

# 2024 FINRA Annual Regulatory Oversight Report

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## Introduction

The 2024 FINRA Annual Regulatory Oversight Report (the Report) provides member firms with insight into findings from FINRA’s Member Supervision, Market Regulation and Enforcement programs (collectively, “regulatory operations programs”). The Report reflects FINRA’s commitment to providing greater transparency to member firms and the public about our regulatory activities.

The 2021-2023 versions of the Report were published under its previous title (*i.e.*, Report on FINRA’s Examination and Risk Monitoring Program). The new title represents FINRA’s ongoing efforts to increase both the integration among our regulatory operations programs and the utility of the Report for member firms as an information source they can use to strengthen their compliance programs.

As in the 2021-2023 Reports, this year’s Report addresses a broad range of topics. Notably, the Report introduces new content dedicated to crypto assets; new topics within the Market Integrity section (*e.g.*, OTC Quotations in Fixed Income Securities, Advertised Volume); information related to artificial intelligence’s potential impact on firms’ regulatory obligations; and guidance concerning firms’ supervision and retention of off-channel communications.<sup>1</sup>

Additionally, for each topical area covered, the Report continues to:

- ▶ identify the relevant rule(s);
- ▶ highlight key considerations for member firms’ compliance programs;<sup>2</sup>
- ▶ summarize noteworthy findings or observations from recent oversight activities;
- ▶ outline effective practices that FINRA observed through its oversight activities; and
- ▶ provide additional resources that may be helpful to member firms in reviewing their supervisory procedures and controls and fulfilling their compliance obligations.

FINRA’s intent is that the Report be an up-to-date, evolving resource or library of information for member firms. To that end, the Report builds on the structure and content in the 2021-2023 Reports by adding new topics denoted **NEW FOR 2024** and new material (*e.g.*, new findings, effective practices) to existing sections where appropriate. (New material in existing sections is in **bold** type.)

As always, FINRA welcomes feedback on how we can improve future publications of this Report. Please [contact](#) the FINRA Office of Strategic Engagement to provide recommendations.

## How to Use This Report

We selected the topics in this Report for their interest to the largest number of member firms; consequently, they may include areas that are not relevant to an individual member firm and omit other areas that are applicable.

FINRA advises each member firm to review the Report and consider incorporating relevant elements into its compliance program in a manner tailored to its activities. The Report is intended to be just one of the tools a member firm can use to help inform the development and operation of its compliance program; the Report does not represent a complete inventory of regulatory obligations, compliance considerations, findings, effective practices or topics that FINRA will examine.

FINRA also reminds member firms to stay apprised of new or amended laws, rules and regulations, and update their written supervisory procedures (WSPs) and compliance programs on an ongoing basis. FINRA encourages member firms to reach out to their designated Risk Monitoring Analyst if they have any questions about the considerations, findings and effective practices described in this Report.

Each area of regulatory obligations is set forth as follows:

### Regulatory Obligations and Related Considerations

A brief description of:

- ▶ relevant federal securities laws, regulations and FINRA rules; and
- ▶ questions firms may consider in designing or strengthening their compliance programs.

### Findings and Effective Practices

- ▶ Noteworthy findings that FINRA has noted at some—but not all—member firms, including:
  - new findings from recent examinations, market surveillance, investigations or enforcement activities;
  - findings we highlighted in prior Reports and that we continue to note in recent oversight activities;
  - in certain sections, some topics are noted as “Emerging Risks” representing potential concerns due to an evolving regulatory landscape and may pose new or additional risk (e.g., New Account Fraud); and
  - for certain topics—such as Cybersecurity, Liquidity Management and Credit Risk—observations that suggested improvements to a firm’s control environment to address potential weaknesses that elevate risk, but for which there were not specific rule violations.
- ▶ Select effective practices FINRA observed through our oversight activities, as well as those we noted in prior Reports and which we continue to see, that may help member firms, depending on their business model, evaluate their own programs.

### Additional Resources

A list of relevant FINRA *Notices*, other reports, tools and online resources.

The Report also includes an Appendix that outlines how member firms have used similar FINRA reports (e.g., Findings Reports, Priorities Letters) in their compliance programs.

As a reminder, the Report—like our previous Exam and Risk Monitoring Reports, Findings Reports and Priorities Letters—does not create any new legal or regulatory requirements or new interpretations of existing requirements, or relieve member firms of any existing obligations under federal securities laws and regulations. You should not infer that FINRA requires member firms to implement any specific practices described in this Report that extend beyond the requirements of existing federal securities provisions or FINRA rules. Rather, member firms may consider the information in this Report in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member firm’s size and business model. Moreover, some questions may not be relevant due to certain member firms’ business models, size or practices.

#### Updates on FINRA’s Ongoing Targeted Exams

- ▶ In an effort to keep member firms and the industry informed of FINRA initiatives, the 2024 Report highlights our recent updates to our ongoing targeted sweep exams:
  - [FINRA Provides Update on Sweep: Special Purpose Acquisition Companies \(SPACs\)](#) (October 2023);
  - [FINRA Provides Update on Sweep: Social Media Influencers, Customer Acquisition and Related Information Protection](#) (February 2023); and
  - [FINRA Provides Update on Sweep: Option Account Opening, Supervision and Related Areas](#) (November 2022).

# Financial Crimes

## Cybersecurity and Technology Management

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

**Several SEC and FINRA rules directly relate to cybersecurity.** Rule 30 of SEC Regulation S-P requires member firms to have written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information. Regulation S-ID (Identity Theft Red Flags) requires member firms to develop and implement a written program reasonably designed to detect, prevent and mitigate identity theft in connection with the opening or maintenance of “covered accounts.”<sup>3</sup>

FINRA Rule [4370](#) (Business Continuity Plans and Emergency Contact Information) also applies to denials of service and other interruptions to member firms’ operations. In addition to member firms’ compliance with SEC regulations, FINRA reminds firms that cybersecurity remains one of the principal operational risks facing broker-dealers, and expects firms to develop and maintain reasonably designed cybersecurity programs and controls that are consistent with their risk profile, business model and scale of operations.

Cybersecurity incidents, such as account takeovers, ransomware or network intrusions, and any related exposure of customer information or fraudulent financial activity can expose member firms to financial losses, reputational risks and operational failures that may compromise firms’ ability to comply with a range of rules and regulations, including FINRA Rules [4370](#), [3110](#) (Supervision) and [3120](#) (Supervisory Control System), as well as Exchange Act Rules 17a-3 and 17a-4, **Rule 30 of Regulation S-P and Regulation S-ID. Such incidents could also implicate FINRA Rule [4530\(b\)](#) (Reporting Requirements), which requires members to promptly report to FINRA when it has concluded (or reasonably should have concluded) that it or its associated person has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization, where such violative conduct meet the standards in FINRA Rule [4530.01](#) (Reporting of Firms’ Conclusions of Violations).**

#### New SEC Cybersecurity Rules

In July 2023, the SEC adopted rules requiring public reporting companies to disclose:

- ▶ material aspects of cybersecurity incidents they experience (e.g., nature, scope, timing, material impact) within four business days after the firm determines the incident is material; and
- ▶ material information regarding their cybersecurity risk management, strategy and governance on an annual basis.

In addition, in March 2023, the SEC proposed a cybersecurity risk management rule that, if adopted, would require member firms and other market participants to address cybersecurity risks, including by:

- ▶ establishing, maintaining and enforcing written policies and procedures that are reasonably designed to address cybersecurity risks; and
- ▶ providing the SEC with immediate written electronic notice of significant cybersecurity incidents.

Member firms that are “covered entities” would further be required to:

- ▶ include minimum specified elements in their written cybersecurity policies and procedures;
- ▶ report to the SEC and update information about significant cybersecurity incidents; and
- ▶ publicly disclose summary descriptions of their cybersecurity risks and the significant cybersecurity incidents they experienced during the current or previous calendar years.

For additional guidance, FINRA recommends:

- ▶ [FINRA Cybersecurity Advisory – SEC Rules on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure by Public Companies](#) (September 21, 2023)
- ▶ [SEC Proposes New Requirements to Address Cybersecurity Risks to the U.S. Securities Markets](#) (March 15, 2023)

## Related Considerations

### Technology Management

#### *Complexity of Business*

- ▶ **Does your firm have supervisory controls for designing, implementing and monitoring the health and performance of technology solutions?**
- ▶ **Has your firm established supervisory control reviews and metrics to measure control effectiveness?**

#### *Vendor Management*

- ▶ What process has your firm established to assess the risks associated with third-party vendors during the initial onboarding and on a regular basis thereafter? In the event there is a report of a security breach at a vendor, can your firm identify all components and services third parties provide?
- ▶ **Has your firm established supervisory controls for technology vendors' business impact, including assessments and contingency plans?**
- ▶ **Has your firm established supervisory controls to manage vendor offboarding, ensuring that former vendors' access to systems, data and corporate infrastructure is revoked?**

#### *Change Management*

- ▶ **Has your firm established supervisory controls to manage technology changes that include change risk assessments, rollback plans, change validations and change approval processes?**
- ▶ **What type of testing does your firm perform before, and after, moving system and application changes into a production environment?**
- ▶ **Does your firm have repeatable processes for root cause analysis, incident and problem management tracking and metrics reporting?**

#### *System Availability and Business Continuity*

- ▶ **Has your firm established capabilities to prevent technology disruptions and respond to technology incidents, including assessing customer impact and remediation?**
- ▶ **What controls has your firm implemented to mitigate system capacity performance and integrity issues that may undermine its ability to conduct business and operations, monitor risk or report key information?**
- ▶ **How does your firm determine whether to maintain, refresh or retire its end-of-life products?**

### Cybersecurity

#### *Data Management*

- ▶ What steps has your firm taken to prevent a cybersecurity intrusion, such as a ransomware attack? In the event your firm experiences an intrusion, how will it restore critical data from backups, as well as identify and recover customer information that was exfiltrated?
- ▶ How does your firm protect sensitive customer information or confidential firm data from being exposed to, or copied by, nonauthorized individuals (**including associated persons or "insiders" of your firm**) or threat actors, including blocking unauthorized copying and monitoring sensitive data in outbound emails?

#### *Cybersecurity Events*

- ▶ What steps has your firm taken to prevent a cybersecurity intrusion, such as a **business email compromise, phishing** or ransomware attack?
- ▶ In the event your firm experiences an intrusion, how will it restore critical data from backups, as well as identify and recover customer information that was exfiltrated?



- ▶ What are your firm's procedures to communicate cybersecurity events to Anti-Money Laundering (AML) or compliance staff related to meeting regulatory obligations, such as the filing of Suspicious Activity Reports (SARs) and reviewing **and remediating** potentially impacted customer accounts?
- ▶ Does your firm maintain an Incident Response Plan (IRP) that includes guidance or playbooks for common cybersecurity incidents (e.g., data breaches, ransomware infections, account takeovers) **and conduct a simulation exercise to practice the IRP? Does the IRP also include steps for responding to a cybersecurity incident that occurs at a critical vendor?**
- ▶ How does your firm verify the identity of an individual when creating a new account or accessing an existing account? **What controls are in place for higher-risk account changes (e.g., multifactor authentication (MFA) or commensurate controls for linked bank account changes, third-party wires, account email address changes)?**
- ▶ How does your firm monitor for imposter websites that may be impersonating your firm or your registered representatives? How does your firm address imposter websites once they are identified?
- ▶ What kind of security training does your firm conduct, such as email best practices and phishing? Does your firm provide training to all staff and not just to registered persons? **Is the training tailored to the staff's role and level of access to systems?**

### Increased Risk of Cybersecurity Incidents

FINRA has observed an increase in the variety, frequency and sophistication of certain cybersecurity incidents, including:

- ▶ **Imposter Websites** – phishing campaigns involving fraudulent emails claiming to be from FINRA;
- ▶ **Insider Threats** – incidents where firm employees, advertently or inadvertently, use their access to firms' systems and data to cause harm to firms, their investors or both;
- ▶ **Ransomware** – cyberattacks where bad actors gain unauthorized access to firm systems, encrypting or otherwise accessing sensitive firm data or customer information, and then holding that hijacked data for ransom; and
- ▶ **Cybersecurity Events at Critical Vendors** – incidents experienced by vendors that provide information technology services to firms, resulting in harm to firms and their investors.<sup>4</sup>

Firms can find guidance related to identifying, preventing and mitigating these cybersecurity incidents in the FINRA [Cybersecurity](#) and [Industry Risks and Threats – Resources for Member Firms](#) Topics Pages, which include:

- ▶ Cybersecurity Alerts and Advisories that, for example, [warn firms about imposter websites](#) and [highlight CISA Advisories concerning ransomware threats](#);
- ▶ *Regulatory Notices* [23-06](#) (FINRA Shares Effective Practices to Address Risks of Fraudulent Transfers of Accounts Through ACATS) and [22-21](#) (FINRA Alerts Firms to Recent Trend in Fraudulent Transfers of Accounts Through ACATS); and
- ▶ the [Insider Threats – Effective Controls and Practices](#) guidance resources.

## Branch Controls

- ▶ How does your firm identify and address branch-specific cybersecurity risks, including those associated with branch-hosted email or other software systems and servers?
- ▶ If your firm permits registered representatives to use personal technology (*e.g.*, devices, applications, servers) for business, how does your firm ensure its foundational security controls are implemented (*e.g.*, security patches, anti-virus software)?
- ▶ Does your firm maintain an inventory of all technology assets branch office staff use to access your firm's systems or data, including personal computers and servers?
- ▶ How does your firm review branch office security controls to ensure compliance with required standards established in your firm's written policies and procedures?
- ▶ Do branch office personnel know how to respond to cybersecurity incidents in the branch, including when to report the incident to the home office?

## Observations and Effective Practices

### Observations

#### Technology Management

- ▶ **WSPs:** Not updating WSPs to reflect the firm's current cybersecurity practices; and not enforcing the firm's WSPs related to cybersecurity.
- ▶ **Branch Office Security Controls:** Not establishing security controls that branch offices must follow when they maintain their own email systems or other application systems or servers; and failing to detect and respond when a branch office is not compliant with established security controls for maintaining a branch-hosted email or application server.
- ▶ **Third-Party Vendor Supply Chain Management:** Not maintaining a list of all third-party services, or hardware and software components, the vendor provides and which the firm's technology infrastructure uses.
- ▶ **Digital Transformation and the Adoption of Cloud:** Inadequate planning and design when adopting the use of cloud-based systems or technology.

#### Cybersecurity

- ▶ **Account Access Authentication:** Not requiring MFA for login access to the firm's operational, email and registered representatives' systems for employees, contractors and customers, **and not using tools to identify potential unauthorized access to the firm's internal and customer-facing systems.**
- ▶ **New Account Opening Identify Validation:** Ineffective processes and tools for validating the identity of customers who are opening new accounts or detecting suspicious activity associated with new account fraud (*e.g.*, opening of multiple new accounts opened from the same internet protocol (IP) address, **device ID or email address**).
- ▶ **Data Loss Prevention (DLP):** Not monitoring network activity to identify unauthorized copying or deletion of customer or firm data, and not monitoring outbound emails to identify sensitive customer data in text or attachments.
- ▶ **Log Management Practices:** Not sufficiently logging or retaining data related to business or technical activities to effectively assist with the forensic analysis of cybersecurity incidents (*e.g.*, determining the entry point and scope of an attack).
- ▶ **Identify Theft Prevention Program (ITPP):** Implementing a generic ITPP that is not appropriate for the firm's size, complexity, and the nature and scope of the firm's activities, and not periodically updating the firm's ITPP to reflect changes in identify theft risks.

- ▶ **SAR Filings:** Not having reasonably designed procedures for investigating cybersecurity events and considering whether a SAR filing is required, consistent with applicable guidance from the Financial Crimes Enforcement Network (FinCEN).

