

Two Cents on the 2023 FINRA Report

By Ryan P. Smith



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The Report reflects FINRA's commitment to providing greater transparency to member firms and the public about our regulatory activities as well as the increasing integration among our regulatory operations programs. We hope that this integrated approach will also increase the Report's utility for member firms as an information source they can use to strengthen their compliance programs.

FINRA, *2023 Report on FINRA's Examination and Risk Monitoring Program (January 2023)* at 1

Over the years, FINRA's report has been exactly that: a helpful tool for a broker-dealer's compliance program. This year's edition is no exception. Below are a few thoughts – my two cents, if you will – on the 2023 Report on FINRA's Examination and Risk Monitoring Program (the "Report"). This is not intended to be a play-by-play of FINRA's observations. Rather, I offer a few general themes and commentary on some of FINRA's findings and effective practices. In addition, while FINRA (to its credit) includes various resources to help compliance personnel address the items discussed in the Report, I added several other resources that the NSCP already makes available to its members on these topics.

I. General Themes

A. *A new "Financial Crimes" section is front and center . . . and significant.*

Anyone who has litigated cases understands the value of putting the most valuable information at the front. One simply does not know how long someone else is going to read a motion or listen to an argument. FINRA gets to the point here as well as it announces in the very first paragraph of the very first page that the Report contains a "new Financial Crimes section, consisting of three topics— Anti-Money Laundering (AML), Fraud and Sanctions; Cybersecurity and Technological Governance; and Manipulative Trading— that highlight FINRA's increased focus on protecting investors and safeguarding market integrity against these ongoing threats." Report at 1. And it is significant, comprising nearly a quarter of the Report's content. None of these topics are new obligations, but it was notable how FINRA treated them. This should be a focus in examinations.

B. *Compliance personnel do not need to be able to write code, but familiarity with technology and data science is an increasingly important part of the job.*

As noted, FINRA highlights cybersecurity issues at the front of the Report. This, of course, involves technological considerations more than the Securities Exchange Act of 1934 or FINRA rules. However, grappling with technology is not confined to cybersecurity as this is a considerable component of best execution surveillance and trade reporting (e.g., Consolidated Audit Trail (CAT) and Blue Sheets) and other disclosures (e.g., Rule 606 reports). Technology also plays a significant role in monitoring compliance with the panoply of privacy laws (e.g., a data map is helpful to address GDPR, CCPA, etc.). Having a working knowledge of technology and data science – and, in particular, what data your firm maintains and where it is stored – is a critical tool in the toolbox.

C. *Policies and procedures continue to matter . . . and always will.*

FINRA mentions "procedures" 90 times, "controls" 51 times, "policies" 37 times and "WSPs" 33 times in the Report's 75 pages. Indeed, FINRA addresses the adequacy of process and procedures in some manner in almost every single topic. This is especially true in FINRA's commentary about Regulation Best Interest, which almost exclusively addresses policies and procedures to comply with the various obligations.

II. More on the Financial Crimes Section

It comes as no surprise that FINRA put cybersecurity at the front of the Report as it has issued at least 10 Regulatory Notices or Information Notices since 2020 concerning this topic. Consistent with this, FINRA now has its Cyber and Analytics Unit (CAU) that “examines member firms’ cybersecurity risk management through reviews of their controls”. Report at 3. The prospect of dealing with another FINRA exam unit should provide compliance personnel with another incentive to keep its lines of communication with its Risk Monitoring Analyst (RMA) and related FINRA personnel open. They may be able to help the firm with this specialized exam team, particularly if those examiners do not have the same level of familiarity with the firm’s business and structure.

FINRA also encourages firms to plan how they will respond to a cybersecurity breach, including maintaining a current inventory of assets that access its systems or data and determining how it will restore data from backup. Report at 5-6. The SRO also suggests that firms train their personnel on information security best practices and what to do in the event of a cybersecurity incident. Indeed, as Benjamin Franklin once said, “By failing to prepare, you are preparing to fail.”¹ No one saw the widespread disruption to business in March 2020 coming, yet there the industry was trying to maintain business as usual when the world was far from normal.

