments to financial limits in anticipation of increased order activity related to events such as an index rebalancing or a public offering, but once the event concluded (typically the next trading day), firms did not return the limits to their original values. Some firms maintained a manual process for reverting limits to their original values or did not revert the elevated credit limits in a timely fashion, which exposed clients and firms to elevated levels of financial risk.
- **Ineffective Erroneous Trading Controls –** Some firms failed to implement adequate controls relating to duplicative and erroneous orders. For example, some firms set controls to prevent the routing of a market order based on impact (Average Daily Volume Control) at unreasonable levels, preventing such firms from blocking erroneous trades. These controls can be effective tools (particularly in thinly traded securities) when set at reasonably high levels, and firms should calibrate them to reflect, among other things, the characteristics of the relevant securities, the business of the firm, and market conditions.
- **Insufficient Post-Trade Controls and Surveillance –** Some firms that provide direct market access via multiple systems, including sponsored access arrangements, did not employ reasonable controls to confirm that those systems' records were aggregated and integrated in a timely manner. As a result, those firms were not able to successfully conduct holistic post-trade and supervisory reviews for, among other things, potential manipulative trading patterns.

Additional Resources

- *Regulatory Notice* 15-09 (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)
- *Regulatory Notice* 16-21 (SEC Approves Rule to Require Registration of Associated Persons Involved in the Design, Development or Significant Modification of Algorithmic Trading Strategies)
- Algorithmic Trading Topic Page
- Market Access Topic Page

Short Sales

Regulatory Obligations

Regulation SHO Rules 200 to 204 require firms to address risks relating to market manipulation, market liquidity and investor confidence by regulating excessive and "naked" short sales so that purchasers of securities from short sellers receive their securities positions in a timely manner. Regulation SHO requires firms to appropriately mark their securities orders; confirm that they have deliverable securities to complete short sale transactions; and have a process to close-out fails to deliver within the required timeframes.

Noteworthy Examination Findings

In addition to the findings FINRA shared in the Regulation SHO section of the 2017 Report, we found some firms were not able to satisfy the Continuous Net Settlement (CNS) System fail-to-deliver close-out requirements pursuant to Rule 204 because they did not implement a sufficient process to age fails, resulting in fails not being closed out timely. In other instances, firms did not accurately allocate CNS fails to correspondents. For example, some firms faced challenges relating to both inaccurate calculation of pre-fail credits prior to allocating fails to the correspondent, and used inconsistent methods when allocating fails to the correspondents where the share quantities exceeded the CNS fails.

In addition, firms may consider as an effective practice to periodically review their policies relating to rates charged for borrowing, sourcing or locating securities in connection with short sales, including monitoring the aging of short positions and determining whether the rates assigned at the onset of those positions are still appropriate.

Observations on Liquidity and Credit Risk Management

Effective liquidity and credit risk management controls are critical elements in a broker-dealer's risk management framework, and should be documented in a firm's books and records.[19] FINRA routinely reviews firms' practices in these areas, and in *Regulatory Notice* 15-33 (Guidance on Liquidity Risk Management Practices) shared observations on liquidity management practices.

FINRA shares the following practices that some firms used to strengthen their liquidity management programs.

- **Liquidity Contingency Plans –** Small clearing and introducing firms developed contingency plans for operating in a stressed environment and outlined specific steps to address certain stress conditions. Further, firms' contingency plans identified the firm staff responsible for enacting the plan, the process for accessing liquidity during a stress event or standards to determine how liquidity funding would be used.
- **Liquidity Risk Management Updates –** Firms updated their liquidity risk management practices to take into account their current business activities.
- **Stress Tests –** Firms conducted stress tests in a manner and frequency that was appropriate for their business model. In addition, such stress tests evaluated the potential impact of off-balance sheet items on liquidity. Some firms that relied on a shared funding source with affiliated entities for their liquidity stress test and their shared Master Credit Agreement confirmed that source would be ring-fenced for them during a stress event.
- **Credit Risk Management –** Firms maintained a robust internal control framework to capture, measure, aggregate, manage and report credit risk.[20] In particular, firms evaluated their risk management and control processes to review whether they were accurately capturing their exposure to credit risk; maintained approval and documentation processes for increases or other changes to assigned credit limits; and monitored exposure to their affiliated counterparties.

Additional Resources

- 2018 Report – Liquidity
- *Regulatory Notice* 10-57 (Funding and Liquidity Risk Management Practices)
- Funding and Liquidity Topic Page

Segregation of Client Assets

Regulatory Obligations

Exchange Act Rule 15c3-3 (Customer Protection Rule) requires firms that maintain custody of customer securities and safeguard customer cash to segregate these assets from the firm's proprietary business.