## Effective Practices

### Technology Management

- ▶ **Data Backups:** Completing regular backups of critical data and systems, and ensuring the backup copies are encrypted and stored off-network; and regularly testing the recovery of data from backups to ensure information can be restored from backup tapes.
- ▶ **Vendor Management:** Maintaining a list of all third-party-provided services, systems and software components that can be leveraged in the event of a cybersecurity incident at one of the firm's third-party vendors.
- ▶ **Branch Office Procedures:** Limiting the use of branch-managed servers for email or other applications (e.g., customer relationship management, reporting) and, if branch-managed servers are permitted, ensuring adequate security controls are maintained.
- ▶ **Risk Assessments:** Regularly assessing the firm's cybersecurity risk profile based on changes in the firm's size and business model and newly identified threats; and regularly updating the firm's cybersecurity program and AML program based on those assessments.
- ▶ **Secure Configurations:** Confirming that desktops, laptops and servers are using current software systems with secure settings that expose only required services to reduce system vulnerabilities; and implementing timely application of systems security patches.
- ▶ **Log Management:** Capturing log data from a broad set of sources and retaining it for a sufficient amount of time (e.g., a minimum of 24 months).
- ▶ **IT Resiliency:** Implementing and testing firm controls to ensure established acceptable service levels are maintained during disruption of critical business operations relying on IT systems.

### Cybersecurity

- ▶ **Account Intrusion:** Reviewing potentially violative activity when identified to determine whether further action (e.g., trading and fund restrictions on the accounts) is appropriate.
- ▶ **Imposter Domains:** Monitoring the internet for any new imposter domains that pretend to represent the firm or a registered representative; and maintaining written procedures for responding to reports of imposter domains that include reporting the domains and notifying impacted customers or business partners.
- ▶ **Outbound Email Monitoring:** Implementing systems that scan outbound email text and attachments to identify and potentially block sensitive customer information or confidential firm data.
- ▶ **Potential Intrusion Report Card:** Leveraging the FINRA [Cross Market Options Supervision: Potential Intrusion Report Card](#), which provides lists of trades related to potentially fraudulent options transactions facilitated by account takeover schemes.
- ▶ **Training and Security Awareness: Periodically training staff to identify and thwart tactics, techniques and procedures (TTPs) associated with people-centric attack vectors (e.g., phishing attacks, social engineering).**
- ▶ **Identity Verification:** For firms that allow new accounts to be opened online, developing a comprehensive process for validating the identity of new clients; and using third parties that can verify identities and provide a score related to the level of risk associated with a new account (to help firms determine if additional verification is required).



## Additional Resources

### ► FINRA

- [Cybersecurity Key Topics Page](#), including:
  - [Core Cybersecurity Threats and Effective Controls for Small Firms](#) (May 5, 2022)
  - [Cross-Market Options Supervision: Potential Intrusions Report Card](#)
  - [Customer Information Protection Key Topics Page](#)
  - [Firm Checklist for Compromised Accounts](#) (September 5, 2023)
  - [List of Non-FINRA Cybersecurity Resources](#)
  - [Report on Selected Cybersecurity Practices – 2018](#)
  - [Report on Cybersecurity Practices – 2015](#)
  - [Small Firm Cybersecurity Checklist](#) (September 7, 2023)
- **[FINRA Cybersecurity Advisory – FINRA Highlights Effective Practices for Responding to a Cyber Incident \(December 12, 2023\)](#)**
- **[Quantum Computing and the Implications for the Securities Industry \(October 30, 2023\)](#)**
- **[FINRA Cybersecurity Advisory – SEC Rules on Cybersecurity Risk Management Strategy, Governance, and Incident Disclosure by Public Companies \(September 21, 2023\)](#)**
- **[Industry Risks and Threats – Resources for Member Firms](#)**
- *Regulatory Notices*
  - *Regulatory Notice [22-29](#)* (FINRA Alerts Firms to Increased Ransomware Risks)
  - *Regulatory Notice [22-18](#)* (FINRA Reminds Firms of Their Obligation to Supervise for Digital Signature Forgery and Falsification)
  - *Regulatory Notice [21-42](#)* (FINRA Alerts Firms to “Log4Shell” Vulnerability in Apache Log4j Software)
  - *Regulatory Notice [21-30](#)* (FINRA Alerts Firms to a Phishing Email Campaign Using Multiple Imposter FINRA Domain Names)
  - *Regulatory Notice [21-29](#)* (FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors)
  - *Regulatory Notice [21-18](#)* (FINRA Shares Practices Firms Use to Protect Customers From Online Account Takeover Attempts)
  - *Regulatory Notice [20-32](#)* (FINRA Reminds Firms to Be Aware of Fraudulent Options Trading in Connection With Potential Account Takeovers and New Account Fraud)
  - *Regulatory Notice [20-30](#)* (Fraudsters Using Registered Representatives Names to Establish Imposter Websites)
  - *Regulatory Notice [20-13](#)* (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic)
  - *Regulatory Notice [15-09](#)* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)

### ► SEC

- **[Proposed Amendments to Cybersecurity Rules \(March 15, 2023\)](#)**
  - **[SEC Proposes to Expand and Update Regulation SCI](#)**
  - **[SEC Proposes New Requirements to Address Cybersecurity Risks to the U.S. Securities Markets](#)**
  - **[SEC Proposes Changes to Reg S-P to Enhance Protection of Customer Information](#)**

## Emerging Risk: Artificial Intelligence

- ▶ Artificial Intelligence (AI) technology is rapidly evolving, most recently with the emergence of generative AI tools. As in other industries, broker-dealers and other financial services industry firms are exploring and deploying these technologies—either with in-house solutions or through third parties—to create operational efficiencies and better serve their customers. While these tools may present promising opportunities, their development has been marked by concerns about accuracy, privacy, bias and intellectual property, among others. As member firms continue to consider the use of new technologies, including generative AI tools, they should be mindful of how these technologies may implicate their regulatory obligations.
- ▶ The use of AI tools could implicate virtually every aspect of a member firm’s regulatory obligations, and firms should consider these broad implications before deploying such technologies. Member firms may consider paying particular focus to the following areas when considering their use of AI:
  - Anti-Money Laundering
  - Books and Records
  - Business Continuity
  - Communications With the Public
  - Customer Information Protection
  - Cybersecurity
  - Model Risk Management (including testing, data integrity and governance, and explainability)
  - Research
  - SEC Regulation Best Interest
  - Supervision
  - Vendor Management
- ▶ In addition to existing rules and regulatory obligations, member firms should be mindful that the regulatory landscape may change as this area continues to develop.
- ▶ For additional guidance, member firms may also consider:
  - FINRA’s [FinTech Key Topics Page](#)
  - 2023 FINRA Annual Conference: [Leveraging Regulatory Technology For Your Firm](#)<sup>5</sup>
  - FINRA Report: [Artificial Intelligence \(AI\) in the Securities Industry](#) (June 2020)
  - FINRA Unscripted Podcast: [AI Virtual Conference: Industry Views on the State of Artificial Intelligence](#) (November 24, 2020)
  - National Institute of Standards and Technology (NIST): [Artificial Intelligence Risk Management Framework \(AI RMF 1.0\)](#) (January 2023)

## Anti-Money Laundering, Fraud and Sanctions

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [3310](#) (Anti-Money Laundering Compliance Program) requires that each member firm develop and implement a written AML program that is approved in writing by senior management and is reasonably designed to achieve and monitor the firm's compliance with the Bank Secrecy Act (BSA) and its implementing regulations.<sup>6</sup> FINRA Rule 3310(a) requires that member firms establish and implement AML policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions;<sup>7</sup> FINRA Rule 3310(c) requires that the AML program provide for independent testing for compliance each calendar year (or every two years in some specialized cases); FINRA Rule 3310(e) requires that the program provide ongoing training for appropriate personnel; and FINRA Rule 3310(f) requires that member firms' AML programs include appropriate risk-based procedures for conducting ongoing customer due diligence.

Other requirements contained in the BSA's implementing regulations include maintaining a Customer Identification Program (CIP); verifying the identity of legal entity customers; establishing due diligence programs to assess the money laundering risk presented by correspondent accounts maintained for foreign financial institutions; and responding to information requests from FinCEN within specified timeframes.<sup>8</sup>

#### Related Considerations

##### *Scope of AML Program*

- ▶ Does your firm's AML program reasonably address the AML risks associated with its business model, including new and existing business lines, products and services offered, customers and the geographic area in which your firm operates?
- ▶ Has your firm experienced substantial growth or changes to its business? If so, has your firm's AML program evolved alongside the business?
- ▶ **Does your firm's AML program reasonably address the AML risks associated with effecting transactions in low-priced securities, including transactions effected through omnibus accounts (particularly accounts maintained for foreign financial institutions)?**

##### *Suspicious Activity Reporting*

- ▶ Do your firm's AML procedures recognize that suspicious activity reporting obligations may apply to any transactions conducted by, at or through your firm?
- ▶ Does your firm have reasonably designed AML procedures to detect and respond to indicators of illicit activities (generally referred to as "red flags") that are relevant to its business model, such as those detailed in:
  - *Regulatory Notice [19-18](#)* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations); and
  - *Regulatory Notice [21-03](#)* (FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities).
- ▶ Does your firm have AML policies and procedures that can be reasonably expected to respond to red flags of sanctions evasion?
- ▶ **Does your firm have reasonably designed AML procedures that account for FinCEN guidance addressing when SARs should be filed in addition to Office of Foreign Assets Control (OFAC) blocking reports?**<sup>9</sup>

- ▶ Does your firm have AML procedures reasonably designed to:
  - detect and cause the reporting of cyber events and cyber-enabled crime as detailed in the FinCEN [Advisory to Financial Institutions on Cyber-Events and Cyber-Enabled Crime](#) and [Frequently Asked Questions \(FAQs\) regarding the Reporting of Cyber-Events, Cyber-Enabled Crime, and Cyber-Related Information through Suspicious Activity Reports \(SARs\)](#); and
  - inform reviews of potentially impacted customer accounts?
- ▶ **If your firm has determined that it is reasonable, based on your firm's business, to use a manual review for suspicious transactions, are those reviews appropriately comprehensive, are they reasonably designed to detect suspicious patterns of transactions, and do they cover a sufficient timeframe to reasonably detect suspicious transactions?**
- ▶ If your firm uses automated surveillance systems for suspicious activity detection and reporting, does it:
  - **appropriately monitor trading activity and money movements conducted or attempted by, at or through your firm;**
  - review the integrity of its data feeds; and
  - assess scenario parameters as needed?
- ▶ If your firm introduces customers and activity to a clearing firm, do your AML procedures reasonably address how your firm will communicate and share information with your clearing firm with respect to the filing of SARs?
- ▶ Does your firm maintain appropriate risk-based procedures for conducting ongoing Customer Due Diligence (CDD) to:
  - understand the nature and purpose of customer relationships **for the purpose of developing a customer risk profile;** and
  - to conduct ongoing monitoring to identify and report suspicious transactions, and, on a risk basis, to maintain and update customer information?

#### *Customer Onboarding*

- ▶ Does your firm have reasonable AML procedures to collect identifying information and verify the identity of its customers under the CIP Rule, and the beneficial owners of all who are considered its legal entity customers under the CDD Rule?<sup>10</sup>
- ▶ **Does your firm use information gathered as part of CIP and CDD to help ensure compliance with other requirements, such as OFAC regulations?**
- ▶ Does your firm have AML policies and procedures that can be reasonably expected to detect identity theft or synthetic identity fraud in connection with account openings, and **has your firm considered the example red flags included in Regulation S-ID?**

#### *AML Independent Testing*

- ▶ **Is your firm's AML independent test performed by someone with a working knowledge of the BSA and its implementing regulations?**
- ▶ **Does your firm ensure that it is performing its independent AML test with the required frequency (once each calendar year for most firms)?<sup>11</sup>**
- ▶ Does your firm's AML independent test confirm that your firm has established and implemented reasonably designed procedures for customer identification and verification, customer due diligence and suspicious activity reporting?

## Findings and Effective Practices

### Findings

- ▶ **Misconstruing Obligation to Conduct CIP and CDD:** Failing to recognize that certain formal relationships established with the firm to effect securities transactions are customer relationships (and, consequently, not conducting CIP or CDD as required).
- ▶ **Inadequate Verification of Customer Identities:** Failing to collect identifying information at the time of account opening and reasonably verify the identity of customers and beneficial owners of legal entity customers with documentary and/or non-documentary methods within a reasonable timeframe.
- ▶ **Inadequate Responses to Red Flags:**
  - **Auto-approving customer accounts despite red flags, or otherwise failing to perform a reasonable review of potential red flags associated with verifying customer identities (e.g., applicant provided a social security number that was not valid or was associated with the name of a different person, including a deceased individual).**
  - **Failing to have established policies and procedures that can be reasonably expected to detect identity theft or synthetic identity fraud in connection with account opening (e.g., personal identifying information does not match a consumer report or was used on another account the firm knew was fraudulent).**
- ▶ **Inadequate Due Diligence:** Failing to conduct initial and ongoing risk-based CDD to understand the nature and purpose of customer relationships to develop a customer risk profile, or conduct due diligence on correspondent accounts of foreign financial institutions in compliance with FINRA Rule 3310(b).
- ▶ **Inadequate Ongoing Monitoring and Reporting of Suspicious Transactions:**
  - Failing to establish and implement written AML procedures that can reasonably be expected to detect and cause the reporting of suspicious activity.
  - Failing to reasonably review for and respond to red flags associated with:
    - **orders and securities trading;**
    - the movement or settlement of cash or securities (e.g., wire and Automated Clearing House (ACH) transfers, debit card and ATM transactions, securities trading (including order entry), journal transfers);
    - the member's business operations, including activity related to high-risk products and services (e.g., cash management products and services; trading of low-priced, thinly traded securities);
    - suspicious activity introduced to the member by other FINRA member broker-dealers; **and**
    - **orders for crypto asset trades.**
  - Failing to notify the AML department of events that may require the reporting of a SAR, including cybersecurity events, account compromise or takeovers, or fraudulent wire or ACH transfers.
  - Failing to reasonably investigate inquiries from law enforcement, clearing firms, regulators or other federal and state agencies that concern red flags of suspicious activity.
- ▶ **Inadequate Handling of FinCEN Information Requests:** Failing to review and respond to information requests from FinCEN issued pursuant to Section 314(a) of the Patriot Act,<sup>12</sup> or not doing so within the required two-week timeframe.
- ▶ **Inadequate Testing:** Failing to conduct adequate independent testing of their AML program by:
  - not providing for annual testing of the program on a calendar year basis (or every two years in specialized circumstances);

- not testing critical aspects of the AML program for reasonableness (e.g., suspicious activity detection and reporting), including where firms have taken on new products, services or client bases that may have materially shifted the firm's AML risk profile or situations where new threats to the industry are applicable to the firm;
- conducting testing that is not reasonably designed, such as testing that fails to consider whether AML reports and systems are accurately and reasonably capturing suspicious transactions and are reasonably tailored to the AML risks of the member's business; and
- not confirming that persons with the requisite independence and qualifications perform the testing.