FINRA puts a finer point on the intersection of cybersecurity and AML by noting that it observed broker-dealers that did not have “reasonably designed procedures for investigating cyber events and considering whether a SAR filing is required or not following applicable guidance from the Financial Crimes Enforcement Network (FinCEN) when evaluating whether a cyber event requires the filing of a SAR.” Report at 7. (Again, note the emphasis on procedures.) This is another reminder that compliance personnel often need to take a multi-disciplinary approach when dealing with certain fact patterns.

Finally, FINRA reminds firms that financial crimes do not necessarily start on their premises because, as it recounted *Regulatory Notice 22-21*, it has observed an increased number of instances in which a bad actor opened an account using another customer’s identity, requested an account transfer from the customer’s legitimate account through ACATS, and upon receiving the ACATS transfer, liquidated the assets and withdrew the proceeds or transferred them to another firm. Report at 13. There is little question that our industry values speed and efficiency, but it is helpful to remember that discretion is the better part of valor in some areas. This is especially so when dealing with asset transfers. At risk of sounding like the late Yogi Berra, once the assets are gone, they are gone.²

Resources:

- *Powell, Converting Critical Enterprise Risks into a Usable Risk Assessment Matrix, March 2022 NSCP Currents*
- *Cybersecurity Toolkit, March 2022 NSCP Currents*
- *Stutz (ed. Smith, J.), How to Prepare for an SEC Cybersecurity Exam, October 2020 NSCP Currents*
- *Watanabe, Twelve Tips for Teleworking Cybersecurity, May 2020 NSCP Currents*
- *Anderson and Snider, The Hidden Risks of Data Aggregation, March 2020 NSCP Currents*
- *NSCP Currents Cybersecurity Special Issue*
- *Cybersecurity Exam Initiative Review Checklist*

1. See <https://www.goodreads.com/quotes/15061-by-failing-to-prepare-you-are-preparing-to-fail>.

2. Although Mr. Berra was an 18-time All-Star catcher of the legendary “Bronx Bombers” and a member of the Baseball Hall of Fame, he is probably better known for such gems as “It ain’t over till it’s over” and “When you come to a fork in the road, take it.” See, e.g., <https://ftw.usatoday.com/2019/03/the-50-greatest-yogi-berra-quotes>.

III. More on Technology

Not long ago, electronic compliance reports were considered cutting-edge surveillance. Now, of course, these are commonplace. And absolutely necessary given the increasing responsibilities placed on compliance departments. FINRA demonstrates all too clearly in the Report that compliance personnel must be at least familiar with technology and data science as it shows up in a number of critical surveillance areas. Below are some of FINRA's more interesting observations.

A. Consolidated Audit Trail (CAT)

The CAT has been one of the hotter topics in the compliance world since implementation began nearly three years ago. A broker-dealer may delegate the task of reporting its data to the CAT to a third party, but it cannot delegate the responsibility of reporting it correctly. A firm must still review its submissions to the CAT for timeliness and accuracy. The SRO notes that an effective practice for this includes “a comparative review of CAT submissions versus firm order records” and “[m]aintaining a ‘map’ that shows how the firm’s internal records and blotters correspond to various fields reported to CAT.” Report at 51. Compliance personnel need to have a working knowledge of the firm’s data structure, how those elements translate to the CAT’s data structure and the firm’s process for creating the reports. Compliance personnel must also be able to deploy this knowledge quickly and cogently as FINRA expects a broker-dealer to promptly respond to inquiries from its Rapid Remediation Review. Id.

Resources:

- [Smith, R., *A Strategy for Creating an Effective CAT Compliance Program, May 2022 Currents*](#)
- [CAT CAIS Registration, Testing & Certification – Steps for Small Firms](#)

B. Trade Execution and Reporting to Clients

Another hot topic is trade execution, particularly in light of the SEC’s recent proposals.³ FINRA continues to assess firms’ compliance with their best execution obligations under FINRA Rule 5310. Report at 2. FINRA highlights “[r]eviewing how PFOF [payment for order flow] affects the order-handling process” and “[c]onducting ‘regular and rigorous’ reviews, at a minimum, on a quarterly or more frequent basis (such as monthly), depending on the firm’s business model, **that consider the potential execution quality available at various trading centers, including those to which a firm does not send order flow**” as effective practices. Report at 54 (emphasis in the original). All of this requires a solid understanding of technical systems and data.

