# Regulatory Alert

**Financial Services Regulatory Insight Center**

**October 2019**

## FINRA's 2019 Report on Examination Findings and Observations

### Key points

- FINRA's third annual report highlights examination findings and selected observations identified during supervisory examinations completed during 2019 in the areas of: sales practice and supervision, firm operations, market integrity, and financial management.
- FINRA notes a number of its findings are additive to issues identified in previous reports and continue to challenge firms.
- Firms are encouraged to use this and earlier reports as a resource to improve their compliance practices and processes based on the experiences of other firms and to better anticipate and address potential areas of supervisory concern.

*KPMG regularly assists clients in the review and/or remediation of the items highlighted by FINRA. Many of our clients have challenges with change management that may be very difficult to explain to FINRA. Strong risk assessments performed regularly and documented controls help ensure that policies and procedures are reasonably designed to help ensure compliance. Issues will continue to surface, but caught quickly and with the right compliance program, should aid in defense of supervision and failure to have reasonably designed processes. KPMG can assist firms with these efforts.*

FINRA's 2019 Examination Findings and Observations Report highlights key findings and observations identified in recent examinations as well as effective practices that may help firms improve their compliance and risk management programs. In contrast to reports in previous years, FINRA seeks to clearly distinguish between "findings," described as violations of a rule or regulation, and "observations," which are suggestions about how firms can improve controls to address perceived weaknesses that elevate risk but do not typically rise to the level of a rule violation or cannot be tied to a specific rule. ("Observations" were referred to as "recommendations" in earlier FINRA examination reports.)

The report covers four broad topics outlined below and summarizes relevant regulatory obligations as appropriate.

**Sales practice and supervision.** Key issues and findings include:

- **Supervision and documentation** – Inadequate supervision and written supervisory procedures and controls to address new or amended rules; detect or prevent various forms of falsified documents; or conduct reasonably designed branch supervision and inspection programs.

— **Suitability** – Inadequate supervisory systems to review the suitability of recommendations to individual customers; identify patterns of unsuitable recommendations or other "red flags;" scrutinize customer account changes; or impose controls to limit activity based on a customer's investor profile.

— **Digital communication** – Failure to maintain processes to identify and respond to "red flags" indicating registered representatives are using impermissible personal digital communications channels in connection with firm business, including conducting "electronic sales seminars."

— **Anti-money laundering** – Deficiencies in the design and implementation of systems and processes to detect and report suspicious activity, including failing to tailor AML resources to the firm's business, delegating outside of the AML department, and placing an overreliance on monitoring by clearing firms.

— **Uniform Transfers to Minors Act, Uniform Grants to Minors Act Accounts** – Failure to establish, maintain, or enforce supervisory systems to track or monitor when a beneficiary reaches the age of majority or to require the custodian to transfer the custodial assets to the beneficiary at that time.

**Firm operations.** FINRA's key issues and observations address:

— **Cybersecurity** – FINRA observed that the following practices can strengthen cybersecurity risk management programs:
  – Maintaining branch-level written policies
  – Documenting and implementing formal policies and procedures to manage critical vendors
  – Establishing and testing written incident response plans
  – Encrypting all confidential data of customers and the firm, whether held internally or with a vendor
  – Implementing policies for timely system patching; limited system and data access; information technology assets inventories; and change management processes for hardware and software changes.

— **Business continuity plans** – FINRA observed that firms were challenged to meet their business obligations when their plans did not reflect certain market conditions, business models, or other circumstances such as:
  – Mission-critical systems
  – Significant operational changes (e.g., outsourcing functions or relocating systems)
  – Capacity constraints (e.g., staffing, systems)

— **Fixed-income mark-up disclosure** – FINRA observed many of the same issues identified in its 2018 findings related to providing retail customers with transaction-related pricing information (including failure to enter information into order entry systems, improper adjustments to prevailing market prices, inadequate disclosures, and vendor issues) as well as new challenges related to:
  – Separate line item disclosures for additional charges, sales credits, or concessions
  – Incorrect determination of prevailing market prices
  – Mismatched disclosure of the time of execution between the customer confirmation and EMMA or TRACE.

**Market integrity**. Key issues and findings include:

— **Best execution** – Quality review and conflicts of interest issues continue to be identified. In particular, FINRA highlights that some firms struggled with: conducting quality assessment reviews of competing markets or based on type of order; considering and addressing potential conflicts of interest related to routing or orders to affiliated alternative trading systems or market centers; or adequately disclosing relationships with significant venues.

— **Direct market access controls** – Issues identified in 2017 and 2018 continued in 2019, especially with regard to fixed-income transactions. FINRA highlighted additional issues including insufficient or inadequate controls for financial risk management (covering capital thresholds and credit limits), intra-day (ad hoc) adjustments, duplicative and erroneous orders, and post-trade controls and surveillance.

— **Short sales** – Insufficient processes related to fails, including aging, allocation to correspondents, and inaccurate pre-fail credit.

**Financial management.** FINRA's key issues and observations address:

— **Liquidity and credit management** – FINRA observed certain practices to strengthen liquidity management programs that included updating plans to reflect current business, developing contingency plans, and stress testing. Strong credit risk management practices include evaluating risk management and control processes for accuracy, documentation of approvals, and exposures to affiliates.

- **Segregation of client assets** – challenges with check-forwarding and possession or control continue from 2018, including omitted or inaccurate blotter information, missing lien documentation, inaccurate reserve formula calculations, and account coding errors.
- **Net capital calculations** – issues identified in 2017 and 2018 continue and additional issues have been identified including:
  - Applying incorrect inventory haircuts because of inadequate assessments and monitoring of the creditworthiness of securities
  - Failing to recognize receivables due to insurance claims
  - Inaccurately accruing expenses on a firm's books and records and incorrectly netting intercompany accounts with affiliates.

* * *

FINRA's earlier reports are available here: 2017 Examination Report and 2018 Examination Report. Please click here to access KPMG's Regulatory Alert covering the 2018 Examination Report.

**For additional information** please contact Tracy Whille or Stefan Cooper.

*Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities*

**Amy Matsuo**
**Principal and National Lead**
Regulatory Insights
**T:** 919-664-7302
**E**: amatsuo@kpmg.com

**Contributing authors:**
Amy Matsuo, Principal and National Lead, Regulatory Insights

Karen Staines, Director, Financial Services Regulatory Insight Center

**kpmg.com/socialmedia**