Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS NOVEMBER 10, 2010

FINRA Issues Guidance on Broker-Dealer Funding and Liquidity Risk Management Practices

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued Regulatory Notice 10-57 (the "Notice") to alert member firms that it expects broker-dealers to develop and maintain robust funding and liquidity risk management practices in preparation of adverse circumstances, including instances where funding necessary to cover a broker-dealer's operations is unavailable or prohibitively expensive. FINRA identifies several risk management practices it has observed through examinations and surveys of mid-sized and large broker-dealers that hold inventory positions and carry customer accounts. Although the Notice is not intended to provide a comprehensive description of all appropriate funding and liquidity risk management practices, it is provided as guidance to broker-dealers and as a resource in preparing for adverse firm-specific events or systemic credit events. The full text of the Notice is located at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122388.pdf.

Suggested Practices for Funding and Liquidity Risk Management

FINRA expects broker-dealers to regularly review their risk management practices in order to maximize the possibility of operating under adverse firm-specific circumstances or systemic credit events. Broker-dealers affiliated with holding companies are expected to conduct this analysis at the broker-dealer level in addition to planning at the holding-company level.

The Notice provides several practices which can help broker-dealers prepare for various scenarios that could jeopardize their liquidity positions and ability to fund operations (such as the loss of funding sources, unanticipated deteriorations of asset quality, contagion across markets, and volatility in future earnings). The suggested practices are not intended to be comprehensive or exhaustive, and each broker-dealer should consider the practices that are best suited to its operations.

Risk Limits and Reporting

A broker-dealer's senior management and governing board should be fully informed of the firm's risk management policies and procedures, and should participate in setting and periodically re-evaluating the levels of funding and liquidity risk the firm is willing to accept. Senior management should ensure that determinations of risk tolerance are communicated throughout the organization so managers of the various business lines can set appropriate risk limits and evaluate the risks presented by various markets and counterparties.

Robust systems that capture funding and liquidity exposure in a timely manner and across all business lines should be maintained. FINRA believes that it is critical to have escalation procedures where appropriate management is notified when pre-established limits are exceeded. This includes provisions for determining when breaches should be immediately reported to senior management.

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Appropriate staff should also consider regularly reviewing quantitative and qualitative risk reports with senior management. The scope and frequency of evaluating funding and liquidity levels will vary depending on the firm's size and complexity, but FINRA believes that analysis should include the following measures, among others:

- the amount of excess liquidity available;
- future cash-flow projections based on multiple scenarios, including under stressed conditions;
- the maturity profile of available funding sources;
- liquidation and mark-down assumptions for inventory positions, including those based on mark-to-model values;
- price volatility and correlation trends with respect to certain asset classes;
- inventory concentrations in related asset classes;
- the usage and limits of secured and unsecured lines of credit;
- how existing risk levels compare with pre-established risk limits;
- the level of funding through particular markets and position concentrations for certain counterparties; and
- the ability to timely monetize assets that have been set aside in an excess liquidity pool.

Independent Risk Oversight

FINRA encourages firms to use staff independent of business lines to ensure that the firm does not exceed levels of risk tolerance set by senior management and the board. The selected staff should perform functions such as:

- analyzing exposure across business lines,
- monitoring for early warning signs concerning potential funding and liquidity problems,
- evaluating pricing decisions,
- performing stress tests, and
- maintaining and regularly updating contingency funding plans.

Maturity Profile of Funding Sources

FINRA is concerned that during the recent credit crisis many financial companies discovered that they relied too heavily on short-term funding to finance long-term assets. Broker-dealers that use this form of financing should regularly assess their ability to operate under a variety of market conditions and firm-specific events. Firms should consider the following steps in order to match fund holding periods:

- extend maturity terms beyond overnight for repurchase agreements or other short-term funding sources and
- establish irrevocable lines of credit or other supplementary sources of short-term funding.

Red Flags of Potential Funding and Liquidity Problems

Many broker-dealers have programs that monitor for early warning signs of funding and liquidity problems. These programs trigger red flags, indicating to management the need to take immediate action or perform additional monitoring. The Notice sets forth an extensive list of red flags that firms should consider as part of any monitoring program.