### Effective Practices

- ▶ **Regulatory Updates:** Reviewing alerts, advisories, significant cases and other updates from the SEC, FinCEN, FINRA, OFAC, and other regulators and agencies.
- ▶ **Risk Assessments:** Conducting formal, written AML risk assessments that are updated in appropriate situations, such as the findings of its **independent AML test** or other internal or external audits; changes in size or risk profile of the firm (e.g., changes to business lines, products and services, registered representatives, customers or geographic areas in which the firm operates); or material macroeconomic or geopolitical events.
- ▶ **Verifying Customers' Identities When Establishing Online Accounts:** Incorporating additional methods for verifying customer identities as part of the firm's CIP through, for example, methods such as:
  - requiring both documentary (e.g., driver licenses) and non-documentary identifying information, or multiple forms of documentary information;
  - asking follow-up questions or requesting additional documents based on information from credit bureaus, credit reporting agencies or digital identity intelligence (e.g., automobile and home purchases);
  - contracting third-party vendors to help verify the legitimacy of suspicious information in customer applications (e.g., **cross-referencing information across multiple vendors**);
  - validating identifying information that applicants provide through likeness checks;<sup>13</sup>
  - reviewing the IP address **or other available geolocation data** associated with:
    - new online account applications for consistency with the customer's home address; and
    - transfer requests (for consistency with locations from which the firm has previously received legitimate customer communications);
  - obtaining a copy of the account statement from the account slated to be transferred before sending an Automated Customer Account Transfer Service (ACATS) request;
  - delivering firms sending notifications to account owners (e.g., "push" notifications on mobile apps, emails, phone calls), contacting any broker(s) assigned to the account or both when an ACATS transfer is initiated;
  - ensuring that any tools used for automated customer verification are reasonably designed to detect red flags of identity theft and synthetic identity fraud;
  - limiting automated approval of multiple accounts for a single customer;
  - reviewing account applications for common identifiers (e.g., email address, phone number, physical address) present in other applications and in existing accounts, especially seemingly unrelated accounts; and
  - reviewing account applications for use of temporary or fictitious email addresses (e.g., @temporaryemail.org) or phone number (e.g., 555-555-5555, 999-999-9999).



### Emerging Risk: New Account Fraud

- ▶ FINRA has observed an increase in suspicious and fraudulent activity related to new account fraud (NAF), which occurs when a bad actor uses stolen or synthetic identification<sup>14</sup> information to fraudulently open an account.
  - NAF relies on the availability of stolen identification information, which is often extracted during data breaches and then sold on dark web marketplaces.
  - Customers' increasing interest in fully online account-opening processes—including those for mobile application-based brokerage accounts—has decreased human interaction between prospective customers and firms, creating the potential for bad actors to fraudulently open brokerage accounts with greater ease.
- ▶ NAF may be a precursor to other fraud schemes. Examples observed in FINRA examinations and investigations include, but are not limited to:
  - fraudulent requests to the ACATS to steal securities and other assets from an investor;
  - fraudulent ACH transfers and wire transfers, including instances in which accounts opened through NAF were used as conduits to steal money from customers at other financial institutions; and
  - deposit or movement of fraudulently obtained funds from government benefit programs (e.g., fraudulently obtained COVID-relief funds).
- ▶ FINRA encourages firms, especially those that offer fully online account opening services and rely on automated account opening or customer verification services, to:
  - evaluate their review of red flags of NAF during the account opening process;
  - evaluate their monitoring of ongoing customer account activity for NAF and other known fraud schemes; and
  - enhance these processes, as needed, to ensure compliance with [Regulation S-ID](#) and other applicable rules.
- ▶ For additional guidance, FINRA recommends:
  - *Regulatory Notice 23-06* (FINRA Shares Effective Practices to Address Risks of Fraudulent Transfers of Accounts Through ACATS)
  - *Regulatory Notice 22-21* (FINRA Alerts Firms to Recent Trend in Fraudulent Transfers of Accounts Through ACATS)
  - *Regulatory Notice 21-18* (FINRA Shares Practices Firms Use to Protect Customers from Online Account Takeover Attempts)
  - *Regulatory Notice 21-14* (FINRA Alerts Firms to Recent Increase in ACH "Instant Funds" Abuse)
  - *Regulatory Notice 20-32* (FINRA Reminds Firms to Be Aware of Fraudulent Options Trading in Connection with Potential Account Takeovers and New Account Fraud)
- ▶ **Delegation and Communication of AML Responsibilities:** Delegating AML duties to business units in the best position to conduct ongoing monitoring to identify suspicious activity; and establishing written escalation procedures and recurring cross-department communication between AML, compliance and relevant business unit(s).
- ▶ **Training:** Establishing and maintaining an AML training program for appropriate personnel that is tailored to the individuals' roles and responsibilities, addresses industry developments impacting AML risk and regulatory developments, and, where applicable, leverages trends and findings from the firm's quality assurance controls and independent AML test.

## Additional Resources

### ▶ FINRA

- [Anti-Money Laundering \(AML\) Key Topics Page](#)
- [Anti-Money Laundering \(AML\) Template for Small Firms](#) (September 8, 2020)
- [Frequently Asked Questions \(FAQ\) regarding Anti Money Laundering \(AML\)](#)
- **[Industry Risks and Threats – Resources for Member Firms](#)**
- [SEC Identity Theft Red Flags Rule \(Reg S-ID\)](#)
- *Regulatory Notices:*
  - **[Regulatory Notice 23-06 \(FINRA Shares Effective Practices to Address Risks of Fraudulent Transfers of Accounts Through ACATS\)](#)**
  - [Regulatory Notice 22-25](#) (Heightened Threat of Fraud: FINRA Alerts Firms to Recent Trend in Small Capitalization (“Small Cap”) IPOs)
  - [Regulatory Notice 22-21](#) (FINRA Alerts Firms to Recent Trend in Fraudulent Transfers of Accounts Through ACATS)
  - [Regulatory Notice 22-06](#) (U.S. Imposes Sanctions on Russian Entities and Individuals)
  - [Regulatory Notice 21-36](#) (FINRA Encourages Firms to Consider How to Incorporate the Government-Wide Anti-Money Laundering and Countering the Financing of Terrorism Priorities Into Their AML Programs)
  - [Regulatory Notice 21-18](#) (FINRA Shares Practices Firms Use to Protect Customers from Online Account Takeover Attempts)
  - [Regulatory Notice 21-14](#) (FINRA Alerts Firms to Recent Increase in ACH “Instant Funds” Abuse)
  - [Regulatory Notice 21-03](#) (FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities)
  - [Regulatory Notice 20-32](#) (FINRA Reminds Firms to Be Aware of Fraudulent Options Trading in Connection with Potential Account Takeovers and New Account Fraud)
  - [Regulatory Notice 20-13](#) (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic)
  - [Regulatory Notice 19-18](#) (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations)

### ▶ FINRA Unscripted Podcasts

- **[A New Twist on New Account Fraud: Detecting and Preventing ACATS Fraud](#)** (May 2, 2023)
- [AML Update: The Latest Trends and Effective Practices](#) (May 31, 2022)
- [At, By or Through: Fraud in the Broker-Dealer Industry](#) (April 20, 2021)
- [Overlapping Risks, Part 2: Anti-Money Laundering and Elder Exploitation](#) (November 10, 2020)
- [Overlapping Risks, Part 1: Anti-Money Laundering and Cybersecurity](#) (October 27, 2020)
- [Beyond Hollywood, Part II: AML Priorities and Best Practices](#) (May 14, 2019)
- [Beyond Hollywood, Part I: Money Laundering in the Security Industry](#) (April 30, 2019)

## ▶ SEC

- [\*\*Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities\*\*](#) (October 17, 2023)
- [\*\*Risk Alert: Observations from Anti-Money Laundering Compliance Examinations of Broker-Dealers\*\*](#) (July 31, 2023)
- [Anti-Money Laundering \(AML\) Source Tool for Broker-Dealers](#) (May 16, 2022)
- [Risk Alert: Compliance Issues Related to Suspicious Activity Monitoring and Reporting](#) (March 29, 2021)

## ▶ Treasury and FinCEN

- [\*\*FinCEN Alert to Financial Institutions to Counter Financing to Hamas and its Terrorist Activities \(October 20, 2023\)\*\*](#)
- [\*\*FinCEN Alert on Prevalent Virtual Currency Investment Scam Commonly Known as “Pig Butchering” \(September 8, 2023\)\*\*](#)
- [Advisory on Elder Financial Exploitation](#) (June 15, 2022)
- [Advisory on Kleptocracy and Foreign Public Corruption](#) (April 14, 2022)
- [Alert: FinCEN Advises Increased Vigilance for Potential Russian Sanctions Evasion Attempts](#) (March 7, 2022)
- [Treasury Publishes National Risk Assessments for Money Laundering, Terrorist Financing, and Proliferation Financing](#) (March 1, 2022)
- [The Anti-Money Laundering Act of 2020](#) (June 30, 2021)
- [Anti-Money Laundering and Countering the Financing of Terrorism National Priorities](#) (June 30, 2021)
- [Answers to Frequently Asked Questions Regarding Suspicious Activity Reporting and Other Anti-Money Laundering Considerations](#) (January 19, 2021)
- [Advisory on Ransomware and the Use of the Financial System to Facilitate Ransom Payments](#) (October 1, 2020)
- [Advisory on Cybercrime and Cyber-Enabled Crime Exploiting the Coronavirus Disease 2019 \(COVID-19\) Pandemic](#) (July 30, 2020)
- [FinCEN 314\(a\) Fact Sheet](#) (February 26, 2019)
- [Advisory to Financial Institutions on Cyber-Events and Cyber-Enabled Crime](#) (October 25, 2016)
- [Frequently Asked Questions \(FAQs\) regarding the Reporting of Cyber-Events, Cyber-Enabled Crime, and Cyber-Related Information through Suspicious Activity Reports \(SARs\)](#) (October 25, 2016)
- [The SAR Activity Review, Issue 8, Section 5 “Revised Guidance on Filing Suspicious Activity Reports Relating to the Office of Foreign Assets Control List of Specially Designated Nationals and Blocked Persons”](#) (April 2005)
- [Interpretive Release No. 2004-02 \(Unitary Filing of Suspicious Activity\)](#) (December 23, 2004)

## ▶ Financial Action Task Force

- [Risk-based Approach Guidance for the Securities Sector](#) (October 26, 2018)

## Manipulative Trading

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Several FINRA rules prohibit member firms from engaging in impermissible trading practices, including manipulative trading—for example, FINRA Rules [2010](#) (Standards of Commercial Honor and Principles of Trade), [2020](#) (Use of Manipulative, Deceptive or Other Fraudulent Devices), [5210](#) (Publication of Transactions and Quotations), [5220](#) (Offers at Stated Prices), [5230](#) (Payments Involving Publications that Influence the Market Price of a Security), [5240](#) (Anti-Intimidation/Coordination), Rule [5270](#) (Front Running of Block Transactions), [5290](#) (Order Entry and Execution Practices) and [6140](#) (Other Trading Practices).

Under FINRA Rule [3110](#) (Supervision), member firms are required to include in their supervisory procedures a process for the review of securities transactions that are reasonably designed to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices that are effected for accounts of the member and its associated persons. The member firm must conduct promptly an internal investigation into any such trade to determine whether a violation of those laws or rules has occurred.

Among other obligations, FINRA Rule 5210 prohibits member firms from publishing or circulating communications regarding transactions and quotations unless they believe the information is bona fide; FINRA Rule 5270 prohibits trading in a security that is the subject of an imminent customer block transaction while in possession of material, non-public market information concerning that transaction; and FINRA Rule 6140 contains several requirements to ensure the promptness, accuracy and completeness of last sale information for NMS stocks and to prevent that information from being publicly trade reported in a fraudulent or manipulative manner.

#### Related Considerations

- ▶ Do your firm's surveillance systems monitor for patterns of suspicious order entries and trading activity across multiple customers, multiple days or both? Does the surveillance system identify trading that appears to lack legitimate economic sense? **If appropriate, do your systems also monitor the activity of proprietary traders on firm platforms?**
- ▶ **Does your firm monitor for patterns of suspicious activity during the distribution of securities (if your firm is a distribution participant) as well as the aftermarket?**
- ▶ Does your firm monitor for red flags of potential coordination among customers (*e.g.*, numerous unrelated accounts being opened or depositing shares at the same time; multiple customers being referred to a firm by an issuer or third-party representative; multiple customer accounts accessed from the same IP address; **multiple accounts sharing a common physical address; multiple accounts being controlled by the same officer, trustee or other authorized party**)?
- ▶ **Do your firm's surveillance systems monitor for patterns of suspicious order entries and trading activity received from foreign financial institutions?**
- ▶ How does your firm determine thresholds for its surveillance controls to detect potentially manipulative trading? **Does your firm periodically assess these thresholds to determine, for example, whether they are outdated or do not adequately reflect current market conditions?**
- ▶ Does your firm take into consideration its business, client base and structure when establishing its surveillance thresholds?

- ▶ Do your firm's supervisory procedures adequately address steps to analyze, document the review of, and escalate surveillance alerts where appropriate?
- ▶ What processes and procedures does your firm have in place to regularly assess whether changes in its business model or the addition of new customers require changes in supervisory controls to detect possible manipulation?
- ▶ **Does your firm monitor for changes in customers' trading behavior that may prompt your firm to reassess the firms' pre-trade or post-trade supervisory controls?**
- ▶ Does your firm test changes to its surveillance controls before placing them into production, and monitor the changes for unanticipated impacts?
- ▶ Does your firm document changes to surveillance controls and the rationale for such changes?

## Findings and Effective Practices

### Findings

- ▶ **Inadequate WSPs:**
  - **Not having procedures reasonably designed to identify patterns of manipulative conduct;** not identifying specific steps and individuals responsible for monitoring for manipulative conduct; and not outlining escalation processes for detected manipulative conduct.
  - **Not tailoring procedures to adequately supervise differing sources of order flow (e.g., proprietary trades, retail customers, institutional customers, foreign financial institutions).**
- ▶ **Non-Specific Surveillance Thresholds:**
  - Not reasonably designing and establishing surveillance controls to capture manipulative trading (e.g., thresholds not designed to capture the appropriate market class of securities or type of securities, or include both customer and proprietary trading; thresholds set too low or too high to identify meaningful activity).
  - **Failing to periodically evaluate adequacy of firms' controls and thresholds in light of changes in their customer base or the market.**
- ▶ **Surveillance Deficiencies:** Not adequately monitoring customer activity for patterns of potential manipulation; not reviewing surveillance exception reports; not documenting review findings; and not considering non-surveillance sources for red flags (e.g., inquiries from regulators or service providers, **publicly available information about known manipulators**, not training responsible staff).

### Effective Practices

- ▶ **Manipulative Schemes:**
  - Maintaining and reviewing customer and proprietary data to detect manipulative trading schemes (e.g., momentum ignition, layering, front running, trading ahead, spoofing, wash sales, prearranged trading), including those that involve correlated securities, such as stocks, exchange-traded products (ETPs) and options.
  - **Tailoring supervisory systems and processes to differing types of manipulative order entry and trading activity based on product class, including listed and OTC equities, options and fixed income products (e.g., Treasuries).**
- ▶ **Multiple Platform and Product Monitoring:** Monitoring activity occurring across multiple platforms that also may involve related financial instruments or multiple correlated products, **as well as cross-border activity in related products.**

- ▶ **Algorithmic Trading:** Using *Regulatory Notice 15-09* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies) to inform a firm’s surveillance program in areas such as general risk assessment and response, software/code development and implementation, software testing and system validation, trading systems and compliance.
- ▶ **Momentum Ignition Trading:** Designing a robust surveillance program to detect firms’ customers engaging in potential momentum ignition trading, including:
  - layering and spoofing activity in which a customer places a non-bona fide order on one side of the market (e.g., above the offer or below the bid) to bait other market participants to react and trade with an order on the other side of the market; and
  - transactions in cross-product securities that manipulate the price of an underlying security, thereby influencing the price at which a market participant can either establish or close an overlying options position (e.g., marking the close, mini-manipulation).
- ▶ **ETPs:** Developing and maintaining a robust supervisory system to safeguard material, non-public information to prevent front running and trading ahead by:
  - establishing effective information barriers and controls to prevent information leakage and the misuse of material, non-public information;
  - reviewing for manipulative strategies that exploit the unique characteristics of ETPs (e.g., their creation and redemption processes) and strategies that exploit information leakage related to portfolio composition files; and
  - tailoring the firm’s compliance program to align with how the firm trades ETPs.
- ▶ **Wash Trading:** Monitoring activity to identify firms’ customers engaging in wash trading to collect liquidity rebates from exchanges by:
  - monitoring accounts identified as related (or in concert) in the firm’s wash/pre-arranged trading surveillance reports; and
  - reviewing trading activity that relates to information provided on account opening documents.