FINRA also reviews firms’ reporting obligations under SEC Rule 606, which includes “adequately conducting periodic “regular and rigorous reviews,” and clearly and completely disclosing the specific terms of any profit-sharing relationships—such as payment for order flow (PFOF)—with venues to which they route orders.” Report at 2. FINRA posts two effective practices – reviewing the vendors that provide the inputs (trade data) and reviewing the firm’s result (the report). Report at 57-58. Thus, as with surveilling CAT submissions, surveilling Rule 606 reporting is largely dependent on being familiar with the firm’s data and process for creating the reports.

3. See, e.g., Regulation Best Execution, SEC Rel. No. 34-96496, File No. S7-32-22 (available at <https://www.sec.gov/rules/proposed/2022/34-96496.pdf>); Order Competition Rule, SEC Rel. No. 34-96495, File No. S7-31-22 (available at <https://www.sec.gov/rules/proposed/2022/34-96495.pdf>); Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, SEC Rel. No. 34-96494, File No. S7-30-22 (available at <https://www.sec.gov/rules/proposed/2022/34-96494.pdf>); Disclosure of Order Execution Information, SEC Rel. No. 34-96493, File No. S7-29-22 (available at <https://www.sec.gov/rules/proposed/2022/34-96493.pdf>).

Resources:

- [Sample Best Execution Analysis](#)
- [Best Execution and Portfolio Management Trading Concern](#)
- [SEC Risk Alert, Observations Related to Regulation NMS Rule 606 Disclosures, November 2022](#)
- [Sample FINRA request regarding SEC Rule 606](#)

C. Fractional Shares

In a new section, FINRA discusses the issues associated with transactions in fractional shares, and in particular, reporting to the CAT and surveilling trade execution. Reporting such transactions to the CAT is outlined in the appropriate scenario(s) in the current version of the Industry Member Reporting Scenarios.⁴

Surveilling best execution for such transactions is not as straightforward. FINRA cites “[e]stablishing and maintaining reasonably designed best execution supervisory processes that address fractional share orders, order routing and executions; and regularly evaluating exception reports supporting the firm’s supervisory processes and modifying them, as appropriate, to reflect current market circumstances” and “[i]ncluding fractional share orders, routes and executions in regular and rigorous best execution reviews to confirm that the firm’s practices are reasonably designed to achieve best execution” as best practices. Report at 61. The biggest question remains how to do this when these orders trade much differently than round lot or odd lot orders. Again, understanding market structure, and the technology that support it, are keys to answering this question.

Resources:

- [Voter and Watanabe, U.S. Equity Market Structure, January 2023 NSCP Currents](#)
- [Egan, Broker-Dealers: Direct Market Access Compliance Continues to be a Focus for Regulators, September 2022 NSCP Currents](#)

IV. More on Policies and Procedures

Declaring that policies and procedures are a cornerstone of an effective compliance program should not come as any sort of great insight to anyone reading this article. However, in case one harbored any doubt, FINRA poses questions throughout the Report to prompt firms when assessing their own written supervisory procedures (WSPs) and processes. A sampling of these includes:

- *CAT* - “Do your firm’s CAT-related WSPs: (1) identify the individual, by name or title, responsible for the review of CAT reporting; (2) describe specifically what type of review(s) your firm will conduct of the data posted on the CAT Reporter Portal; (3) specify how often your firm will conduct the review(s); and (4) describe how your firm will evidence the review(s)?” Report at 50.
- *Communication Systems* - “Does your firm’s digital communication policy address all permitted and prohibited digital communication channels and features available to your customers and associated persons[?]” Report at 21.

