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Risk Management

Nine Risks That Inform FINRA's Examination and Surveillance Program

Mar. 16, 2017
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FINRA has a broad purview when it comes to examining and investigating firms and enforcing regulations and rules within the financial industry. There are nine areas of risk that continually arise in the discussions between FINRA and representatives of its member firms. These fall into two general categories:

1. financial and operational risks, encompassing the areas of credit, liquidity, market, net capital, operations and segregation of client assets; and
2. sales practices and business conduct risks, encompassing fraud and deception, money laundering and sales.

These points came across in a panel discussion presented by FINRA, entitled "A Few Minutes With FINRA – Nine Risks That Inform FINRA's Examination and Surveillance Program." Moderated by Chip Jones, FINRA's Senior Vice President for Member Relations and Education, the panel featured Bill Wollman, FINRA's Executive Vice President for the Office of Risk Oversight and Operational Regulation, and Mike Rufino, FINRA's Executive Vice President for the Office of Sales Practice.

The panel discussion provided valuable insight for any fund manager with an affiliated broker-dealer, as well as all fund managers that trade with broker-dealers, about the principle risks those firms face. This article explores the nine risks outlined by the panelists.

For more on FINRA, see "OCIE 2017 Examination Priorities Illustrate Continued Focus on Conflicts of Interest; Branch Offices; Advisers Employing Bad Actors; Oversight of FINRA; Use of Data Analytics; and Cybersecurity" (Jan. 26, 2017); and "What the Record Number of 2016 SEC and FINRA Enforcement Actions Indicates About the Regulators' Possible Enforcement Focus for 2017" (Dec. 15, 2016).

Financial and Operational Risks

Credit Risk

Credit risk is the risk that a market participant will lose money through lending money to someone else. The varieties of credit risk are many and diverse, Wollman said, but in the broker-dealer business, the bulk of the credit risk that FINRA members face is secured by securities or other assets. Drawing a contrast with the banking world, where banks normally make unsecured

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loans, he remarked, "At its core, credit risk is not all that high compared to, let's say, a bank, but we are interested in it, and we'd like to monitor for how firms are dealing with it."

The largest firms quite naturally have a greater chance than smaller ones to encounter credit risk in the course of their business, and even though the lending may be secured lending, it is not free from risk. As an example, Wollman noted that the larger firms may engage in repurchase transactions (*i.e.*, repos), where they lend money and receive collateral in return in the form of securities. Firms will borrow and lend securities to each other as part of their routine operations, and will also make margin loans to clients. See "Morgan Stanley Sues Commodities Hedge Fund Peak Ridge for Alleged Failure to Satisfy Margin Calls" (Nov. 19, 2010). Wollman described those activities as comprising the most significant portions of a typical broker-dealer's balance sheet.

Given that the activities described above are largely in the domain of the bigger firms, Wollman said, he and his colleagues wrestled with the question of how much attention should be paid to smaller firms as they put their monitoring programs into place. Upon consideration, it was clear enough that the small firms with customers engaging in margin borrowing were subject to significant risk, since those small firms will incur obligations to a clearing firm to reimburse for any client that does not pay a loan back.

Consequently, credit risk is not strictly limited to firms of one or another profile, Wollman acknowledged, stressing that he and his colleagues focus on margin lending made from the clearing firm to the clients. "What is the small firm doing to make sure that the margin loans that they're allowing their clients to have are not concentrated, or that they have the right risk profile of each client?" he asked.

Despite the existence of some limited-purpose business models that face relatively minimal credit risk, Wollman sees FINRA's risk assessment process as being largely applicable on one level or another to the bulk of FINRA's roughly 4,000 member firms.

Liquidity Risk

Wollman described liquidity risk as a highly prominent one. Looking at the cases of larger firms that have had serious problems in recent years, such as Lehman Brothers and MF Global, Wollman explained that liquidity was a core issue behind some of their problems. Institutions with liquidity problems are unable to pay off their short-term obligations because they have run out of cash. Although they were not yet bankrupt, they did not have enough cash on hand to do business.