Inventory Valuation

FINRA believes that strong practices for identifying the true liquidation value of inventory holdings are essential for an effective funding and liquidity management program. The Notice indicates that it is important to have staff which is technically competent, independent from the firm's lines of business, and empowered to challenge pricing assumptions in order to evaluate pricing decisions. Firms should consider using controls to ensure that:

- firms value securities and derivative instruments daily based on current fair values;
- each business line correctly and consistently categorizes assets;
- firms use consistent prices across business lines so that each security has only one price across the firm's inventory positions, reverse repo, repo, and customer collateral;
- valuation methodologies are re-evaluated periodically (with greater frequency in rapidly changing market conditions) and when realized results have deviated from results that were expected based on the firm's methodologies; and
- inputs and resources used in verifying prices are well-documented and independent from the trader.

Material deviations from expected results should be reviewed with senior management for all product lines. The Notice encourages firms to establish procedures for senior management to formally approve price modeling assumptions and to develop policies and procedures for determining circumstances under which pricing information is to be shared with the firm's governing board.

Stress Tests

FINRA believes that firms can use stress-testing programs to help identify and quantify potential sources of liquidity strains and any subsequent effects on cash flows, profitability, and solvency. Firms should consider performing stress tests on a regular basis that contemplate firm-specific and market-wide events for varying time horizons and levels of liquidity duress. The Notice sets forth a list of items for firms to consider in conducting stress tests. The Notice also encourages firms to establish procedures for senior management to review and formally sign-off on stress testing results.

Contingency Funding Plan

Having a contingency funding plan may help a broker-dealer prepare for and manage situations where extraordinary fluctuations in liquidity occur. FINRA encourages firms' governing boards and senior management to consider maintaining and regularly updating contingency funding plans in order to:

- clarify responsibilities and decision-making authority so that all personnel understand their roles during a potential credit crunch;
- match sources of funds with contractual and potential obligations;
- list contingency funding sources and identify when they should be employed;
- identify business restrictions and reductions that may be employed to counteract a strain on liquidity, such as reducing certain trading positions, limiting or reducing margin loans, calling for additional margin or collateral from customers, or other measures that may be needed to manage liquidity risks; and
- identify the various operational conditions that could affect access to back-up credit lines, such as credit rating triggers or loan covenants (e.g., leverage ratios), and outline plans in the event of loss of such funding sources.

The Notice encourages firms to establish procedures for senior management and governing boards to formally sign-off on the contingency funding plans.

Use of Customer Assets

Under Rule 15c3-3 of the Securities Exchange Act of 1934, a carrying broker-dealer must calculate what amount, if any, it must deposit in its reserve bank account on behalf of customers. Under this "reserve formula," a carrying broker-dealer generally must determine the amount of cash it owes to its customers and the amount of funds generated through the hypothecation of customer securities (i.e., credits) and compare this amount to any amounts its customers owe it (i.e., debits). If customer credits exceed debits, a carrying broker-dealer must deposit the net amount in its reserve bank account. For firms that carry customer funds exceeding $1 million, this computation must be made weekly, as of the last business day of the week, and the deposit must be made no later than the second business day following the computation.

The Notice cautions carrying broker-dealers against taking advantage of the fact that the reserve formula is only required to be computed weekly by using customer assets (cash and securities in margin accounts) in the interim periods to help fund operations. FINRA notes that excessive reliance on this approach may create unacceptable risks and be an indication of funding and liquidity stress. The Notice encourages carrying broker-dealers to:

- establish and enforce limits on the use of customer cash and the hypothecation of customer securities and
- consider developing contingency plans to prepare for possible customer withdrawal of assets, particularly at an accelerated rate.

Conclusion

The Notice urges broker-dealers to be proactive in reviewing and improving funding and liquidity risk management practices. Firms should review the sound practices discussed in the Notice and adapt policies and procedures as appropriate to a particular firm's size and structure.

If you would like to discuss any of the issues discussed in this Client Alert, please contact Scott Anderson or any other attorney in our Investment Management Group or visit us online at chapman.com.

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