## Additional Resources

- ▶ [Algorithmic Trading Key Topics Page](#)
- ▶ [Cross-Market Equities Supervision Manipulation Report Card](#)
- ▶ *Regulatory Notices*
  - *Regulatory Notice 21-03* (FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities)
  - ***Regulatory Notice 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations)**
  - *Regulatory Notice 18-25* (FINRA Reminds Alternative Trading Systems of Their Obligations to Supervise Activity on Their Platforms)
  - *Regulatory Notice 17-22* (FINRA Adopts Rules on Disruptive Quoting and Trading Activity and Expedited Proceedings)
  - *Regulatory Notice 16-21* (Qualification and Registration of Associated Persons Relating to Algorithmic Trading)
  - *Regulatory Notice 15-09* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)



# Crypto Asset Developments **NEW FOR 2024**

## Background and Related Considerations

### Background

Crypto assets—also known as digital assets—are assets issued or transferred using distributed ledger or blockchain technology.

Member firms seeking to engage in crypto asset-related activity should identify and address the relevant regulatory and compliance challenges and risks. This would include, for example, reviewing and evaluating their supervisory programs and controls, and compliance policies and procedures, in areas such as cybersecurity, AML compliance, communications with customers, manipulative trading, performing due diligence on crypto asset private placements<sup>15</sup> and supervising their associated persons' involvement in crypto asset-related outside business activities (OBAs) and private securities transactions (PSTs).<sup>16</sup>

### FINRA Member Firms' Crypto Asset Activities

FINRA's Membership Application Program (MAP) follows the SEC's guidance in assessing a firm's proposed crypto asset securities business line under applicable rules, such as the SEC's financial responsibility rules and customer protection rule.<sup>17</sup> FINRA's MAP has approved firms to engage in crypto asset securities business, including:

- ▶ serving as placement agent in the private placement of crypto asset securities;
- ▶ operating an Alternative Trading System (ATS) for crypto asset securities; and
- ▶ providing custodial services for crypto asset securities, under the SEC's December 23, 2020, statement regarding Custody of Digital Asset Securities by Special Purpose Broker-Dealers (the "SPBD Policy Statement").<sup>18</sup>

In addition to these firms that have been specifically approved to engage in crypto asset securities business, FINRA has asked member firms to notify us if they or their affiliates engage or plan to engage in crypto asset-related activities, including activities related to crypto assets that are not securities. (For example, some member firms have established relationships with affiliates or other third parties to grant their customers access to crypto asset-related (non-securities) activities.) FINRA has also asked member firms to complete a questionnaire related to their and their affiliates' activities in the crypto asset space (and will publish any helpful observations from this questionnaire at a later date, as appropriate).<sup>19</sup>

Additionally, FINRA has identified associated persons engaged in a range of crypto asset-related activities through OBAs or PSTs. Examples of crypto asset-related OBAs and PSTs include, but are not limited to, proprietary trading, operating investment funds that invest in crypto assets, selling private placements or crypto asset offerings, and participating in crypto mining operations.

For additional resources, please see FINRA's [Guidance for Digital Asset Applications](#) webpage and the 2024 Report's [OBA and PST topic](#).

## Related Considerations

- ▶ If your firm is considering submitting a New Member Application (NMA) or Continuing Membership Application (CMA) to operate as a crypto asset ATS or Special Purpose Broker-Dealer, does your proposed business plan comport with SEC guidance under applicable rules (e.g., the SEC's financial responsibility rules and customer protection rule)? This includes, but is not limited to:
  - [Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#) (December 23, 2020);
  - [ATS Role in the Settlement of Digital Asset Security Trades](#) (September 25, 2020); and
  - [Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#) (July 8, 2019).
- ▶ Has your firm established written policies, procedures and controls related to any crypto asset activities being conducted by the firm and its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, as well as with applicable FINRA rules? This may include policies, procedures and controls, as applicable, related to:
  - due diligence when recommending the sale of unregistered crypto asset securities through private placements;
  - trading of crypto assets, including crypto asset securities, with customers and counterparties;
  - the use of distributed ledger or blockchain technology in the offering of cash management, investment or other products;
  - business lines operated through an agreement the firm has in place with a crypto asset exchange, Virtual Asset Service Provider (VASP) or other third-party crypto asset intermediary to enable its customers to trade or invest in crypto assets;
  - custody of crypto asset securities in line with guidance provided by the SEC in its December 2020 statement on [Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#); and
  - registered persons' OBAs and associated persons' PSTs involving crypto assets?
- ▶ Has your firm established written policies, procedures and controls that enable the firm to:
  - reasonably determine, where necessary, whether a crypto asset is a security (e.g., when assessing whether an activity is a PST);
  - confirm whether any crypto asset securities offered or sold by the firm are subject of an effective registration statement or sold pursuant to an applicable exemption from registration; and
  - issue retail communications to customers that have a fair and balanced presentation of the risks associated with these assets and are free from unwarranted or misleading content?<sup>20</sup>
- ▶ Does your firm's AML compliance program<sup>21</sup> incorporate, for example, the crypto asset orders and trading activity occurring by, at or through the broker-dealer?
- ▶ Has your firm tested for potential weaknesses in the cybersecurity controls<sup>22</sup> for your firm's crypto asset-related business lines, including any business that operates through an agreement the firm has in place with a crypto asset exchange, VASP or other third-party crypto asset intermediary?

### Crypto Asset-Related Market Abuse

- ▶ Bad actors are taking advantage of investor interest in crypto assets and blockchain technology by engaging in manipulative schemes similar to those that exist in the equities market, including those that are commonly associated with low-priced securities (e.g., pump-and-dump schemes).
- ▶ These manipulative schemes may also be amplified by social media promotions, including those that suddenly and frequently appear across social media platforms, contain unverifiable information or both.
- ▶ Additional forms of market abuse involving crypto assets may result from differences in their market structure (e.g., centralized and decentralized exchanges, the ability to trade every day and at any time).
- ▶ For additional guidance related to preventing market abuse in crypto assets, please see:
  - the [Manipulative Trading](#) topic in the 2024 Report; and
  - *Regulatory Notice 21-03* (FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities).

## Surveillance Themes and Effective Practices

### Surveillance Themes

While not exhaustive, themes identified with respect to potential violations by FINRA members and associated persons involving crypto assets include:

- ▶ **2210 (Communications with the Public):**
  - Failing to appropriately and accurately address relevant risks and include appropriate disclosures in communications with the public.
  - Disseminating promotional materials that contain material misstatements or omissions in connection with securities offerings.
- ▶ **3110 (Supervision):** Failing to conduct appropriate due diligence on crypto asset private placements recommended to customers.
- ▶ **3310 (Anti-Money Laundering Compliance Program):**
  - Failing to establish and implement AML programs reasonably designed to detect and cause the reporting of:
    - suspicious crypto asset transactions occurring by, at or through the broker-dealer; and
    - suspicious trading involving issuers with a purported involvement in crypto asset-related activities.

### Targeted Examination on Crypto Asset Retail Communications

- ▶ Crypto asset-related retail communications reviewed by FINRA's Advertising Regulation Department have had a non-compliance rate that is significantly higher than that of other products.
- ▶ As a result, in November 2022, FINRA launched a [targeted exam](#) to review practices of certain member firms that actively communicate with retail customers concerning crypto assets and crypto asset-related services.
- ▶ FINRA is working to complete this review and publish an update on findings and effective practices.

## Effective Practices

- ▶ **Due Diligence of Unregistered Offerings:** Before recommending crypto asset securities to customers through an unregistered offering, confirming that investments can be issued in the form of crypto assets and, if so, understanding:
  - where the assets will be maintained;
  - who will have access to the wallet(s);
  - how the funds or assets will be returned in the event of a contingent offering not meeting the minimum contingency;
  - how the raised proceeds will be used; and
  - the specific mechanics associated with the crypto asset security, including:
    - the blockchain protocol used to issue the security;
    - any smart contract features or functionalities;
    - how and when the security will be delivered to customers; and
    - how the security will be custodied by or for the customers.<sup>23</sup>
- ▶ **On-Chain Reviews:** Conducting risk-based on-chain assessments when the firm or its associated persons are accepting, trading or transferring crypto asset securities and non-securities, and establishing procedures that address when and how these on-chain reviews should be performed and documented based on the product or services being offered.
- ▶ **Customer Outreach:** Ensuring customers clearly understand the differences between their brokerage account and any linked/affiliated crypto account, including differences in:
  - protections of the accounts via SIPC under SIPA;
  - regulatory oversight;
  - firm supervision; and
  - avenues of communications for customers' concerns, questions or complaints.

## Additional Resources

- ▶ FINRA
  - **2023 FINRA Annual Conference: [Crypto Asset Developments](#)**
  - [An Inside Look into FINRA's Crypto Asset Work](#) (August 3, 2023)
  - MAP [Guidance for Digital Asset Applications](#) (June 28, 2023)
  - [Industry Risks and Threats – Resources for Member Firms](#)
  - Targeted Exam Letter on [Crypto Asset Communications](#) (November 2022)
  - Report Topics
    - [AML, Fraud and Sanctions](#)
    - [Communications with the Public](#)
    - [Cybersecurity and Technology Management](#)
    - [Manipulative Trading](#)
    - [Outside Business Activities and Private Securities Transactions](#)

- *Regulatory Notices:*
  - [Regulatory Notice 21-25](#) (FINRA Continues to Encourage Firms to Notify FINRA if They Engage in Activities Related to Digital Assets)
  - [Regulatory Notice 21-03](#) (FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities)
  - [Regulatory Notice 20-23](#) (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets)
- FINRA Unscripted Podcasts:
  - [FINRA's Blockchain Lab: Regulation and Innovation for the Future](#) (September 19, 2023)
  - [A Closer Look at Crypto: The Crucial Role of FINRA's CAI Team](#) (September 5, 2023)
  - [An Introduction to FINRA's Crypto Asset Work and the Crypto Hub](#) (August 8, 2023)
  - [2023 Senior Investor Protection Conference: The Latest Trends, Scams and Schemes](#) (April 18, 2023)
  - [Membership Application Program: Reviewing and Approving Digital Asset Firms](#) (November 1, 2022)
- ▶ SEC
  - [Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#) (December 23, 2020)
  - [ATS Role in the Settlement of Digital Asset Security Trades](#) (September 25, 2020)
  - [Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#) (July 8, 2019)

# Firm Operations

## Outside Business Activities and Private Securities Transactions

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rules [3270](#) (Outside Business Activities of Registered Persons) and [3280](#) (Private Securities Transactions of an Associated Person) require registered persons to notify their member firms in writing of proposed OBAs, and all associated persons to notify their firms in writing of proposed PSTs, so firms can determine whether to prohibit, limit or allow those activities. A member firm approving a PST where the associated person has or may receive selling compensation must record and supervise the transaction as if it were executed on behalf of the firm.

#### Related Considerations

- ▶ What methods does your firm use to identify individuals involved in undisclosed OBAs and PSTs?
- ▶ Do your firm's WSPs explicitly state when and how registered persons must notify your firm of a proposed OBA or PST?
- ▶ Does your firm require associated persons or registered persons to complete and update, as needed, questionnaires and attestations regarding their involvement— or potential involvement—in OBAs and PSTs; and if yes, how often?
- ▶ Upon receipt of a written notice of proposed OBAs, does your firm consider whether the activity will interfere with or otherwise compromise the registered person's responsibilities to your firm and its customers, or be viewed by customers or the public as part of the member's business? Does your firm also determine whether such activities should be treated as a PST (subject to the requirements of FINRA Rule 3280)?
- ▶ Does your firm have a process in place to update a registered person's Form U4 with activities that meet the disclosure requirements of that form?
- ▶ Does your firm take into account the regulatory considerations and characteristics of crypto assets when reviewing crypto asset-related OBAs and PSTs?
- ▶ Does your firm record PSTs for compensation on its books and records, including PSTs involving new or unique products and services?
- ▶ How does your firm supervise activities that are PSTs for compensation, including those involving crypto asset securities, and document its compliance with the supervisory obligations?
- ▶ What training and guidance does your firm provide registered persons and associated persons, during onboarding and periodically thereafter, with regard to their potential engagement in OBAs and PSTs?

### Findings and Effective Practices

#### Findings

- ▶ **Incorrect Interpretation of Selling Compensation for Potential PSTs:** Interpreting "selling compensation" too narrowly (by focusing on only direct compensation, such as commissions, rather than evaluating all direct and indirect financial benefits from PSTs, such as receipt of securities and tax benefits); and, as a result, erroneously determining that certain activities were not PSTs for compensation.
- ▶ **Inadequate Approval Process for Potential PSTs:** Approving participation in proposed PSTs for compensation without adequately considering how the individual's participation in the proposed PSTs would be supervised as if the transactions were executed on the firms' behalf.



▶ **No Documentation:**

- Not retaining the documentation necessary to demonstrate the firm’s compliance with the supervisory obligations for PSTs involving compensation.
- Not recording transactions for compensation on the firm’s books and records because certain PSTs were not consistent with the firm’s electronic systems (such as where securities transactions conducted by an **associated** person would not be captured in their clearing firm’s feed of purchases and sales activity).

▶ **No or Insufficient Notice and Notice Reviews:** Registered persons failing to provide prior written notice to their firms of OBAs or, for associated persons, of PSTs; and WSPs not requiring the review of such notices, or the documentation that such reviews had taken place.

▶ **Inadequate Controls:** Inadequate controls to confirm adherence to the firm’s limitations placed on OBAs or PSTs, such as prohibiting registered persons from soliciting firm clients to participate in an OBA or PST.

▶ **No Review and Recordkeeping of Crypto Asset-Related Activities:**

- **Failing to disclose, approve or follow required rule steps for crypto asset-related OBAs and PSTs.**
- **Making a false statement related to OBAs or PSTs involving crypto assets on member firms’ annual attestations.**
- Assuming that all crypto assets are not securities and therefore not evaluating crypto asset-related activities, including activities performed through affiliates, to determine whether they should be treated as PSTs.
- For certain crypto assets or other activities that were deemed to be PSTs for compensation, not supervising a person’s participation in such activities or recording such transactions on the firm’s books and records.

### Effective Practices

▶ **Questionnaires:** Requiring registered persons and other associated persons to complete upon hire, and periodically thereafter, detailed, open-ended questionnaires with regular attestations regarding their involvement—or potential involvement—in new or previously disclosed OBAs and PSTs, which include questions concerning:

- any other businesses where they are owners or employees;
- whether they are raising money for any outside activity;
- whether they act as “finders” for issuers seeking new investors; and
- any expected revenues, payments, or direct and indirect financial benefits they receive from any entities other than the firm, including affiliates.

▶ **Due Diligence:** Conducting due diligence to learn about all OBAs and PSTs at the time of a registered person’s initial disclosure to the firm and periodically thereafter, including interviewing the registered person and thoroughly reviewing:

- social media, professional networking and other publicly available websites, and other sources (such as legal research databases and court records);
- email and other communications;
- documentation supporting the activity (such as organizational documents); and
- OBAs that involve investment advisers or fund companies in order to identify potential PSTs.