FINRA has issued notices addressing liquidity risk for some time, even before the genesis of the new program under discussion here, Wollman noted. He cited FINRA Regulatory Notice 10-57, which lists a number of factors of vital importance when considering liquidity risk. Stress testing was one of the key criteria identified in this notice, which urged firms to think about possible mishaps and about how much cash they had on hand to meet their obligations.

Another publication Wollman cited is FINRA Regulatory Notice 15-33, which discusses a standardized stress test that he and his colleagues carried out on more than 43 firms with a view to assessing how prepared they were to deal with liquidity risk. The notice outlined a stress test that FINRA had designed and urged firms to apply it.

For guidance from other regulatory bodies on how asset managers should manage liquidity, see "FCA Outlines Priorities of Liquidity and Fair Practices for Open-End Funds Investing in Illiquid Assets" (Mar. 16, 2017); "FSB Recommends Essential Risk Mitigation Requirements for Asset

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Managers" (Aug. 25, 2016); and "FSOC Report Focuses on Liquidity, Leverage and Other Risks Facing Hedge Fund and Asset Managers" (Apr. 28, 2016).

Market Risk

Market risk is the risk that a firm will lose money from changes in asset prices, typically market-traded asset prices for bonds or equities. While acknowledging that market risk could come into play in real estate, for example, Wollman said that he and his colleagues are looking at marketable securities and the impact they may have on a firm.

When people learn of FINRA's interest in this area, Wollman explained, a common reaction is to ask why a small firm, without the resources and sophistication of one of the larger firms, would come into the discussion. There are many ways to look at the issue of controlling market risk, however, he maintained.

"Even just looking at the notional size of the position you carry, how big are your positions relative to your capital or your available funding? The bigger, the more chance you have to lose money that's sizable. So, that's a very basic [test] that people can do," Wollman said.

Brokerage firms that make use of more elaborate strategies can advance to more sophisticated means of measuring market risk. One example is to assess value at risk (referred to as VaR), using statistical methods to predict how much a firm might lose in a given portfolio. Another method is to look at the positions that a firm holds and consider how sensitive they may be to market changes. For example, a firm holding a portfolio of fixed income securities can calculate their sensitivity to a fluctuation in interest rates.

Wollman emphasized that in raising all these issues with firms, he and his colleagues are not presuming to tell them whether a given risk is appropriate. The goal is for the firms to understand the risk they are taking, as well as how to limit risk and avoid disaster.

Net Capital Risk

When designing FINRA's risk hierarchy, Wollman noted that one question he and his colleagues considered was whether they should focus on the adequacy of a member firm's net capital or its accuracy. Both are important, but net capital risk is directly tied to accuracy, and one of FINRA's primary tasks is to enforce the SEC's net capital rule. Wollman described the net capital rule as important for ensuring that a firm has sufficient resources to do business.

"When we get net capital reported to us through the FOCUS reports,[1] it's important for us to know how accurate that is because we may only examine a firm every two, three or four years. In between, we're reviewing a lot of FOCUS report filings, and it's helpful for us to know how accurate the net capital computation is," Wollman explained.

Adequacy of net capital is a different kind of issue. If someone takes on a risky securities portfolio, for example, then the question arises of how much he or she can afford to lose versus how much capital is on hand.

Operational Risk

Operational risk encompasses more than simply a firm's daily operations. Books and records, oversight of technology and cybersecurity are examples of areas where operational risk comes into play. Wollman explained that operational risk is the likelihood that mishaps will occur because people do not do what they are supposed to do. To counter operational risk, it is
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necessary to assess how well a compliance department is functioning. "Is compliance strong? Do they have a strong voice? Are they able to identify where the business line is veering off from the path that was intended?" Wollman asked.

