Client Update
FINRA Focuses on Broker-Dealer Liquidity Risk Management

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On September 15, 2015, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 15-33 (the "Notice") entitled "Guidance on Liquidity Risk Management Practices."[1] The Notice stakes out FINRA's position on liquidity risk management as an important function for its member broker-dealers and discusses the areas that FINRA considers relevant when determining whether a firm has implemented appropriate liquidity risk management practices. FINRA developed the contents of the Notice in the course of examining the liquidity practices of 43 firms with the twin goals of understanding existing practices and "raising awareness of the need for liquidity stress planning" at broker-dealers.[2]

The Notice comes at a time when the Basel Committee and U.S. banking regulators are focused intently on liquidity risk through the recently developed liquidity coverage ratio ("LCR") and net stable funding ratio ("NSFR").[3] U.S. banking organizations have started to implement the requirements of the LCR, which was finalized on September 3, 2014, and must be fully implemented by January 1, 2017.[4] The LCR, in broad terms, requires banking organizations, on a

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1 FINRA, Notice 15-33, *Guidance on Liquidity Risk Management Practices* (Sept. 3, 2015), *available at* https://www.finra.org/industry/notices/15-33.

2 *Id.* at 2.

3 *See* Lee A. Schneider, Chen Xu & Gregory J. Lyons, *Application of Recent Liquidity Regulations to Banking Organizations and Key Impacts When Implementing Them*, J. TAX'N & REG. FIN. INST. (May/June 2015).

4 *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (Oct. 10, 2014); *see also* Byungkwon Lim, Gregory J. Lyons, Satish M. Kini, Lee A. Schneider, David L. Portilla, Samuel E. Proctor, Amelia Russell & Chen Xu, *Questions and Answers on the Liquidity Coverage Ratio*, HARVARD L. F. CORP. GOVERNANCE & FIN. REG. (Oct. 4, 2014), *available at* http://corpgov.law.harvard.edu/2014/10/04/questions-and-answers-on-the-liquidity-coverage-ratio/.

consolidated basis, to keep one dollar of high quality liquid assets for each dollar of expected net cash outflows over a thirty-day period. The NSFR is designed to complement the LCR by requiring banking organizations to, in effect, have capital and long-term borrowing facilities in place to support their assets. While the regulators have not yet proposed a U.S. version of the NSFR, the Basel Committee finalized the global version on October 31, 2014.[5]

With the Notice, FINRA now seeks to have its member broker-dealers make liquidity management part of their best practices: "[e]ffective liquidity management is a critical control function at broker-dealers and across firms in the financial sector."[6] While bank-affiliated broker-dealers must grapple with these issues as part of a consolidated financial services organization, the Notice plainly states that these firms must also consider liquidity even within their four walls.

DISCUSSION: FINRA EVALUATES LIQUIDITY RISK MANAGEMENT PRACTICES

The Notice is based upon FINRA's review of 43 firms' practices with respect to liquidity risk management and its view of the need for liquidity stress planning to ensure firms properly measure and consider liquidity needs in a stressed environment. FINRA chose a thirty-day stress period as the time frame for effective liquidity risk management.[7] In analyzing each firm's preparedness for such a situation, FINRA assessed: (1) the impact on liquidity of five scenarios that stressed the firm's business and (2) any mitigating actions the firm could take to offset stressed outflows of cash. FINRA noted that it developed the stress scenarios based in part on situations that have led to failures of broker-dealers. The five scenarios involved:

- Loss of funding from inventory positions due to devaluation;
- Stressing of match-book repo and securities lending transactions;

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5 Basel Committee on Banking Supervision, *Basel III: The Net Stable Funding Ratio* (Oct. 31, 2014), *available at* http://www.bis.org/bcbs/publ/d295.htm; *see also* Gregory J. Lyons, Satish M. Kini, Lee A. Schneider, David L. Portilla, Melissa A. Mitgang, Samuel E. Proctor & Chen Xu, *Basel Committee Adopts Net Stable Funding Ratio: How Much Liquidity is Enough?*, HARVARD L. F. CORP. GOVERNANCE & FIN. REG. (Dec. 13, 2014), *available at* http://corpgov.law.harvard.edu/2014/12/13/basel-committee-adopts-net-stable-funding-ratio/.

6 Notice at 1.

7 The LCR also looks at a 30-day period.

- Operational items such as clearing deposits were assumed to dramatically increase;
- Customer withdrawals of free credit balances over the period were assumed to significantly increase; and
- Trading losses were assumed to occur.