▶ **Monitoring:** Monitoring significant changes in, or other red flags relating to, registered persons’ or associated persons’ performance, production levels or lifestyle that may indicate involvement in undisclosed or prohibited OBAs and PSTs (or other business or financial arrangements with their customers, such as borrowing or lending), including conducting regular, periodic background checks and reviews of:

- correspondence (including social media);
  - fund movements;
  - marketing materials;
  - online activities;
  - customer complaints;
  - financial records (including bank statements and tax returns);
  - branch office activities; and
  - gifts and gratuities logs.
- ▶ **Affiliate Activities:** Considering whether registered persons' and other associated persons' activities with affiliates, especially self-offerings, may implicate FINRA Rules 3270 and 3280.
  - ▶ **WSPs:** Clearly identifying types of activities or investments that would constitute an OBA or PST, as well as defining selling compensation and in some cases providing FAQs to remind employees of scenarios that they might not otherwise consider to implicate these rules.
  - ▶ **Training:** Conducting training on OBAs and PSTs during registered person and associated person onboarding and periodically thereafter, including regular reminders of written notice requirements and for registered persons to update their public disclosures.
  - ▶ **Disciplinary Action:** Imposing significant consequences—including heightened supervision, fines or termination—for persons who fail to notify firms in writing of their OBAs and PSTs, or fail to receive approval of their PSTs for compensation.
  - ▶ **Controls for Outside Crypto Asset-Related Activities**
    - Establishing policies, procedures and controls related to crypto asset-related OBAs of registered persons that clearly detail:
      - the conditions under which crypto asset OBAs will be prohibited (and when limitations on the activity will be imposed); and
      - how the firm will assess whether the activity is a PST, such as when crypto assets are sold as investment contract securities.
    - Searching for indicators of undisclosed crypto asset-related OBAs and PSTs during reviews of electronic correspondence.
    - Establishing policies, procedures and controls requiring associated persons to disclose accounts in which they could effect crypto asset securities transactions and for supervisory review of transactions in those accounts.
  - ▶ **Crypto Asset Checklists:** Creating checklists with a list of considerations to confirm whether crypto asset-related activities would be considered OBAs or PSTs (including reviewing private placement memoranda or other materials and **public statements of promoters of crypto assets**, and analyzing the underlying products and investment vehicle structures).

## Additional Resources

- ▶ *Notice to Members 96-33* (NASD Clarifies Rules Governing RR/IAs)
- ▶ *Notice to Members 94-44* (Board Approves Clarification on Applicability of Article III, Section 40 of Rules of Fair Practice to Investment Advisory Activities of Registered Representatives)

## Books and Records

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Exchange Act Rules 17a-3 and 17a-4 **specify minimum requirements with respect to the records that broker-dealers must make, how long those records and other documents relating to a broker-dealer's business must be kept and in what format they may be kept. Exchange Act Rule 17a-4(b)(4) and FINRA Rules 3110(b)(1) (General Requirements), 3110.09 (Retention of Correspondence and Internal Communications) and 2210(b)(4) (Recordkeeping) require member firms to establish, maintain and enforce written procedures to supervise the types of business in which they engage and the activities of their associated persons that are reasonably designed to**, among other things, create and preserve, in an easily accessible place, originals of all communications received and sent relating to their "business as such" (e.g., emails, instant messages, text messages, chat messages, interactive blogs). In addition, FINRA Rule 3110(b) (Written Procedures) requires member firms to establish, maintain and enforce written procedures to supervise the types of business in which they engage and the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.

**FINRA Rule 4511(a) (General Requirements) requires members to make and preserve books and records as required under the FINRA Rules, the Exchange Act and applicable Exchange Act Rules. The obligations set forth in Rules 17a-3 and 17a-4 and FINRA Rules 2210(b)(4) and 4511(a) (collectively, Books and Records Rules) apply to all member firms, including those that permit staff to use off-channel communications to conduct firm business.**

**Effective January 3, 2023, the SEC amended Rule 17a-4 to modify the requirements regarding the maintenance and preservation of electronic records, including the use of third-party recordkeeping services to hold records and the prompt production of records. In part, these amendments impact the required language of the third-party access undertakings applicable to firms that utilize an electronic recordkeeping system to maintain and preserve records required under Rules 17a-3 and 17a-4. As a result, those firms that preserve required records electronically, including those firms that elect to continue using their current third-party access arrangements, must file with FINRA updated third-party access undertakings that reflect the new language specified under Rule 17a-4(f)(3)(v).**

#### Related Considerations

- ▶ If your firm emails its clients and customers links to Virtual Data Rooms (VDRs)—online data repositories that secure and distribute confidential information—does your firm retain and store documents embedded in those links once the VDRs are closed?
- ▶ If your firm is converting paper records to electronic records, does it maintain procedures and controls to verify the conversion process (e.g., comparing electronic and original records) to confirm that the electronic records are accurate, complete and readable?
- ▶ **If applicable, has your firm filed with FINRA an updated Third-Party Access Undertaking letter or an undertaking signed by a Designated Executive Officer?**

## Off-Channel Communications

- ▶ FINRA uses a risk-based approach to review how firms capture, surveil and maintain business-related communications.
  - ▶ Because off-channel communications occur on non-firm platforms or devices, there is an increased risk that they are not maintained and preserved as part of the firm's books and records.
  - ▶ This risk has become a particular area of focus for regulators—the SEC has issued fines in [2021](#), [2022](#) and [2023](#) related to firms' failures to maintain and preserve certain off-channel electronic communications.
  - ▶ FINRA will share any helpful observations or effective practices that may emerge from its risk-based reviews of member firms' practices related to off-channel communications. Firms may also find it helpful to consider the guiding questions below when assessing whether their supervisory systems and compliance programs are reasonably designed to capture, supervise and maintain off-channel communications.
- ▶ Does your firm's electronic communication policy include:
    - procedures and controls to maintain, preserve and monitor all business-related correspondence by staff, including that which is conducted via off-channel communication methods;
    - processes and procedures to monitor for new electronic communication channels available to customers and associated persons; and
    - required training and guidance that your firm's associated persons must complete before they are permitted access to firm-approved electronic communication channels?
  - ▶ **How does your firm communicate to its associated persons, and monitor and surveil for compliance with, the prohibition against using unapproved off-channel communication methods for business communications? For example, does your firm surveil:**
    - approved communication channels and customer complaints for indicia of communications occurring through off-channel text or encrypted messaging channels (e.g., email chains that copy a registered representative's email address from an off-channel domain, references in emails to electronic communications that occurred outside firm-approved channels or customer complaints mentioning such communications); and
    - approved communication channels for signs of underutilization (that could present a red flag that an associated person is utilizing an unapproved channel for business communications)?
  - ▶ **What corrective or disciplinary measures has your firm implemented to deter its associated persons from circumventing supervisory controls related to off-channel communications?**

## Findings and Effective Practices

### Findings

- ▶ **Misinterpreted Obligations:** Not performing due diligence to verify vendors' ability to comply with Books and Records Rules requirements; or not confirming that service contracts and agreements comply with the recordkeeping requirement because firms did not understand that all required records must comply with the Books and Records Rules, including records vendors store.
- ▶ **Failure to Maintain Email Correspondence:** Failing to capture, review and archive electronic correspondence of:
  - registered representatives (or outside or part-time chief compliance officers and Financial and Operations Principals (FINOPs)) conducting firm business via third-party vendor email addresses (because vendors failed to automatically archive this correspondence and staff failed to follow firms' procedures to copy their firm email addresses on all business-related email correspondence); or
  - registered representatives' permitted use of non-firm email addresses to conduct firm business, including domains for "doing business as" (DBA) entities.

- ▶ **Failure to Maintain Converted Records:** Failing to maintain policies and procedures and related controls to protect the integrity of records from the time the records are created or received throughout the applicable retention period, and confirm physical books and records converted to electronic records were accurate, complete and readable.

### Effective Practices

- ▶ **Contract Review:** Reviewing vendors' contracts and agreements to assess whether firms will be able to comply with the recordkeeping requirements.
- ▶ **Testing and Verification:** Testing recordkeeping vendors' capabilities to fulfill regulatory obligations by, for example, simulating a regulator's examinations by requesting records and engaging regulatory or compliance consultants to confirm compliance with the recordkeeping requirements.

### Additional Resources

- ▶ FINRA
  - [Books and Records Key Topics Page](#)
  - [Books and Records Requirements Checklist](#)
  - [Exchange Act Rule 17a-4 Amendments: Chart of Significant Changes](#)
  - **[Regulatory Notice 17-18 \(Guidance on Social Networking Websites and Business Communications\)](#)**
  - [Frequently Asked Questions about the 2001 Amendments to Broker-Dealer Books and Records Rules Under the Securities Exchange Act of 1934](#)
- ▶ SEC
  - [Fact Sheet: Final Amendments to Electronic Recordkeeping Requirements](#) (October 12, 2022)

## Regulatory Events Reporting

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [4530](#) (Reporting Requirements) requires member firms to promptly report to FINRA, and associated persons to promptly report to firms, specified events, including, for example, findings of violations of securities laws and FINRA rules, certain written customer complaints, and certain disciplinary actions the firm takes.

Member firms **must also promptly report to FINRA certain internal conclusions of violations**, and must report quarterly to FINRA statistical and summary information regarding certain written customer complaints. In addition, FINRA Rule 4530 requires member firms to file with FINRA copies of specified criminal actions, civil complaints and arbitration claims.

#### Related Considerations

- ▶ Does your firm provide periodic reminders or training on such requirements, and what consequences does your firm impose on those persons who do not comply?
- ▶ How does your firm monitor for red flags of unreported written customer complaints and other reportable events?
- ▶ How does your firm confirm that it accurately and timely reports to FINRA written customer complaints, including ones that associated persons reported to your firm's compliance department?
- ▶ Does your firm look for trends in events and written customer complaints required to be reported pursuant to FINRA Rule 4530? How is information on trends raised to relevant business and compliance management?

- ▶ Do your firm's procedures for reporting internal conclusions of violations:
  - clearly identify the person(s)—or, if applicable, the members of a committee—responsible for determining whether a violation has occurred, and whether it is of a nature that requires reporting under FINRA Rule 4530(b), as well as the level of seniority of such person(s) (e.g., general counsel, chief compliance officer or a senior staff committee); and
  - provide protocols for escalating violations and potential violations to such person(s), as well as for reporting internal conclusions of violations to FINRA within 30 calendar days after your firm has concluded, or reasonably should have concluded, that a violation has occurred?

### Guidance for Form U5 Filings

FINRA reminds firms that they are required to provide timely, complete and accurate information on Forms U5 (Uniform Termination Notice for Securities Industry Registration):

- ▶ Each question on the Form U5 stands on its own, and firms should carefully read each question on the form and respond appropriately to each question.
  - For example, when reporting information relating to the reason for full termination, firms must separately consider and respond to Section 3 of the form (Full Termination) and all of the disclosure questions in Section 7.
  - Additionally, reporting the reason for termination in Section 3 does not abrogate the requirement that a firm answer the questions in Section 7 timely, completely and accurately—including, in particular, Questions 7B (Internal Review Disclosure) and 7F (Termination Disclosure).
    - When firms provide an affirmative response to Question 7B, they also complete the Internal Review Disclosure Reporting Page (DRP). As a reminder, when a firm indicates on that DRP that the internal review is pending, the firm is required after concluding the internal review to file a Form U5 amendment and provide resolution details.
  - In this regard, with respect to factual situations that would cause a reasonable person to answer affirmatively a disclosure question in Form U5, a firm may not parse through the questions in a manner that would allow the firm to avoid responding affirmatively to the question.
- ▶ A firm must provide sufficient detail when responding to Form U5 questions such that a reasonable person may understand the circumstances behind the reason for termination.
  - For example, Form U5's Question 7F asks whether the individual who is the subject of the Form U5 voluntarily resigned, or was discharged or permitted to resign, after allegations were made that accused the individual of certain types of misconduct.
  - If a firm is required to answer Question 7F, they must answer it in the affirmative, irrespective of whether or not the firm is the entity making the allegations of misconduct.
- ▶ For additional guidance, please see *Regulatory Notice 10-39* (Obligation to Provide Timely, Complete and Accurate Information on Form U5).

## Findings and Effective Practices

### Findings

- ▶ **No Reporting to the Firm:** Associated persons not reporting written customer complaints, judgments concerning securities, commodities or financial-related insurance civil litigation and other events to the firms' compliance departments because they were not aware of firm requirements.
- ▶ **Inadequate Surveillance:** Firms not conducting regular email and other surveillance for unreported events and written customer complaints.



- ▶ **No Reporting to FINRA:** Failing to report to FINRA written customer complaints that associated persons reported to the firms' compliance departments.
- ▶ **Incorrect Rule 4530 Product/Problem Codes:** As part of the statistical reporting to FINRA, failing to use codes that correlated to the most prominent product or the most egregious problem alleged in the written customer complaints, but instead reporting less prominent or severe codes or other codes based on the firms' investigations or other information.

### Effective Practices

- ▶ **WSPs: Maintaining procedures that address how associated persons should report customer complaints they receive and how the compliance department should proceed when associated persons report such customer complaints (e.g., routing the complaint to the personnel responsible for FINRA Rule 4530 reporting).**
- ▶ **Compliance Questionnaires:** Developing detailed annual compliance questionnaires to verify the accuracy of associated persons' disclosures, including follow-up questions (such as whether they are the subject of any pending lawsuits or arbitration claims, or have received any written customer complaints).
- ▶ **FINRA Risk Monitoring Reports Cards: Reviewing the quarterly reports provided by the FINRA [Customer Complaints](#) and [Sales Practice Complaint](#) Reports.**
- ▶ **Surveillance of Communications Channels:** Conducting surveillance **of firm-approved communications channels (e.g., email, messaging apps)** targeted to identify unreported written customer complaints (by, for example, including complaint-related words in their keyword lexicons, reviewing for unknown email addresses and conducting random email checks).
- ▶ **Review of Registered Representatives' Financial Condition:** Identifying expenses, settlements and other payments that may indicate unreported events by conducting periodic reviews of their associated persons' financial condition, including background checks and credit reports.
- ▶ **Review of Publicly Available Information:** Conducting periodic searches of associated persons' names on web forums, court filings and other publicly available databases, including reviewing for any judgments concerning securities, commodities or financial-related insurance civil litigation and other reportable events.
- ▶ **Assessing Disclosure Timeliness: Monitoring trends in disclosure-reporting timeliness and reviewing the FINRA [4530 Disclosure Timeliness](#) Report Card.**
- ▶ **Training: Providing training, periodic reminders or both to associated persons related to compliance with FINRA Rule 4530, including guidance for assessing and escalating potential customer complaints received by e-communications channels other than firm-approved email.**

### Additional Resources

- ▶ [Rule 4530 Reporting Requirements](#)
- ▶ [FINRA Report Center](#)
  - [4530 Disclosure Timeliness Report Card](#)
  - [Customer Complaints Report](#)
  - [Sales Practice Complaint Report](#)
- ▶ [Rule 4530 Frequently Asked Questions](#)
- ▶ [Rule 4530 Product and Problem Codes](#)
- ▶ [Regulatory Notices](#)
  - [Regulatory Notice 20-17](#) (FINRA Revises Rule 4530 Problem Codes for Reporting Customer Complaints and for Filing Documents Online)

- *Regulatory Notice 20-02* (FINRA Requests Comment on the Effectiveness and Efficiency of Its Reporting Requirements Rule)
- *Regulatory Notice 13-08* (FINRA Amends Rule 4530 to Eliminate Duplicative Reporting and Provide the Option to File Required Documents Online Using a New Form)
- *Regulatory Notice 11-06* (SEC Approved Consolidated FINRA Rule Governing Reporting Requirements)

## Trusted Contact Persons

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [4512\(a\)\(1\)\(F\)](#) (Customer Account Information) requires member firms, for each of their non-institutional customer accounts, to make a reasonable effort to obtain the name and contact information for a trusted contact person (TCP) age 18 or older. FINRA Rule 4512 also describes the circumstances in which member firms and their associated persons are authorized to contact the TCP and disclose information about the customer account.

