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FINRA Keeping Pressure on Complex Products in 2014.

Annual list of priorities has old favorites as well as some new areas of concern

Finra's opening salvo of 2014, its annual list of examination priorities, sent a clear message to broker-dealers, especially those dealing in complex products: Don't expect any relief in the new year.

The document, which Finra's approximately 4,200 member firms will review carefully to shape their compliance efforts in the coming year, re-emphasized common trouble spots for broker-dealers, while also ratcheting up enforcement in key areas, including interest-rate-sensitive products and rogue brokers.

"It's kind of like, 'We're going to look at everything like we always do every time,'" said Daniel Wildermuth, chief executive of Kalos Financial.

PRODUCT CONCERNS

Nontraded real estate investment trusts, complex structured products, emerging-markets investment funds, mortgage-backed securities, long-duration bond funds and municipal securities are among Finra's priorities in its monitoring program, according to the letter, which was posted on its website last Thursday.

Complex structured products have made the list every year since Finra began sending the letter out in 2006 under the National Association of Securities Dealers, so their inclusion came as little surprise, according to Joe Halpern, who runs Exceed Investments, a product development company focused on structured investments.

"Structured products will be on this list forever," he said. "This whole list is a fair list of the complex products out there."

The new twist this year was Finra's focus on fixed-income products and hedging products that could be susceptible to interest rate volatility. The regulator included investments such as long-duration bond funds and emerging-markets debt on its list of concerns.

"Finra remains concerned about the suitability of recommendations to retail investors for complex products whose risk-return profiles, including their sensitivity to interest rate changes, underlying product or index volatility, fee structures or complexity may be challenging for investors to understand," Finra's letter stated.

Mr. Wildermuth, whose firm focuses on alternative investments and structured products, said he agrees with Finra's concerns that investors might not understand the impact of rising rates on these products, but he also said that Finra's regular inclusion of these products on its watch list continues to make it tough on firms that seek to employ these strategies legitimately.

"I don't disagree with interest rate sensitivity, but I do disagree with the assumption that they're boxing you into a corner that anything you do is suspect or suspicious," he said.

Executives at Mr. Wildermuth's firm have found themselves trying to keep ahead of regulator demands. The firm hosts weekly two-hour due-diligence meetings and he said that one of the most helpful practices has been increasing its record keeping.

In the end, brokers have to take Finra's focus in stride, said the head of an industry trade group for the nontraded real estate investment trusts.

"There's not anything out of the ordinary there that has us concerned," said Kevin Hogan, president and chief executive of the Investment Program Association. "I don't think there's undue scrutiny. It's their recognition that this product is not a mainstream stock or bond. There's some complexity."

Mr. Hogan agrees with Finra that selling complex products requires enhanced training for sales representatives.

"Education and training is important to this industry in particular," Mr. Hogan said.

Steven Thomas, director of compliance at Lexington Compliance, a division of RIA in a Box, said that financial advisers need to be even more careful with hedging products, what he calls "land mines" in a volatile interest-rate environment.

"If you haven't been vigilant in documenting why you've been recommending these products and strategies, you better reassess your process and procedures. Otherwise, you're going to get tagged [by Finra] for putting your clients in unsuitable investments," said Mr. Thomas, former chief compliance officer for South Dakota. "If you've planted the land mines, you better not step backward."

ROGUE BROKERS

Finra also said that it will expand a program implemented last year to target rogue brokers who land at new firms after being disciplined or fired.

"When Finra examines a firm that hires these high-risk brokers, examiners will review the firm's due diligence conducted in the hiring process, review for the adequacy of supervision of higher-risk brokers — including whether the brokers have been placed under heightened supervision — based on the pattern of past conduct, and examiners will place particular focus on these brokers' clients' accounts in conducting reviews of sale practices," the Finra letter states.

Mr. Thomas supports Finra's crackdown on brokers who have a history of disciplinary problems.

"There's not enough legitimate and accurate reporting about why someone has left a firm," Mr. Thomas said. "Firms are afraid of defamation of character lawsuits."

But he cautioned that the pipeline between the insurance and securities industries is not being monitored well enough, allowing problem insurance brokers to restart their careers at securities firms.

"There is not a national reporting system for insurance bad apples," Mr. Thomas said.

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