The results of these stress tests across the sample of firms revealed a wide range of preparedness. In signaling the need for more rigorous practices at broker-dealers based upon these results, FINRA suggests that firms take the following steps to implement a comprehensive liquidity risk management program tailored to the needs of a particular firm.

Management Oversight

Senior management and risk managers at firms should take steps to understand and implement a plan for handling an erosion of funding or changes in counterparty business due to stressed conditions. In order to be ready with a comprehensive plan to mitigate funding risks, FINRA expects management to develop a system to review and understand sources of funding and the liquidity process, as well as the scenarios in which those sources may become limited or completely unavailable. This process also should include an assessment of the liquidity risk associated with each new product marketed to customers.

Risk Measurement

Firms should ensure that their systems appropriately calculate cash outflows under particular stress scenarios and that these calculations are reported to senior managers who will then determine how to address liquidity stress when it arises.

Stress Testing

Each firm should conduct regular stress testing appropriate to its size and business activities that incorporates issues seen in recent and historical market events. These regular stress tests should form part of each firm's overall governance process and liquidity risk management plan. The tests should apply a range of potential shocks to assess the firm's needs during different types of stressed environments with clear differentiation for normal business activities versus contingent funding due to a significant stress scenario. In particular, the Notice asks each firm to assess a stress scenario that it might face, as well as a scenario derived from actual events at another broker-dealer with a similar business model.

Sources of Funding

As counterparties may limit or discontinue funding or apply greater collateral haircuts during stress events, firms should assess how their lenders and other sources of funding may react, including by considering reasonable haircut ranges for assets. Furthermore, firms should understand the potential effects of the Fixed Income Clearing Corporation general collateral finance facility capacity limit to determine how to allocate access to different sources of funding. By gaining a more complete understanding of their funding sources, and seeking new sources, firms will maintain better preparedness for stress conditions.

Contingent Funding

FINRA's guidance also indicates that firms should have a well-developed contingent funding plan. This plan should include a committed facility dedicated specifically to the firm, rather than one committed to multiple affiliates, as this could limit its availability during a stress event. Any third-party lending facilities with restrictions that may impede the availability of funding should be excluded from the plan. Finally, a firm should be at the ready to quickly meet any conditions precedent to a drawdown.

Liquidation

A firm's liquidity risk management program should include a cushion for losses in inventory positions. This suggestion is, in part, based on the concern that firms may need to substantially mark down the value of less liquid securities in order to sell them quickly in a stressed environment. In the Notice, FINRA states that firms should give consideration to selling less liquid securities, as well as more marketable positions such as government securities or highly rated corporate debt, when needing to increase liquidity.

Customer Withdrawal of Funds

Daily computations of customer reserve account requirements appear to be expected under the Notice, as many of the observed firms indicated that they could conduct daily computations in a stressed environment.

CONCLUSION: FINRA CONSIDERS LIQUIDITY RISK PLANNING IMPORTANT TO FIRM FINANCIAL HEALTH

In creating this expectation that firms pay attention to liquidity risk management, FINRA relies on the notions underlying the traditional broker-

dealer financial responsibility rules[8] as well as broad investor protection themes.[9] The Notice stands as FINRA's most definitive statement yet on the topic and provides a roadmap for compliance. Broker-dealers can expect FINRA's examination protocols to include these issues going forward, particularly for firms that are self-clearing or act as clearing brokers. Broker-dealers that clear through others would seem to have less to consider from the Notice because they rely on the liquidity and capital positions of their clearing brokers. Nevertheless, with FINRA adding this new dimension to financial responsibility, there may be an associated increase in costs for the industry and its customers.

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Please do not hesitate to contact us with any questions.

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8 Rule 15c3-1 and Rule 15c3-3 under the Securities Exchange Act of 1934. *See* 17 C.F.R. 240.15c3-1; 17 C.F.R. 240.15c3-3. *See also* Lee A. Schneider, Gregory J. Lyons, Satish M. Kini & Samuel E. Proctor, *Debevoise discusses SEC Amendments to Financial Responsibility and Custody Rules*, CLS BLUE SKY BLOG (Sept. 5, 2013), *available at* http://clsbluesky.law.columbia.edu/2013/09/05/debevoise-discusses-sec-amendments-to-financial-responsibility-and-custody-rules/.

9 Notice at 3 (citing two prior FINRA Regulatory Notices, 10-57 and 99-92, which discussed liquidity practices).