FINRA Rule [3241](#) (Registered Person Being Named a Customer's Beneficiary or Holding a Position of Trust for a Customer) requires a registered person to decline being named a beneficiary of a customer's estate, executor or trustee, or to have a power of attorney for a customer unless certain conditions are met, including providing written notice to the member firm and receiving approval. The rule requires the member firm with which the registered person is associated, upon receiving required written notice from the registered person, to review and approve or disapprove the registered person assuming such status or acting in such capacity.

FINRA Rule [2165](#) (Financial Exploitation of Specified Adults) permits member firms to place temporary holds on a disbursement of funds or securities and—as of March 2022, securities transactions—when firms reasonably believe that financial exploitation has occurred, is occurring, has been attempted or will be attempted, and requires firms to notify the TCP, if available, when placing temporary holds.

#### Related Considerations

- ▶ **If your firm allows registered persons to be named to positions of trust, such as an executor or trustee, or as beneficiaries for customer accounts, has it established a process for conducting a reasonable assessment of the risks created by the registered person assuming such status or acting in such capacity?**
- ▶ Has your firm established an adequate supervisory system, including WSPs, related to obtaining and using the names and contact information of TCPs; and, if relying on FINRA Rule 2165, placing temporary holds to address risks relating to financial exploitations?
- ▶ Does your firm educate registered representatives about the importance of collecting and using trusted contact information?

### Findings and Effective Practices

#### Findings

- ▶ **No Reasonable Attempt to Obtain TCP Information:** Not making a reasonable attempt to obtain the name and contact information of a TCP for all non-institutional customers (e.g., seeking to obtain this information only from senior non-institutional customers, not requesting this information within the firm's regularly scheduled 36-month customer account records update letter).

- ▶ **No Written Disclosures:** Not providing a written disclosure explaining the circumstances under which the firm may contact a TCP when seeking to obtain TCP information (e.g., when a customer opens a new non-institutional account or when the firm updates an existing account's information (in accordance with FINRA Rule 4512(b))).
- ▶ **No Documented Training:** Relying on FINRA Rule 2165 but not developing and documenting training policies or programs reasonably designed to ensure associated persons comply with the requirements of the rule.
- ▶ **No Documented Internal Review:** Relying on FINRA Rule 2165 but not retaining records that document the firm's internal review underlying the decision to place a temporary hold on a disbursement or transaction.
- ▶ **Attempted Circumvention of FINRA Rule 3241: Registered persons attempting to circumvent the rule's requirements by having customers name the registered person's spouse or other family members as beneficiaries for customers' accounts.**

### Effective Practices

- ▶ **Training:** Conducting training, for both front office and back office staff, on the warning signs of potential: (1) customer exploitation; (2) diminished capacity; or (3) fraud perpetrated on the customer.
- ▶ **Escalation Process:** Implementing and training registered representatives to use a comprehensive process to escalate issues relating to seniors, including but not limited to concerns about financial exploitation, diminished capacity or cognitive decline.
- ▶ **Emphasizing the Importance of TCP and Promoting Effective Practices:**
  - Emphasizing at the senior-management level on down the importance of collecting TCP information.
  - Using innovative practices, such as creating target goals for collecting TCP and internally publicizing results among branch offices or regions.
  - Promoting effective ways of asking for TCP information and seeking feedback from registered representatives and supervisors on techniques that they have successfully used that have not already been publicized across the organization.
  - Establishing a system that notifies registered representatives when accessing non-institutional customer accounts that do not have a TCP listed and reminds them to request that information from customers.
  - Providing guidance to registered representatives regarding contacting TCPs when the firm places a temporary hold.
- ▶ **Senior Investor Specialists:** Establishing specialized groups or appointing individuals to handle situations involving elder abuse or diminished capacity; contacting customers' TCPs—as well as Adult Protective Services, regulators and law enforcement, when necessary—and guiding the development of products and practices focused on senior customers.
- ▶ **Firm Outreach:** Hosting conferences or joining industry groups focused on protecting senior customers.

### Additional Resources

- ▶ FINRA
  - [2023 Senior Investor Protection Conference](#)<sup>24</sup>
  - [Senior Investors Key Topics Page](#)
  - [Frequently Asked Questions Regarding FINRA Rules Relating to Financial Exploitation of Senior Investors](#)
  - [Protecting Senior Investors 2015-2020](#) (April 30, 2020)
  - *Regulatory Notices*
    - [Regulatory Notice 22-31](#) (FINRA Shares Practices for Obtaining Customers' Trusted Contacts)
    - [Regulatory Notice 22-05](#) (FINRA Adopts Amendments to FINRA Rule 2165)

- **Regulatory Notice [20-38](#)** (FINRA Adopts Rule to Limit a Registered Person From Being Named a Customer’s Beneficiary or Holding a Position of Trust for or on Behalf of a Customer)
- **Regulatory Notice [20-34](#)** (Proposed Amendments to FINRA Rule 2165 and Retrospective Rule Review Report)
- **Regulatory Notice [20-30](#)** (Fraudsters Using Registered Representatives Names to Establish Imposter Websites)
- **Regulatory Notice [19-18](#)** (Suspicious Activity Monitoring and Reporting Obligations)
- FINRA Unscripted Podcasts
  - **[Preventing Financial Exploitation: Steps for Safeguarding Senior Investors](#)** (June 27, 2023)
  - **[The Essential Senior Investor Protection Tools: FINRA Rules 2165 and 4512](#)** (May 03, 2022)
- ▶ FINRA, NASAA and SEC
  - **[NASAA/SEC/FINRA Training: Addressing and Reporting Financial Exploitation of Senior and Vulnerable Adult Investors](#)** (June 2023)
  - [Investor Resources for Establishing a Trusted Contact](#)
- ▶ FinCEN
  - **[FinCEN Advisory: Advisory on Elder Financial Exploitation](#)** (June 15, 2022)

## Crowdfunding Offerings: Broker-Dealers and Funding Portals

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Title III of the Jumpstart Our Business Startups (JOBS) Act enacted in 2012 contains provisions relating to securities offered or sold through crowdfunding. The SEC’s Regulation Crowdfunding allows eligible issuers to offer and sell securities exclusively through the platform of an intermediary (*i.e.*, a firm that is registered with the SEC—either as a broker-dealer or as a funding portal—and is also a FINRA member).

Regulation Crowdfunding and FINRA’s corresponding set of [Funding Portal Rules](#) set forth the principal requirements that apply to funding portal members. Funding portals must register with the SEC and become a member of FINRA. Broker-dealer members contemplating engaging in the sale of securities in reliance on Title III of the JOBS Act must notify FINRA in accordance with FINRA Rule [4518](#) (Notification to FINRA in Connection with the JOBS Act).

**Broker-dealer members should note that, in addition to providing the required notification to FINRA, depending on the facts and circumstances, they may also need to apply for approval of a material change in business operations by filing a [Form CMA](#), and paying related fees, unless they are already approved by FINRA to engage in private placements or underwriting.**<sup>25</sup>

Regulation Crowdfunding imposes certain gatekeeper responsibilities on intermediaries (*i.e.*, both funding portals and broker-dealers that engage in Regulation Crowdfunding transactions). SEC Rule 301(a) under Regulation Crowdfunding provides in part that an intermediary must have a reasonable basis for believing that an issuer seeking to offer and sell securities through the intermediary’s platform complies with the requirements of Regulation Crowdfunding. Furthermore, Rule 301(c)(2) requires an intermediary to deny access to its platform if it has a reasonable basis for believing the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection.

Additionally, SEC Rule 404 under Regulation Crowdfunding imposes certain recordkeeping requirements on funding portals. (Broker-dealer members that engage in Regulation Crowdfunding transactions are subject to the full recordkeeping requirements under Exchange Act Rules 17a-3 and 17a-4, as well as FINRA Rule [3110\(b\)](#) and the [4510](#) Rule Series.) Rule 404 requires funding portal members to make and preserve certain records relating to their funding portal activities. Using a third party to prepare and maintain records on behalf of a funding portal does not relieve the funding portal of its recordkeeping responsibilities.

### Related Considerations

- ▶ What steps is your funding portal taking to ensure it maintains all required records in accordance with Regulation Crowdfunding Rule 404?
- ▶ What steps is your funding portal taking to ensure on- and off-platform communications (including social media) do not offer or contain recommendations, solicitations or investment advice?

## Findings and Effective Practices for Funding Portals<sup>26</sup>

### Findings

- ▶ **Failure to Obtain Written Undertaking:** Not obtaining the written undertaking required by Regulation Crowdfunding Rule 404 when using a third-party vendor to store the required records.
- ▶ **Missing Disclosures:** Offerings on the platform do not contain all required disclosures as codified in Regulation Crowdfunding, in particular:
  - names of officers and directors of the issuer, and the positions these individuals held for the past three years;
  - descriptions of the purpose and intended use of proceeds, the process to complete the offering transaction or cancel an investment commitment, the ownership and capital structure, the material terms of any indebtedness of the issuer; and
  - financial statements, as required by Regulation Crowdfunding Rule 201(t).
- ▶ **Failure to Report Customer Complaints:** Not reporting written customer complaints, as required by Funding Portal Rule 300(c).
- ▶ **Late Filings:** Not making required filings in a timely manner—such as filing the funding portal's Statement of Gross Revenue by the deadline of March 1—and not filing updates or changes to contact information within 30 days of the change.
- ▶ **Not Filing CMAs:** Funding portals effecting changes in ownership without obtaining prior approval from FINRA, as required by Funding Portal Rule 110(a)(4).
- ▶ **Offering Investment Advice or Recommendations; Soliciting Purchases, Sales or Offers:** Sending electronic correspondence to customers that recommended investments or otherwise solicited purchases of securities, thereby violating the prohibitions under Regulation Crowdfunding Rule 402(a) against funding portals engaging in such activity.
- ▶ **Misleading Statements:** Failing to correct misleading statements that appeared on funding portals' websites for offerings on their platforms.
- ▶ **Failing to Transmit Funds:** Failing to promptly direct the transmission of funds to the issuers upon the successful completion of the offerings, or to return funds to investors upon cancellation of the offerings or in the event of oversubscription.
- ▶ **Failing to Take Measures to Reduce Risk of Fraud:** Not denying issuers or offerings access to funding portals' platforms, after funding portals had become aware of warning signs of potentially fraudulent activity during the onboarding process and during issuers' campaigns.

### Effective Practices

- ▶ **Compliance Resources:** Developing annual compliance questionnaires to verify the accuracy of funding portals' reporting, regarding associated persons including follow-up questions (such as whether they have ever filed for bankruptcy, have any pending lawsuits, are subject to unsatisfied judgments or liens or received any written customer complaints), as well as compliance checklists and schedules to confirm that required obligations are being met in a timely manner, such as providing all issuer disclosure requirements of Regulation Crowdfunding Rule 201.
- ▶ **Supervision:** Implementing supervisory review procedures for communications requirements that, for example, clearly define permissible and prohibited communications and identify whether any contemplated structural or organizational changes necessitate the filing of a CMA.

### Additional Resources

- ▶ [Funding Portals Page](#), including:
  - [Funding Portal Checklist](#) (April 7, 2023)
  - [Written Supervisory Checklist for Funding Portals](#) (February 13, 2023)
- ▶ [Frequently Asked Questions \(FAQs\) on Regulation Crowdfunding](#) (December 20, 2023)

# Communications and Sales

## Communications With the Public

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [2210](#) (Communications with the Public) defines all communications into one of three categories—correspondence, retail communications, or institutional communications—and sets principles-based content standards that are designed to apply to ongoing developments in communications technology and practices. New member firms are required to file all widely disseminated retail communications with FINRA’s Advertising Regulation Department during their first year of membership, **and all member firms are subject to filing requirements for specified retail communications depending on their content.**

FINRA Rule [2220](#) (Options Communications) governs member firms’ communications with the public concerning options. Additionally, MSRB Rule [G-21](#) (Advertising by Brokers, Dealers or Municipal Securities Dealers) contains similar content standards relating to municipal securities or concerning the facilities, services or skills of any municipal dealer.

#### Related Considerations

##### ► General Content Standards

- Are your firm’s communications free of false, misleading, **unwarranted**, or promissory statements or claims?
- Do your firm’s communications include material information necessary to make them fair, balanced and not misleading? For example, if a communication promotes the benefits of a high-risk or illiquid security, does it explain the associated risks?
- Do your firm’s communications balance specific claims of benefits from a product or service (especially complex products) with the key risks specific to that product or service?
- Do your firm’s communications contain predictions or projections of investment performance to investors that are generally prohibited by FINRA Rule 2210(d)(1)(F)?

##### ► Mobile Apps

- **Does your mobile app include appropriate risk disclosures at account opening or before a customer transaction?**
- Do your mobile apps adequately distinguish between products and services of the broker-dealer and those of affiliates or third parties?
- Has your firm established and implemented a reasonably designed supervisory system for communications through mobile apps?
- Have you tested the accuracy of account information, including labels and data, displayed in your mobile apps?
- Do your mobile apps accurately describe how their features work?
- Do your mobile apps identify information in ways that are easily understandable, based on the experience level of your customers?
- Does any information provided to retail customers through your mobile apps constitute a “recommendation” that would be covered by Reg BI, and in the case of recommendations of options or variable annuities, FINRA Rules [2360](#) (Options) or [2330](#) (Members’ Responsibilities Regarding Deferred Variable Annuities)? If so, how does your firm comply with these obligations?



- ▶ **Crypto Asset Communications:** If your firm communicates with retail customers concerning crypto assets and crypto asset-related services, do its retail communications to customers contain a fair and balanced presentation of the risks associated with these assets (without unwarranted or misleading content)?<sup>27</sup>
- ▶ **Municipal Securities Communications**
  - If your firm offers municipal securities, does it confirm that “advertisements” for such securities—as defined under MSRB Rule G-21—include the necessary information to be fair, balanced and not misleading, and do not include:
    - exaggerated claims about safety or misleading comparisons to U.S. Treasury securities;
    - statements claiming “direct access” to bonds in the primary market if your firm is not an underwriter; or
    - unwarranted claims about the predictability or consistency of growth or payments?
  - If an advertisement includes claims of municipal securities being “tax free,” does it also explain any applicable state, local, alternative minimum tax, capital gains or other tax consequences? If an advertisement includes a “taxable equivalent” yield on a municipal security offering, does it provide sufficient information regarding the tax bracket used to make the calculation?
- ▶ **Communications Promoting Income Sharing Programs:** If your firm distributes or makes available communications that promote or recommend income sharing programs to retail investors (e.g., fully paid securities lending programs), do the communications accurately and clearly disclose the terms and conditions of the program, including fees customers would receive?
- ▶ **Communications Promoting ESG Factors:** If your firm offers products that promote environmental, social and governance (ESG) factors, do your communications:
  - contain only claims that are supported by or consistent with information contained in the product’s offering documents;
  - contain risk disclosure or language necessary to balance any promotional claims regarding ESG; or
  - use rankings, ratings or awards that lack a sound basis or are unwarranted or misleading based on the criteria used or factors considered?