Noteworthy Examination Findings

FINRA has continued to identify many of the same concerns noted in the Segregation of Client Assets section of the 2018 Report, including challenges with check-forwarding and possession or control.

- **Omitted or Inaccurate Blotter Information –** Some firms' blotters lacked sufficient information to demonstrate that checks were forwarded in a timely manner or contained inaccurate information with respect to the status of checks.
- **Inadequate Possession or Control Processes –** FINRA noted the following deficiencies:
  - Failure to obtain documentation (no lien letters) from custodians and issuers to show that all securities in a good control location were free of liens that could be exercised by a third party on the firm;
  - Inability to identify deficits in fully paid and excess margin securities when certain firms did not correctly age the deficits due to errors in their formulas;
  - Failure to confirm that fully paid securities were correctly segregated at custodian banks (FINRA notes that firms should consider verifying whether they have sufficient securities positions that exceed possession or control requirements prior to transferring such excess securities from a custodial account); and
  - Failure to combine balances and positions in related customer securities accounts and accounts with the same Taxpayer Identification Numbers in order to determine the extent to which the market value of securities carried for the customer's account exceeded 140 percent of the customer's debit balance.
- **Inaccurate Reserve Formula Calculations –** Some firms did not exclude concentrated margin debit balances[21] because they did not have a process to identify accounts under common control or related customer accounts.
- **Coding Errors –** FINRA noted joint customer and firm officer accounts miscoded as "non-customer" rather than "customer." Some firms also coded foreign bank accounts as "PAB" without obtaining a written agreement acknowledging that the accounts are proprietary transactions of the foreign bank.[22]

Additional Resources

- Interpretations of Financial and Operational Rules
- Customer Protection – Reserves and Custody of Securities (SEA Rule 15c3-3)

Net Capital Calculations

Regulatory Obligations

Exchange Act Rule 15c3-1 (Net Capital Rule) requires firms to maintain net capital at specific levels to protect customers and creditors from monetary losses that can occur when firms fail.

Noteworthy Examination Findings

FINRA has continued to identify some of the same concerns noted in the Net Capital and Credit Risk Assessments section of the 2017 Report and Accuracy of Net Capital Calculations section of the 2018 Report, as well as the following additional issues.

- **Incorrect Inventory Haircuts –** Some firms did not apply correct haircut charges when computing net capital because they did not adequately assess and monitor the creditworthiness of fixed income securities, such as corporate debt and collateralized mortgage obligations (CMOs), to determine whether these products have a "minimal amount of creditworthiness" pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(I).[23]
- **Incorrect Capital Charges for Underwriting Commitments –** Some firms did not maintain an adequate process to assess moment-to-moment and open contractual commitment capital charges on underwriting commitments and did not understand their role as it pertained to the underwriting (*i.e.*, best efforts or firm commitment).[24]
- **Inaccurate Classification of Receivables, Liabilities and Revenue –** In some instances, firms inaccurately classified receivables, liabilities and revenues, which resulted in inaccurate reporting of a firm's financial position and, in some instances, a capital deficiency. In addition, upon settlement of a customer claim, some firms understated their liability by recognizing the monies due to the customer based on a payment schedule instead of recognizing the full amount owed at the time of settlement.
- **Recognition of Insurance Claims –** Some firms did not recognize on their books and records receivables due from insurance carriers and the corresponding liabilities owed to customers. Other firms did not obtain an opinion of counsel with respect to claims within seven business days, as required under Exchange Act Rule 15c3-1(c)(2)(iv)(D), thereby resulting in the receivables not being allowable for purposes of net capital, and the firm being required to take the full charge for the customer claim.
- **Inadequate Documentation of Methodology for Expense-Sharing Agreements –** Some firms did not maintain sufficient documentation to substantiate their methodology for allocating specific broker-dealer costs to the firm or an affiliate. Some firms were not accurately accruing expenses—such as technology fees, marketing charges, retirement account administrative fees and employees' compensation—on their books and records. Further, some firms incorrectly netted intercompany accounts with different affiliated entities,[25] resulting in books and records that did not accurately reflect the firms' operating performance and financial condition.

Additional Resources

- Interpretations of Financial and Operational Rules
- *Notice to Members* 03-63 (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers)

ENDNOTES

1. *See Regulatory Notice 10-19* (FINRA Reminds Firms of Responsibilities When Providing Customers with Consolidated Financial Account Reports).

2. On June 5, 2019, the SEC voted to adopt a package of rulemakings and guidance, including Regulation Best Interest (Reg BI). This section is intended to provide firms with findings solely related to compliance with existing FINRA suitability and related supervisory obligations and does not address Reg BI. For additional information, please see FINRA's Topic Page on SEC Regulation Best Interest (Reg BI).