4. See <https://catnmsplan.com/specifications/imreportingscenarios> for the current version.

- *Customer Protection Rule (SEC Rule 15c3-3)* - “What is your firm’s process to prevent, identify, escalate and resolve new or increased deficits that are in violation of the Customer Protection Rule?” Report at 70.
- *Funding Portals* – “What steps [are] your funding portal taking to ensure it maintains all required books and records in accordance with Regulation Crowdfunding Rule 404?” and “What steps [are] your funding portal taking to ensure on and off platform communications (including social media) do not offer or contain recommendations, solicitations or investment advice?” Report at 29.
- *OBA’s and PSTs* - “Do your firm’s WSPs explicitly state when and how registered persons must notify your firm of a proposed OBA or PST?” and “Does your firm have a process in place to update a registered person’s Form U4 with activities that meet the disclosure requirements of that form?” Report at 18.
- *Net Capital Rule (SEC Rule 15c3-1)* – “How does your firm assess the potential impact to net capital for new, complex or atypical transactions? Does your firm involve regulatory reporting staff in the process to assess these types of transactions?” Report at 43.
- *Private Placements* – “What policies and procedures does your firm have to address filing requirements and timelines under FINRA Rules 5122 and 5123? How does it review for compliance with such policies?” and “How does your firm confirm that associated persons conduct reasonable investigations prior to recommending private placement offerings, including conducting further inquiry into red flags?” Report at 44.
- *Regulation Best Interest* - “How does your firm track and memorialize the delivery of Form CRS and Reg BI-related disclosure documents to retail investors and retail customers?” Report at 34.
- *Regulation SHO* – “What is your firm’s process for determining if it can reasonably satisfy Reg SHO’s locate requirement prior to executing short sale transactions?” Report at 62.
- *Trusted Contact Person* - “Has your firm established an adequate supervisory system, including WSPs, related to seeking to obtain and using the names and contact information for TCPs and, if relying on Rule 2165, placing temporary holds to address risks relating to financial exploitations?” Report at 26.
- *Variable Annuities* - “How do your firm’s WSPs support a determination that a recommendation of a variable annuity exchange has a reasonable basis?”; “Do your firm’s policies and procedures require registered representatives to inform customers of the various features of recommended variable annuities, such as surrender charges, potential tax penalties, various fees and costs, and market risk?” Report at 47.

That said, it is not enough to have strong WSPs. Frankly, some would say having a procedure that cannot be reasonably executed or executed at all is worse than having no procedure. A firm must have systems and personnel to execute the WSPs. These do not have to be elaborate or elegant, just effective and repeatable. As a colleague once explained to me, whether it is a painting of dogs playing poker or a Rembrandt, it is still art. This is good advice, and hopefully, makes the task less daunting.

Resources:

- Allen and Watanabe, *Policies and Procedures – Service Providers, November 2022 NSCP Currents*
- Rubin, Hanna and Mount, *Everything Old is New Again: The SEC’s First Reg BI Enforcement Action, July 2022 NSCP Currents*
- Selman, *Foundation of Care: Conducting Due Diligence on Alternative Investments, April 2022 NSCP Currents*
- La Nuez, *Developing a Testing Plan: An Integral Part of a Well-Designed Compliance Program, April 2021 NSCP Currents*
- Nathan, *Key Checklists for Implementing and Maintaining GIPS Compliance, March 2021 NSCP Currents*
- Abbriano and Campbell, *Managing Compliance Concerns in the Wake of GameStop and Social Media Driven Volatility, February 2021 NSCP Currents*
- Mount, *How To Maximize Immunity Under State Senior Reporting Statutes, November 2020 NSCP Currents*
- Lefkowitz, *Practice Tips to Satisfy the Care Obligation of Due Diligence for BDs Under Regulation Best Interest, September 2020 NSCP Currents*
- MacKinnon, *Form CRS and Reg BI are Here: Now What?, August 2020 NSCP Currents*
- Danielson, *Remote Inspections of Branch Offices, June 2020 NSCP Currents*

V. Keep the Change

George Carlin wondered what happened to the other penny after someone asks you a penny for your thoughts and you give them your two cents.⁵ (Of course, the compliance officer would have likely told Mr. Carlin if the whereabouts of this additional penny must be disclosed.) Regardless if you believe that the above is worth one or two cents, I encourage you to give the Report a read as part of its utility is that it speaks to a wide range of broker-dealers and compliance personnel. More to the point, you can arrive at your own two cents and enhance your compliance program. ■

5. See <https://www.goodreads.com/quotes/17676-when-someone-asks-you-a-penny-for-your-thoughts-and>.