## Findings and Effective Practices

### Findings

- ▶ **False, Misleading and Inaccurate Information in Mobile Apps:**
  - Misstating **or failing to disclose** the risk of loss associated with certain options transactions.
  - Distributing false or misleading promotions through social media and “push” notifications **or “nudges”** on mobile apps that made promissory claims or omitted material information.
  - **Failing to fully explain and clearly and prominently disclose risks, where required by a specific rule or needed to balance promotional claims, associated with options trading, the use of margin and crypto assets.**
- ▶ **Deficient Communications Promoting Crypto Assets:**
  - **Failing to appropriately and accurately address relevant risks and include appropriate disclosures in communications with the public.**
  - **Disseminating promotional materials that contain material misstatements or omissions in connection with securities offerings.**

- **Failing to clearly differentiate in communications, including those on mobile apps, between crypto assets offered through an affiliate of the member or another third party, and products and services offered directly by the member itself.**
  - **Making false statements or implications that crypto assets functioned like cash or cash-equivalent instruments, or making other false or misleading statements or claims regarding crypto assets.**
  - **Comparing crypto assets to other assets (e.g., stock investments or cash) without providing a sound basis to compare the varying features and risks of these investments.**
  - **Providing misleading explanations of how crypto assets work and their core features and risks.**
  - **Failing to provide a sound basis to evaluate crypto assets by omitting explanations of how crypto assets are issued, held, transferred or sold.**
  - **Misrepresenting the extent to which the federal securities laws or FINRA rules apply to crypto assets.**
  - **Making misleading statements about the extent to which certain crypto assets are protected by SIPC under the SIPA.**
- ▶ **Municipal Securities Advertisements:** Making false and misleading statements or claims about safety, unqualified or unwarranted claims regarding the expertise of the firm, and promissory statements and claims regarding portfolio growth.
- ▶ **Communications Promoting ESG Factors:**
- Using fund communications that contain ESG-related claims that are inconsistent with or unsupported by the fund's offering documents.
  - Including ESG rankings, ratings, or awards that are unwarranted or misleading based on the criteria used or factors considered.

### Effective Practices

- ▶ **Reasonably Designed Procedures for Mobile Apps:** Maintaining and implementing procedures for the supervision of mobile apps, for example, that confirm:
- data displayed to customers is accurate; and
  - information about mobile apps' tools and features complies with FINRA's communications and other relevant rules before it is posted to investors.
- ▶ **Reasonably Designed Procedures for Digital Communications:** Establishing, maintaining and enforcing procedures for supervision of digital communication channels, including:
- **Monitoring of New Tools and Features:** Monitoring new communication channels, apps and features available to associated persons and customers;
  - **Defining and Enforcing Permissible and Prohibited Activity:** Clearly defining permissible and prohibited digital communication channels, tools and features, and blocking those prohibited channels, tools and features that prevent firms from complying with their recordkeeping requirements;
  - **Supervision:** Implementing supervisory review procedures tailored to each digital channel, tool and feature;
  - **Video Content Protocols:** Developing WSPs and controls for live-streamed public appearances, scripted presentations or video blogs;
  - **Training:** Implementing mandatory training programs prior to providing access to firm-approved digital channels, including expectations for business and personal digital communications and guidance for using all permitted features of each channel; and

- **Disciplinary Action:** Temporarily suspending or permanently blocking from certain digital channels or features those registered representatives who did not comply with the policies, and requiring them to take additional digital communications training before resuming use.
- ▶ **Crypto Asset Retail Communications Review: Ensuring that retail communications concerning crypto assets provide a fair and balanced presentation of the risks associated with these assets, including:**
  - the speculative nature of crypto assets (*e.g.*, their significant volatility, the potential for investors to lose the entire amount they invest);
  - the lack of legal or regulatory protections for most crypto assets (*e.g.*, SIPC protections apply only to cash and securities held for an investor for certain purposes in a customer securities account at a SIPC-member broker-dealer and do not apply to crypto assets that do not qualify as SIPC “securities”), the extent to which the protections provided by transacting through a SEC-registered entity will apply;
  - regulatory uncertainty concerning the crypto assets; and
  - fraud risks that may be present.
- ▶ **Differentiating Crypto Asset Products Communications From Broker-Dealer Products Communications:** Identifying, segregating and differentiating firms’ communications related to broker-dealer products and services from those related to offerings by affiliates or third parties, including crypto asset affiliates; and clearly and prominently identifying in communications non-broker-dealer affiliates or other third-parties responsible for non-securities crypto assets businesses (and explaining that such services were not offered by the broker-dealer or subject to the same regulatory protections as those available for securities).
- ▶ **Municipal Securities Advertisements:** Maintaining and implementing reasonably designed procedures for firm municipal securities communications, including:
  - requiring prior approval of all advertisements concerning municipal securities by an appropriately qualified principal to confirm the content complies with applicable content standards;
  - providing education and training for firm personnel on applicable FINRA and MSRB rules and firm policies;
  - balancing statements concerning the benefits of municipal securities by prominently describing the risks associated with municipal securities, including credit risk, market risk and interest rate risk; and
  - reviewing firms’ communications to confirm that the potential benefits of tax features are accurate and not exaggerated.
- ▶ **Communications Promoting ESG Factors:** Implementing and maintaining reasonably designed procedures for communications promoting ESG factors, including:
  - reviewing communications to ensure that ESG-related claims are consistent with and supported by applicable offering documents;
  - balancing statements promoting ESG factors by prominently describing the risks associated with ESG funds, including that:
    - ESG-related strategies may not result in favorable investment performance;
    - there is no guarantee that the fund’s ESG-related strategy will be successful; and
    - the fund may forego favorable market opportunities in order to adhere to ESG-related strategies or mandates.

## Additional Resources

### ▶ FINRA

- [Advertising Regulation Key Topics Page](#)
- [Social Media Key Topics Page](#)
- **2023 FINRA Annual Conference: [Crypto Asset Developments and Redefining Communications Compliance for the Digital Age](#)**
- *Regulatory Notices*
  - *Regulatory Notice [21-25](#)* (FINRA Continues to Encourage Firms to Notify FINRA if They Engage in Activities Related to Digital Assets)
  - *Regulatory Notice [20-21](#)* (FINRA Provides Guidance on Retail Communications Concerning Private Placement Offerings)
  - *Regulatory Notice [19-31](#)* (Disclosure Innovations in Advertising and Other Communications with the Public)
  - *Regulatory Notice [17-18](#)* (Guidance on Social Networking Websites and Business Communications)
  - *Regulatory Notice [11-39](#)* (Social Media Websites and the Use of Personal Devices for Business Communications)
  - *Regulatory Notice [10-06](#)* (Guidance on Blogs and Social Networking Web Sites)

### ▶ MSRB

- *MSRB Notice [2019-07](#)* (MSRB Establishes Effective Date for Advertising Rules and Provides Social Media Guidance and Related Rule Amendments)
- *MSRB Notice [2018-18](#)* (SEC Approves Advertising Rule Changes for Dealers and Municipal Advisors)

## Reg BI and Form CRS

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### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

The SEC's [Regulation Best Interest](#) (Reg BI) establishes a “best interest” standard of conduct for broker-dealers and associated persons when they make recommendations to retail customers of any securities transaction or investment strategy involving securities, including account recommendations. Pursuant to this standard, a broker-dealer and its associated persons must not put their financial or other interests ahead of the interests of a retail customer. The standard of conduct established by Reg BI cannot be satisfied through disclosure alone.

Separately, whether they make recommendations or not, member firms that offer services to retail investors must file and provide retail investors with a Form CRS, a brief relationship summary that discloses material information about the firm in plain language (*e.g.*, investment services provided, fees, conflicts of interest, legal and disciplinary history of the firms and associated persons).

Reg BI and Form CRS became effective on June 30, 2020, and FINRA has been examining member firms' implementation of those obligations throughout 2021-2023. FINRA will share further findings as we continue to conduct exams and gather additional information on member firms' practices.

## Related Considerations<sup>28</sup>

### Reg BI

#### Care Obligation

- ▶ When your firm or associated persons make a recommendation to a retail customer, do they exercise reasonable diligence, care and skill to **form a reasonable basis to believe that the recommendation is in the best interest of that particular retail customer by:**
  - understanding and considering the potential risks, rewards and costs associated with the **recommended product, investment strategy, account type, or series of transactions;**
  - obtaining and analyzing sufficient information about the retail customer's investment profile; and
  - considering a sufficient array of reasonably available alternatives, including lower-cost or lower-risk alternatives, if any, your firm offers?
- ▶ **Does your firm provide guidance to its associated persons on how to evaluate costs and reasonably available alternatives when making recommendations?**
- ▶ Has your firm and its associated persons considered applying heightened scrutiny as to whether recommended investments that are high-risk, high-cost, complex or represent a significant conflict of interest are in a retail customer's best interest?
- ▶ For recommendations of types of accounts, does your firm and its associated persons:
  - establish a reasonable understanding of the characteristics of a particular type of account by considering factors such as:
    - the services and products provided in the account (including ancillary services provided in conjunction with an account type, such as account monitoring services);
    - alternative account types available;
    - whether the account offers the services requested by the retail customer; and
    - whether these factors are consistent with the retail customer's investment profile?
  - consider the projected costs of the recommended account, including, for example, account fees (e.g., asset-based, engagement, hourly), commissions and transaction costs (e.g., markups and markdowns), tax considerations, as well as indirect costs, such as those associated with payment for order flow and cash sweep programs?
- ▶ When making account rollover or transfer recommendations, including retirement accounts:
  - do your firm and its associated persons ensure that they have a reasonable basis to believe that the rollover or transfer itself, the account type being recommended, and any securities or investment strategies recommended are in the retail customer's best interest; and
  - do your firm and its associated persons consider, in addition to the general considerations for all account and securities recommendations, specific factors potentially relevant to rollovers or transfers, such as costs (e.g., costs associated with closing out securities, if the customer has to sell them as a result of the recommendation to transfer), level of services available, features of the existing account, available investment options, ability to take penalty-free withdrawals, application of required minimum distributions, protection from creditors and legal judgments, and holdings of employer stock?
- ▶ **Does your firm and do its associated persons understand how they should consider reasonably available alternatives and, to the extent required by your firm's policies and procedures, when to document these considerations?**
  - **Do your firm and its associated persons consider the potential risks, rewards and costs associated with reasonably available alternatives?**

- **Has your firm developed a process to identify the scope of reasonably available alternatives that its associated persons should evaluate?**
  - **Do your firm and its associated persons begin by considering a broader array of investments or investment strategies generally consistent with the retail customer's profile, before narrowing the scope of a smaller universe of potential investments or investment strategies, as the analysis becomes more focused on meeting the best interest of a particular retail customer?**
- **Do your firm and its associated persons consider reasonably available alternatives to high-risk and complex products when making recommendations to retail customers? If so, how?**
- **When recommending a higher-cost or higher-risk product, do your firm and its associated persons consider whether any reasonably available alternatives are less costly or lower risk, and consistent with the retail customer's investment profile?**

#### *Conflict of Interest Obligation*

- ▶ Does your firm establish, maintain and enforce written policies and procedures **that are tailored to your firm's business model** to identify and at a minimum disclose, or eliminate, all conflicts of interest associated with a recommendation?
- ▶ **To identify conflicts of interest, does your firm consider the following non-exhaustive list of practices:**
  - **defining conflicts in a manner that is relevant to the firm's business;**
  - **evaluating whether conflicts arise in different aspects of the relationship with the retail customer, including account recommendations, product menus, allocation of investment opportunities among retail customers and cash management services;**
  - **establishing a process to identify the types of conflicts the firm and its associated persons may face and how such conflicts may impact recommendations;**
  - **providing for an ongoing process to identify conflicts arising, for example, in connection with changes to the firm's business or structure, changes in compensation structures or introduction of new products or services; and**
  - **establishing training programs regarding conflicts of interest that addresses roles and responsibilities (among other considerations)?**
- ▶ With respect to account recommendations, does your firm consider the following non-exhaustive list of practices that can help your firm meet its obligations with respect to conflicts of interest by:
  - avoiding compensation thresholds that disproportionately increase compensation through openings of certain account types;
  - adopting and implementing policies and procedures reasonably designed to minimize or eliminate incentives, including both compensation and non-compensation incentives, for employees to favor one type of account over another;
  - implementing supervisory procedures to monitor recommendations that involve the rollover or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an Employee Retirement Income Security Act of 1974 (ERISA) account to an IRA); and
  - adjusting compensation for financial professionals who fail to adequately manage conflicts of interest associated with account recommendations?
- ▶ **With respect to your firm's compensation practices for associated persons, does your firm assess:**
  - **whether the firm's compensation practices incentivize its associated persons to offer recommendations that are not in their retail customers' best interests;**

- **whether the basis for calculating associated persons' compensation has the effect of passing along firm-level conflicts to their associated persons, such as incentivizing associated persons to recommend certain products, account types or services to retail customers that are most profitable for the firm; and**
- **whether its associated persons also receive other types of compensation or benefits that may create conflicts of interest that would need to be addressed under Reg BI (and whether the firm has policies and procedures and other supervisory systems in place to identify and address any such conflicts)?**

#### *Disclosure Obligation*

- ▶ Does your firm have adequate controls to assess whether it provides disclosures in a timely manner and, if provided electronically, in compliance with the SEC's electronic delivery guidance?
- ▶ Does your firm provide dually registered associated persons with adequate guidance on how to determine and disclose the capacity in which they are acting?
- ▶ Do your firm and its associated persons supplement firm disclosures when appropriate (*e.g.*, an associated person's licensure only permits them to recommend a limited range of securities products offered by your firm, an associated person who is a dual-registrant disclosing the capacity in which he or she is acting at the time of the recommendation, an associated person has additional material conflicts of interest related to the recommendation beyond those disclosed by your firm)?
- ▶ How does your firm document and track the delivery of Reg BI-related disclosure documents to retail customers?
- ▶ Do your firm and its associated persons periodically evaluate the materiality of any changes related to the scope and terms of their relationship with their customer to determine whether they are required to update the disclosures they provided to their retail customers?

#### *Compliance Obligation*

- ▶ Are your firm's policies and procedures tailored to address your firm's business lines, products and services, customer base and conflicts of interest?
- ▶ Do your firm's policies and procedures:
  - specify the supervisory steps and reviews appropriate supervisor(s) should take and their frequency; and
  - note how supervisory reviews should be documented?
- ▶ To prevent your firm from placing its interest ahead of the retail customers' interest, does your firm continue to periodically re-evaluate the adequacy of its policies and procedures and related processes to achieve compliance with Reg BI, including re-evaluating its conflicts of interest and disclosures, in connection with changes to its product mix or business activities?
- ▶ Does your firm evaluate and test the adequacy of its systems and controls considered to be critical in supporting compliance with Reg BI? For example:
  - how does your firm test its policies and procedures to determine if they are adequate and performing as expected; and
  - does your firm make enhancements to its supervisory system, procedures and processes based on feedback it has received from internal reviews, regulatory examinations or SEC and FINRA guidance concerning Reg BI compliance—if so, does your firm incorporate these enhancements into timely training provided to associated persons?
- ▶ If your firm initially determined that it had no obligation to comply with Reg BI, has it periodically re-evaluated its initial determination in light of any changes to its business practices (*e.g.*, acquiring new business lines or changing how it interacts with customers)?



- ▶ Has your firm considered how it will demonstrate (via documentation or otherwise) that it has met its obligations with respect to the basis for recommendations, particularly, though not exclusively regarding:
  - recommendations of account types;
  - recommendations of complex, risky or illiquid securities; or
  - recommendations that appear inconsistent with a retail customer's investment profile?

### Form CRS

- ▶ Does your firm periodically evaluate changes to its business mix or products or services offered, or otherwise periodically re-evaluate the accuracy of information (e.g., disciplinary history) in its Form CRS, to determine whether it is required to update and file an amended Form CRS? Does your firm have processes in place to communicate (without charge) any changes made to the Form CRS to retail investors who are existing customers?
- ▶ How does your firm track and document the delivery of Form CRS to retail investors?