3. In addition to the items discussed in this document, FINRA reminds firms to consider the findings FINRA shared previously regarding overconcentration in illiquid securities, reasonable due diligence for private placements and certain variable annuity exchanges.

4. *See* FINRA Rule 2330(d) (Members' Responsibilities Regarding Deferred Variable Annuities).

5. FINRA continued to note many of the challenges we discussed in the Abuse of Authority section of the 2018 Report, including registered representatives engaging in discretionary trading without written authorization.

6. *See Regulatory Notices 17-40* (FINRA Provides Guidance to Firms Regarding Ant-Money Laundering Program Requirements Under FINRA Rule 3310 Following Adopting of FinCEN's Final Rule to Enhance Customer Due Diligence Requirements For Financial Institutions) and *18-19* (FINRA Amends Rule 3310 to Conform to FinCEN's Final Rule on Customer Due Diligence Requirements for Financial Institutions) for additional information.

7. *See Regulatory Notice 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations) for a list of potential red flags that firms should consider when designing an effective AML compliance program that is tailored to their business.

8. *See* Frequently Asked Questions (FAQ) Regarding Anti-Money Laundering (AML), Question No. 22.

9. This obligation includes protection against any anticipated threats or hazards to the security or integrity of customer records and information, as well as unauthorized access to or use of such records or information. Also, the rule requires firms to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their rights.

10. Pursuant to *Regulatory Notice 19-06* (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rule on Business Continuity Plans and Emergency Contact Information), FINRA is conducting a retrospective review of Rule 4370. This section is intended to provide firms with findings solely relating to compliance with existing Rule 4370 and does not address the outcome of that review or any potential revisions to the rule.

11. *See* FINRA Rule 4370(d).

12. Specifically, the amendments require firms to disclose the mark-up or mark-down for principal trades with retail customers that a firm offsets on the same day with other principal trades in the same security. Disclosed mark-ups and mark-downs must be expressed as both a total dollar amount for the transaction and a percentage of PMP. In addition, for all retail customer trades in corporate, agency and municipal debt securities (other than municipal fund securities), firms must disclose on the confirmation the time of execution and a security-specific link to the FINRA or MSRB website where additional information about the transaction is available, along with a brief description of the information available on the website.

13. *See, e.g.*, Frequently Asked Questions (FAQ) About the Trade Reporting and Compliance Engine (TRACE) FAQ *3.1.33* (stating that prices reported to TRACE should be inclusive of mark-ups and mark-downs).

14. *See* FINRA Fixed Income Confirmation Disclosure: Frequently Asked Questions (FAQ), FAQ 2.3 and MSRB Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions, FAQ 2.3.

15. *See* FINRA Fixed Income Confirmation Disclosure: Frequently Asked Questions (FAQ), FAQ 4.2; MSRB Confirmation Disclosure and Prevailing Market Price: Frequently Asked Questions, FAQ 4.2.

16. *See also Regulatory Notice 15-46* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets).

17. *See* U.S. Securities and Exchange Commission, Division of Market Regulation: Staff Legal Bulletin No. 13A Frequently Asked Question about Rule 11Ac1-6, Question 14: Disclosing Internalized Order Flow.

18. *See* U.S. Securities and Exchange Commission, Division of Market Regulation: Staff Legal Bulletin No. 13A Frequently Asked Question about Rule 11Ac1-6, Question 13: Disclosing Payment for Order Flow.

19. *See* Exchange Act Rule 17a-3(a)(23).

20. *See* Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 (July 30, 2013), 78 Fed. Reg. 51824 (Aug. 21, 2013), at 51848; *see also* FINRA's Resource Page for the SEC's July 2013 Financial Responsibility Rule Amendments.

21. *See* the SEC's Note E(5) to Exhibit A of SEA Rule 15c3-3 and the associated interpretation, Determination of the Includible Amount of a Customer's Concentrated Margin Debit Balance in the Reserve Formula, Exchange Act Rule 15c3-3, Exhibit A - Note E(5)/01, in the Interpretations of Financial and Operational Rules.

22. Regarding foreign banks, *see* Foreign Banks - Customer and Non-Customer Classification, Exchange Act Rule 15c3-3(a)(1)/032, in the Interpretations of Financial and Operational Rules.

23. These requirements were adopted as part of the SEC's 2013 credit ratings amendments. *See* Exchange Act Release No. 71194 (Dec. 27, 2013), 79 Fed. Reg. 1522 (Jan. 8, 2014).

24. *See* Exchange Act Rule 15c3-1(c)(2)(viii); *see also* Moment to Moment Net Capital, Exchange Act Rule 15c3-1(a)(1)/001, in the Interpretations of Financial and Operational Rules.

