

Financial Industry Regulatory Authority, Inc. (FINRA) 2014 Regulatory and Examination Priorities Include “Recidivist” Brokers, Conflicts of Interest, Frontier Funds, Crowdfunding Portals

Article By:

Neal, Gerber & Eisenberg LLP

On January 2, 2014, the Financial Industry Regulatory Authority, Inc. (FINRA) released its annual letter (Letter) identifying its regulatory and examination priorities for 2014. According to Susan Axelrod, FINRA’s Executive Vice President, Regulatory Operations, “The purpose of this letter is to provide insight to the industry on specific areas of concern for our regulatory programs in the coming year. We encourage firms to use this guidance along with their own analysis to enhance their programs as we will be examining for strong controls and robust compliance efforts in these areas.”

The Letter is divided into four broad categories: Business Conduct Priorities, Fraud Priorities, Financial and Operational Priorities, and Market Regulation Priorities. Although numerous “areas of concern” were identified again this year by FINRA, including concerns relating to the suitability of complex products (particularly the suitability of interest-rate sensitive products) for retail investors, the sale of private placement securities, anti-money laundering compliance, insider trading, margin lending practices, and algorithmic trading, in this Alert we focus on FINRA’s inclusion of four new Business Conduct Priorities identified in the Letter for 2014: recidivist brokers, conflicts of interest, the suitability of “frontier funds,” and crowdfunding portals.

Focus on Recidivist Brokers—and the Firms that Hire Them

As set forth in the Letter, FINRA announced its intention to expand a program first implemented last year to identify brokers with substantial sales practice complaints and disciplinary histories, the “High Risk Broker Initiative.” In 2014, FINRA intends to create a “dedicated Enforcement team” to investigate and prosecute such brokers. Of importance to all firms that undertake to hire such brokers is FINRA’s explicitly stated intention to closely review the due diligence conducted by such firms in the hiring process, the adequacy of supervision of these recidivist brokers, and the heightened scrutiny FINRA examiners will afford client accounts managed by these brokers.

Review of Firms’ Conflicts of Interest Management

FINRA also announced its intention to evaluate firms’ conflicts management practices, “focusing

primarily on actions taken by firms and the impact on their clients.” In October 2013, FINRA released its Report on Conflicts of Interest, a report summarizing the approaches taken by numerous member firms to effectively manage conflicts of interest. Utilizing the topics identified in the report, in 2014 FINRA examiners will evaluate, among others, the following areas:

- Extent of participation of senior management in conflict management;
- Review of new products to identify and mitigate potential conflicts;
- Post-launch product reviews to assess performance;
- Process for supervising offering and sales of proprietary products; and
- Identification and mitigation of potential conflicts created by firm compensation structures.

Suitability of “Frontier Funds”

FINRA has included in its 2014 list of products deserving of particular scrutiny as to suitability for retail investors so-called “frontier funds,” described as funds that “invest in what some fund managers believe to be the next emerging markets.” As noted in the Letter, “Heightened risks associated with investing in foreign or emerging markets generally are magnified in frontier markets. Many frontier markets operate in politically unstable regions of the world and are subject to potentially serious geopolitical risks.” The risks of less liquidity and lowered investor protection are, therefore, exacerbated. As with the sale of any complex product, the suitability inquiry here in general will be:

- Is there a process in place to ensure that an appropriate suitability analysis has been performed in accordance with FINRA Rule 2111?
- Does the registered representative who recommended frontier funds have a thorough understanding of all features and risks sufficient to communicate them effectively to retail clients?
- Does the registered representative have a reasonable basis to believe that the particular retail client is capable of evaluating—and bearing—the risks of the investment?

Compliance with Pending Rules Governing Crowdfunding Portals

The JOBS Act generally will, among other things, allow retail investors to purchase unregistered securities offered through intermediary crowdfunding websites, in addition to registered broker-dealers. The Securities Exchange Commission (SEC) and FINRA proposed rules governing this process on October 23, 2013, and comments on the proposed rules are due by February 3, 2014. Crowdfunding portals, which will be required to register with the SEC and FINRA, will be substantially more limited in their permissible activities compared to registered broker-dealers. Among other prohibited activities, a crowdfunding portal may not solicit purchases, sales, or offers to buy securities, compensate promoters or finders, or hold, manage, or accept customer funds. In its Letter, FINRA advised of its intention to implement a regulatory program “designed to protect investors while recognizing the distinctions between funding portals and broker-dealers.”

For More Information

A copy of FINRA's 2014 Regulatory and Examinations Priorities Letter may be found [here](#).

A copy of FINRA's October 2013 Report on Conflicts of Interest may be found [here](#).

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