Assessment of operational risk as it exists today is a relatively new responsibility, but it forms a critical component of FINRA's surveillance and enforcement program. If a firm can demonstrate that it has made the necessary investments in compliance efforts and that it has solid internal controls and procedures, this can help FINRA become comfortable about the firm's general risk profile.

Segregation of Client Assets

A core function of FINRA is to make sure that firms do not use client assets improperly. When it comes to segregation of client assets, Wollman and his colleagues look closely at firms' compliance with SEC segregation rules. Many firms do not compute a reserve computation or do not take and handle securities, Wollman noted. For those firms, a critical question is how they meet their exemption from the reserve requirement and whether, for example, they handle checks and forward them. While much of the effort focuses on smaller firms, it is also critically important to make sure that the larger firms are segregating assets properly.

Sales Practice and Business Conduct Risks

Fraud and Deception

Rufino defined fraud as potential harm to customers caused by a firm or its registered representatives or personnel. The agent of fraud could be the firm itself or its employees. Depending on the scenario, Rufino clarified, fraud and deception could affect either a firm or its customers.

Unauthorized trading is one common example of fraud, and fraud in the offering of securities is another. On the market manipulation side, insider trading is another key category of fraud. Further examples include front-running and cherry picking. For SEC enforcement cases involving cherry picking, see "Hedge Fund Adviser Structured Portfolio Management Settles SEC Charges Relating to Improper Trade Allocations and Investor Disclosures" (Sep. 25, 2014); and "SEC Charges Hedge Fund Manager and Its Founder With Securities and Investment Adviser Fraud Based on 'Cherry Picking' of Trades" (Jan. 3, 2013).

"We continue to monitor for fraud, and it's something that we will continue to monitor for. If you have that going on within your respective firms, it's obviously quite concerning from a regulatory perspective," Rufino added.

Money Laundering

Part of the risk of money laundering is the impact it can have on the overall financial markets and on financial institutions themselves. The common definition encompasses the running of illicit funds through a financial institution such as a broker-dealer.

Rufino and his colleagues hope and expect that a firm will have a robust anti-money laundering (AML) program in place, and that the program will have certain key specifications, tailored to the firm's customers, geographical location and the type of securities and products being marketed and sold. "That's what we're looking for when we look at a firm's overall program," Rufino said.

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See "FCA 2016-2017 Regulatory and Supervisory Priorities Include Focus on AML, Cybersecurity and Governance" (Apr. 14, 2016).

The expectation when he and his colleagues examine a firm is not that they will find money laundering, Rufino stressed. Rather, they go in with a view to assessing a firm's overall AML program, determining whether the firm has the necessary policies, procedures and controls in place, and ascertaining whether the firm has personnel with the requisite experience to review and evaluate the activity going through the broker-dealer from the point of view of both money and securities.

Rufino said that he and his colleagues have seen situations where an AML program was not up to par or did not fit the firm's business model or clientele. They have also experienced cases where people simply were not following a firm's AML policies and procedures and not carrying out the necessary assessments. The result was an overall breakdown in AML procedures and compliance. Rufino and his colleagues have encountered failures in suspicious activity reporting, which he described as core to an AML program.

Issues have also cropped up with respect to customer identification. "The ability to identify customers, to verify their identities . . . to know your customers and to surveil your customers for suspicious activity is core," Rufino said.

Sales Risk

Sales risk comes into play when a firm is selling to certain classes of vulnerable customers, such as senior investors, those with diminished capacity or those who may have extremely limited education when it comes to financial services and products. FINRA takes this type of risk seriously and has established a senior help line to help such customers avoid or deal with deceptive practices and other forms of bad behavior on the part of brokers.

Another critical component of sales risk concerns whether the same of more complex products, such as exchange-traded funds and variable annuities, are suitable for the particular investor, explained Rufino.

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[1] FINRA members are required to prepare and file FOCUS reports with FINRA pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. FOCUS is an acronym for "Financial and Operational Combined Uniform Single" report.

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