25. *See* Netting of Intercompany Receivables and Payables with Affiliates, Exchange Act Rule 15c3-1(c)(2)(iv)(C)/073 in the Interpretations of Financial and Operational Rules.

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2019 CEFLI SUMMIT MEETING

November 20-21, 2019 | Fairmont Hotel | Washington, DC

The Future of Sales Standards in the Life Insurance Industry.

PRELIMINARY PROGRAM AGENDA

CEFLI Summit Meeting

The Future of Sales Standards in the Life Insurance Industry

November 20-21, 2019
Fairmont Hotel – Washington, DC

WEDNESDAY, NOVEMBER 20:

5:30 – 7:00 PM **Welcoming Reception**

THURSDAY, NOVEMBER 21:

8:00 - 9:00 AM **Networking Breakfast**

9:00 - 9:15 AM **Welcome and Introduction**

Donald J. Walters
President & CEO
CEFLI

9:15 – 10:00 AM **The State Insurance Regulatory Perspective: The NAIC Suitability in Annuity Transactions Model Regulation.**

The NAIC is exploring revisions to the NAIC Suitability in Annuity Transactions Model Regulation. Will the NAIC move to a best interest standard and how will this development impact current sales practices in the life insurance industry. Hear from a panel of representatives from the NAIC Annuity Suitability (A) Working Group who will discuss recent developments and future work plans for the Working Group's effort to revise the NAIC Suitability in Annuity Transactions Model Regulation.

Matthew Gendron
General Counsel
Rhode Island Insurance Department

Jodi Lerner (Invited)
Compliance Bureau
California Department of Insurance

10:00 – 10:30 AM **Break**

10:30 – 11:00 AM **The New York Perspective: New York Department of Financial Services Rule 187 – Best Interest Standard for Life Insurance and Annuities.**

The New York Department of Financial Services adopted amendments to Rule 187 which apply a best interest standard to sales of both life insurance and annuity products. Thought Regulation 187 is New York-specific, it may have implications for regulations in other jurisdictions. Hear from the Deputy Superintendent of the New York Department of Financial Services who will share his viewpoints concerning the impact that Regulation 187 may have upon future sales standards in the life insurance industry.

James Regalbuto (Invited)
Deputy Superintendent
New York Department of Financial Services

11:00 – 12:15 PM **The Federal Perspective: The SEC's Regulation Best Interest and FINRA's Role in a Best Interest Environment.**

The recent issuance of Regulation Best Interest by the US Securities and Exchange Commission (SEC) will have a significant impact in the financial services marketplace. FINRA is reviewing the impact that Regulation Best Interest may have upon existing FINRA Rules which may impact regulatory oversight efforts in the future. Hear from a representative of the SEC and FINRA who will discuss the rationale behind issuing Regulation Best Interest, its potential impact upon current FINRA Rules and the key challenges that will change distribution practices in the future.

Lourdes Gonzales
Assistant Chief Counsel
Division of Trading and Markets
US Securities and Exchange Commission

Joe Savage
Vice President and Counsel
Office of Regulatory Analysis
FINRA

12:15 PM – 1:30 PM **Networking Lunch.**

1:30 PM – 2:15 PM **The Company Perspective: Key Compliance Challenges and Strategies in a Best Interest Environment.**

Compliance and ethics professionals at life insurance companies are examining the challenges of changing sales standards applicable to the distribution of life insurance and annuity products and exploring appropriate compliance strategies. Companies must evaluate their current sales practices to determine appropriate modifications to address the future regulatory environment. Hear from a panel of industry experts and company representatives who will explore the key compliance challenges associated with distributing life insurance and annuity products in a best interest environment.

George Hanley (Moderator)
Managing Director
Deloitte

Maryjean Bonadonna (Invited)
Head of Supervision & Chief Risk Officer
AXA Advisors

Jim Puhala
Head of Field & Regulatory Compliance
MassMutual

2:15 – 2:30 PM **Break.**

2:30 – 3:15 PM **Looking into the Future.**

Life insurance company compliance and ethics professionals face considerable challenges over the months ahead in developing appropriate strategies to reconcile new developments related to evolving sales practices in the industry. From modifications to the NAIC Suitability in Annuity Transactions Model Regulation to complying with Regulation Best Interest and considering the potential impact of fiduciary rules being introduced by the states and the DOL, compliance professionals will need to be adept at developing appropriate strategies to address these developments. Hear from a panel of industry experts who will discuss the potential impact these developments may have upon future compliance strategies.

Patrick Hughes
Partner
Faegre Baker Daniels

Bradford P. Campbell
Partner
Drinker Biddle

Paige Waters (Invited)
Partner
Locke Lord

3:15 – 3:30 PM **Closing and Final Thoughts.**

A Special Thanks to our Premier Partners and Affiliate Members!