

Investment Management

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FINRA 2019 Monitoring and Examination Priorities Letter

By **Ethan L. Silver**, **William Brannan**, and **Brian Nistler**

What You Need To Know:

- **FINRA Releases its 2019 Annual Risk Monitoring and Examinations Priorities Letter with new "Highlighted Items" section.**
- **Online Distribution Platforms and Digital Assets Businesses highlighted.**
- **"Payment for order flow" arrangements identified as a market risk.**

On Jan. 22, 2019, the Financial Industry Regulatory Authority (FINRA) published its 2019 Annual Risk Monitoring and Examination Priorities Letter (the 2019 Priorities Letter), which may be found [here](#). Unlike in previous years, the 2019 Priorities Letter has a section on "Highlighted Items" that focuses on emerging issues relating to FINRA's risk monitoring and examination programs. It also gives firms a look at how FINRA views these issues through wider regulatory and compliance lenses.

Although the 2019 Priorities Letter focuses on emerging issues, it still addresses long-standing concerns of FINRA. Further, FINRA will continue to use its regulatory program to monitor other areas aside from those addressed in the 2019 Priorities Letter, such as anti-money laundering (AML). Therefore, all FINRA member firms should not only familiarize themselves with the 2019 Priorities Letter but also be cognizant of past priorities letters and other FINRA guidance in order to ensure compliance with applicable rules and regulations and an understanding of the areas relating to their business lines that FINRA is prioritizing.

Highlighted Items in the 2019 Priorities Letter

Online Distributions Platforms (+ Digital Assets Business and Reg Tech)

As online distribution platforms relying on Rule 506(c) of Regulation D and Regulation A proliferate, FINRA is concerned that firms are not following the appropriate rules and regulations or are skirting all responsibility for compliance. The obligation to comply with appropriate rules and regulations is further complicated by the emergence of digital asset private placements and

the unique challenges that these products present in the context of online distribution platforms. Further, FINRA believes that certain platforms used by firms not registered with it should be registered, depending on the platform's conduct and activities. Firms should be diligent in ensuring that third-party vendors and those they conduct business with are properly registered as required so they are not sharing compensation illegally. Additionally, FINRA is concerned that many platforms are taking the position that they do not sell or recommend securities, and they should expect to be able to back up that assertion, especially in the digital asset context, and should expect heightened scrutiny from FINRA. Further, FINRA is concerned with how these platforms handle customer accounts and funds, receive transaction-based compensation, supervise communications, meet AML requirements, and conduct their suitability analyses.

As indicated, the SEC and FINRA are continuing to work through the application of traditional securities concepts to the emerging digital asset space. Issues such as Securities Exchange Act Rule 15c3-3 possession or control considerations with respect to digital assets held on the blockchain and the mechanics of secondary trading of private securities issued through initial coin offerings continue to act as touchpoints in membership applications and present challenges more broadly to the rollout of these types of digital asset services.

FINRA has indicated that it will work with the SEC to ensure that where a digital asset is a security, the firm has proper controls and supervision in place to handle these unique assets. FINRA has placed particular emphasis on ensuring that digital asset

businesses comply with AML/Bank Secrecy Act rules and regulations. FINRA recognizes that in an attempt to meet these obligations, many firms have turned to various regulatory technology tools to not only enhance the efficiency and effectiveness of existing systems but also to specifically address the unique challenges presented by digital assets. The lack of widely adopted industry-standard conventions in the digital asset space, compounded by issues such as anonymous blockchain protocols as well as the inherent security risks associated with the loss and/or misuse of blockchain wallet keys, presents obstacles to effective and compliant AML procedures.

Market Risk Priorities

Best Execution and Payment for Order Flow

FINRA reminds all firms of their obligations to obtain best execution for their customers' orders. However, both FINRA and the SEC have continued to apply greater scrutiny to the common practice of "payment for order flow" (PFOF) and its possible effects on a firm's best execution procedures. This increased focus accompanies the recently released updates to Rule 606 of Regulation NMS requiring firms to provide greater customer disclosure with respect to PFOF arrangements ([link](#)). Firms should be vigilant in documenting and reviewing all PFOF arrangements, preferably ensuring that all such arrangements across execution venues are on similar terms. Of special importance, we highly recommend that all firms routinely monitor their PFOF arrangements in order to satisfy their "regular and rigorous review" obligations pursuant to FINRA Rule 5310. As a final note, firms should be aware that in contrast to historical law, precedent and FINRA talking points on this issue, the 2019 Priorities Letter suggests that firms will need to be prepared to articulate to FINRA how they quantify the benefits to customers from their PFOF arrangements

and how they are managing the conflict of interest between their duty of best execution and the payments received under such arrangements.

Additional Priorities

- **Fixed-Income Markup Disclosure**
- **Sales Practice Risks**
 - **Suitability**
 - **Senior Investors**
 - **Outside Business Activities and Private Securities Transactions**
- **Operational Risks**
 - **Customer Due Diligence and Suspicious Activity Reviews**
- **Market Risks**
 - **Market Manipulation**
 - **Market Access**
 - **Short Sales**
 - **Short Tenders**
- **Financial Risks**
 - **Credit Risk**
 - **Funding and Liquidity**

Lowenstein Sandler's Investment Management Group is available to answer any questions relating to the 2019 Priorities Letter and your business. Similarly, we are available to assist you in developing best-in-class policies and compliance programs for your firm in accordance with all applicable rules and regulations and industry standards. FINRA-regulated members should take care to re-examine their existing compliance program in light of the 2019 Priorities Letter.

In the interim, please contact any of the authors of this article, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed in this alert or with any questions you may have regarding compliance with FINRA rules and regulations.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

ETHAN L. SILVER

Partner

T: 212.419.5862

esilver@lowenstein.com

WILLIAM BRANNAN

Counsel

T: 646.414.6977

wbrannan@lowenstein.com

BRIAN NISTLER

Associate

T: 646.414.6924

bnistler@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

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