## Findings and Effective Practices

### Findings

#### Reg BI

##### ▶ Failure to Comply with The Care Obligation:

- Failing to conduct a reasonable investigation of offerings prior to recommending them to retail customers (e.g., unable to reasonably evidence due diligence efforts regarding the issuer; relying solely on the firm's past experience and knowledge with an issuer based on previously completed offerings).<sup>29</sup>
- Making recommendations of securities or investment strategies involving securities (including account type) without a reasonable basis to believe that they were in the best interest of a particular retail customer.
- Recommending a series of transactions that were excessive in light of retail customers' investment profiles and factors such as high cost-to-equity ratios and high turnover ratios.
- Limiting consideration of cost solely to sales charges instead of also considering other relevant costs and fees, such as product or account-level fees, when recommending a product.
- Not maintaining profile information for retail customers in accordance with Exchange Act Rule 17a-3(a) (35), thereby undermining the firm and its associated persons' ability to demonstrate compliance with the Care obligation (e.g., not obtaining complete or current customer profile information for new or existing retail customers).
- **Recommending complex or illiquid products that are inconsistent with the retail customer's investment profile by, for example, exceeding concentration limits specified in a firm's policies, or comprising a sizable portion of a retail customer's liquid net worth or securities holdings.**

##### ▶ Failure to Comply with Conflict of Interest Obligation:

- Not identifying conflicts and disclosing, mitigating or eliminating, as appropriate, conflicts of interest associated with recommendations of securities transactions or investment strategies involving securities.
- Not identifying and mitigating (i.e., modifying practices to reduce) conflicts of interest that create an incentive for an associated person to make securities recommendations that place the interests of the associated person or the firm ahead of the interests of the retail customer, including:
  - not properly supervising or enforcing policy restrictions on certain types of recommendations (e.g., transactions in affiliated private funds) intended to mitigate or eliminate potential conflicts; and
  - not identifying and mitigating potential conflicts regarding revenue or fee sharing arrangements with fund managers for offerings that were recommended to retail customers.

- Not identifying and addressing all potential conflicts of interest relevant to a firm’s business model, including, but not limited to, material limitations on securities or investment strategies and conflicts associated with these limitations.

▶ **Failure to Comply with Disclosure Obligation:**

- Not providing retail customers with “full and fair” disclosures of all material facts related to the scope and terms of their relationship with these retail customers or related to conflicts of interest that are associated with the recommendation, including:
  - material fees received as a result of recommendations made (*e.g.*, revenue sharing, or other payments received from product providers or issuers, as well as other fees tied to recommendations to roll over qualified accounts);
  - potential conflicts of interest;
  - material limitations in securities offerings; and
  - transaction-based fees that were inconsistent with—and, in some cases, materially higher than—those outlined in Reg BI customer disclosures.
- Associated persons, firms, or both, improperly using the terms “advisor” or “adviser” in their titles or firm names, even though they lack the appropriate registration.

▶ **Failure to Comply with Compliance Obligation:**

- Failing to adopt and implement written policies and procedures that are reasonably designed to achieve compliance with Reg BI by, for example, stating the rule requirements but failing to identify how the firm will comply with those requirements (*e.g.*, requiring associated persons to consider costs and reasonably available alternatives when making recommendations, but not specifically addressing or detailing how associated persons should do so).
- Failing to develop adequate controls or developing adequate controls but not memorializing these processes in their WSPs.
- Failing to enforce Reg BI procedures or supervisory processes for compliance, such as outlining documentation requirements but failing to implement any process to confirm associated persons are complying with the firms’ requirements.
- Failing to maintain sufficient systems or controls supporting firms’ ongoing trade surveillance to identify potential non-compliance with Reg BI, such as relying on manual review methods that were inconsistently performed or controls that were not reasonable given firms’ volume of transactions.
- Failing to conduct adequate or ongoing training of associated persons regarding the use of systems and processes established to support Reg BI compliance.
- Failing to ensure that recommendations involving variable annuities were compliant with Reg BI (*e.g.*, not adequately collecting and retaining key information on variable annuity transactions; and not sufficiently training registered representatives and supervisors to determine whether variable annuity exchanges complied with the standards of Reg BI).<sup>30</sup>

## Form CRS

- ▶ **Deficient Form CRS Filings:** Firms’ Form CRS filings significantly departing from the [Form CRS instructions](#) or SEC guidance by:
- exceeding prescribed page lengths;
  - omitting material facts (*e.g.*, description of services offered, limitations of the firm’s investment services, incomplete or inaccurate cost disclosures);
  - inaccurately representing the firm’s or its associated persons’ disciplinary histories, including inappropriate qualifying language to explain disciplinary history;

- failing to describe, or inaccurately describing types of compensation and compensation-related conflicts;
  - incorrectly stating that the firm does not provide recommendations; and
  - changing or excluding language required by Form CRS.
- ▶ **Failing to Properly Deliver Form CRS:** Failing to deliver or not creating a record of the date on which your firm provided each Form CRS to each retail investor, including any Form CRS provided before such retail investor opened an account.
- If the relationship summary is delivered electronically, failing to present it prominently in the electronic medium and make it easily accessible for retail investors (**e.g., by solely placing a link to the CRS in an email footer below the signature line; by including the CRS among other disclosures in a zip file attachment without any mention of the CRS in the email.**)
- ▶ **Failing to Properly Post Form CRS:** For firms that have a public website, failing to post or failing to post prominently, in a location and format that is easily accessible to retail investors, the current Form CRS (e.g., requiring multiple click-throughs or using confusing descriptions to navigate to the Form CRS).
- ▶ **Failing to Adequately Amend Form CRS:** Firms not in compliance with Form CRS in relation to material changes because they:
- failed to timely re-file in CRD (*i.e.*, within 30 days of the date when Form CRS became materially inaccurate); or
  - failed to communicate or timely communicate changes to existing retail investors (e.g., delivering amended summary, with required exhibits, showing revised text or summarizing material changes or communicating the information through another disclosure within 60 days after the updates are required to be made—90 days total from the date when Form CRS became materially inaccurate).
- ▶ **Misconstruing Obligation to File and Deliver Form CRS:** Incorrectly assuming a firm is not subject to the Form CRS delivery obligation because of, among other things, their customer base (e.g., retail investors who are high-net-worth individuals) or the services they offer (e.g., selling investment company products held directly by an issuer, self-directed accounts).

## Effective Practices

### Care Obligation

- ▶ **Costs and Reasonably Available Alternatives:** Including in procedures and processes specific factors related to evaluating costs and reasonably available alternatives to recommended products, including but not limited to:
- providing clear guidance to associated persons making recommendations on how to evaluate costs and reasonably available alternatives, such as by:
    - using worksheets, in paper or electronic form, to compare costs and reasonably available alternatives;
    - **creating notes or documents in a similar format to evaluate recommended transactions and provide information on the retail customer’s financial situation, needs and goals (and substantiate why that specific recommendation was in the retail customer’s best interest);**
    - specifying the relevant factors to consider when evaluating costs (e.g., deferred sales charges) and reasonably available alternatives (e.g., similar investment types or less-complex or less-risky products available at the firm); or
    - updating client relationship management (CRM) tools to automatically compare recommended products to reasonably available alternatives.
  - setting forth clear supervisory processes that address reviews and firm-required documentation;
  - sampling recommended transactions to evaluate how costs and reasonably available alternatives were considered;

- outlining firm documentation practices; and
  - discussing limitations on complex or higher-risk products, such as firm concentration guidelines or minimum liquid net worth requirements.
- ▶ **Heightened Scrutiny of Investments for Retail Customers:** Mitigating the risk of making recommendations that might not be in a retail customer's best interest by:
- establishing product review processes to identify and categorize risk and complexity levels for existing and new products; and
  - applying heightened supervision to recommendations of products, or investment strategies involving securities, that are high risk, high cost, complex or represent a significant conflict of interest, or limiting such recommendations to specific customer types.

### Conflict of Interest Obligation

- ▶ **Policies and Procedures:** Establishing and implementing policies and procedures to address conflicts of interest by:
- using conflicts committees or other mechanisms, or creating conflicts matrices tailored to the specifics of the firm's business that address, for example, conflicts across business lines and how to eliminate, mitigate or disclose those conflicts;
  - revising commission schedules for recommendations within product types to flatten the percentage payout rate to employees; and
  - broadly prohibiting all sales contests, regardless of whether they are required to be eliminated under Reg BI.

### Disclosure Obligation

- ▶ **Implementing Systems Enhancements for Tracking Delivery of Required Customer Documents:** Tracking and delivering Form CRS and Reg BI-related documents to retail customers in a timely manner by:
- automating tracking mechanisms to evidence delivery of Form CRS and other relevant disclosures; and
  - memorializing delivery of required disclosures at the earliest triggering event.
- ▶ **Providing Clear Disclosure on Account Type Recommendations:** Providing retail customers with clear, accessible materials that allow them to compare the features, benefits and costs of certain account type recommendations (e.g., rollovers).

### Compliance Obligation

- ▶ **Implementing New Surveillance Processes:** Monitoring associated persons' compliance with Reg BI by:
- conducting **regular** reviews to confirm that their recommendations meet Care Obligation requirements, including system-driven alerts or trend criteria to identify:
    - account type or rollover or transfer recommendations that may be inconsistent with a retail customer's best interest;
    - products that are high risk, high cost, complex or represent a significant conflict of interest;
    - excessive trading; and
    - sale of same product(s) to a high number of retail customers.
  - monitoring communication channels (e.g., email, social media) to confirm that associated persons who were not investment adviser representatives (IARs) were not using the word "adviser" or "advisor" in their titles.

- ▶ Incorporating Reg BI-specific reviews into the branch exam program, in addition to other ongoing monitoring and surveillance.
- ▶ Focusing on areas such as documenting Reg BI compliance and following the firms' Reg BI protocols (as part of overall Reg BI compliance efforts)

## Additional Resources

- ▶ FINRA
  - [SEC Regulation Best Interest Key Topics Page](#)
  - **2023 FINRA Annual Conference: [Current Issues Under Regulation Best Interest and Form CRS](#)**
  - ***Regulatory Notice 23-20* (FINRA Highlights Available Guidance and Resources Related to Regulation Best Interest)**
- ▶ SEC
  - [Regulation Best Interest Guidance Page](#)
  - **[Frequently Asked Questions on Form CRS \(December 8, 2023\)](#)**
  - **[Staff Bulletin – Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations \(April 30, 2023\)](#)**
  - **[Observations from Broker-Dealer Examinations Related to Regulation Best Interest \(January 30, 2023\)](#)**
  - [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest \(August 3, 2022\)](#)
  - [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors \(March 30, 2022\)](#)
  - [Staff Statement Regarding Form CRS Disclosure \(December 17, 2021\)](#)
  - You may submit a question by email to [tradingandmarkets@sec.gov](mailto:tradingandmarkets@sec.gov); additionally, you may contact the SEC's Division of Trading and Markets' Office of Interpretation and Guidance at (202) 551-5777.

## Private Placements

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

In *Regulatory Notice 23-08* (FINRA Reminds Members of Their Obligations When Selling Private Placements), FINRA noted the obligations of member firms that recommend private placements to conduct a reasonable investigation of those securities under Reg BI and FINRA Rule [2111](#) (Suitability), as well as other obligations that apply even in the absence of a recommendation, including FINRA Rules [2210](#) (Communications with the Public), [3110](#) (Supervision), [3280](#) (Private Securities Transactions of an Associated Person), [5122](#) (Private Placements of Securities Issued by Members) and [5123](#) (Private Placements of Securities).

*Regulatory Notice 23-08* updates and supplements guidance published under *Regulatory Notice 10-22* (Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings) and reiterates members' obligation, when recommending a security, to conduct a reasonable investigation of the security by evaluating, at a minimum, "the issuer and its management; the business prospects of the issuer; the assets held by or to be acquired by the issuer; the claims being made; and the intended use of proceeds of the offering."

Although FINRA's Suitability Rule continues to apply to recommendations to non-retail customers, broker-dealers that recommend any securities transaction or investment strategy involving securities, including recommendations of private offerings, to retail customers are subject to the requirements of Reg BI. Among other things, Reg BI requires a broker-dealer to exercise reasonable diligence, care and skill in understanding the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. A broker-dealer could violate the reasonable basis portion of Reg BI's Care Obligation by not fully understanding the recommended security, even if the security could have been in the best interest of at least some retail customers.

Additionally, FINRA Rules 5122 and 5123 require member firms to timely file with FINRA offering documents and information for the private placements they offer or sell, including retail communications used by the broker-dealer to promote or recommend an offering, unless there is an available exemption.

### Related Considerations

- ▶ Does your firm have policies and procedures reasonably designed to achieve compliance with Reg BI when making recommendations of private placements to retail customers?
- ▶ Do your firm's promotional communications for its private placements balance the potential benefits of the investment with a disclosure of the potential risks—including risks relevant to many private placements, such as:
  - their illiquid nature;
  - the lack of access to comprehensive information (with which to value the securities or a transparent market to set the market price);
  - the absence of substantial operating history; and
  - the lack of independently audited financial statements?
- ▶ What policies and procedures does your firm have to address filing requirements and timelines under FINRA Rules 5122 and 5123? How does it review for compliance with such policies?
- ▶ How does your firm confirm that associated persons conduct reasonable investigations prior to recommending private placement offerings, including conducting further inquiry into red flags?
- ▶ How does your firm independently address conflicts of interest identified during the reasonable investigation process and in third-party due diligence reports?
- ▶ How does your firm manage contingency offerings, including the transmission of funds and review of the contingency terms, in order to ensure compliance with Exchange Act Rules 10b-9 and 15c2-4, as applicable?
- ▶ **If your firm prohibits recommending private placements offered by your firm, does it reflect this prohibition in its policies and procedures (and does your firm take steps to confirm that associated persons comply with the prohibition)?**

## Findings and Effective Practices

### Findings

- ▶ **Late Filings:** Not maintaining policies and procedures, processes and supervisory programs to comply with filing requirements; and failing to make timely filings (with, in some cases, delays lasting as long as six to 12 months after the offering's first date of sale).
- ▶ **Failure to Comply with Reg BI's Conflicts of Interest Obligation: Not adequately identifying, disclosing and, where required, mitigating conflicts of interest associated with recommendations of private placements.**<sup>31</sup>
- ▶ **Failing to Conduct Reasonable Investigation: Failing to fulfill reasonable basis obligations prior to recommending private placements to retail investors, by:**

- failing to conduct an appropriate level of research, particularly when there is a lack of operating history;
- relying solely on the firm’s past experience and knowledge with an issuer based on previously completed offerings;
- failing to inquire into, analyze and resolve red flags identified during the reasonable investigation process or in third-party due diligence reports; and
- **failing to conduct a reasonable investigation of the issuer, the individuals involved in its management or other “covered persons” under Reg D.**

▶ **Failure to Evidence Due Diligence**

- Failing to maintain records of, or otherwise evidence or reasonably explain, due diligence efforts into issuers’ financial condition, operations, representations of past performance, and involvement in litigation.

### Effective Practices

- ▶ **Private Placement Checklist:** Creating reasonably designed checklists with—or adding to existing due diligence checklists—articulated processes, requirements for filing and related documentation, assignment of staff responsible for performing functions and tasks, and evidence of supervisory principal approval for the reasonable investigation process.
- ▶ **“Bad Actor” Questionnaires: Reviewing “Bad Actor” forms or similar questionnaires at both the issuer level (e.g., Directors’ and Officers’ Questionnaires) and placement agent level (e.g., registered representative questionnaires) to support compliance with Rules 506(d) and 506(e) of Regulation D.**
- ▶ **Independent Research:** Conducting and documenting independent research on material aspects of the offering; verifying representations and claims made by the issuer that are crucial to the performance of the offering (e.g., unrealistic costs projected to execute the business plan, coupled with unsupported projected timing and overall rate of return for investors); identifying any red flags with the offering or the issuer, such as questionable business plans or unlikely projections or results; and addressing and, if possible, resolving concerns that would be deemed material to a potential investor, such as liquidity restrictions.
- ▶ **Identifying Conflicts of Interest:** Identifying conflicts of interest (e.g., firm affiliates for issuers whose control persons were also employed by the firm) and then addressing such conflicts (such as by confirming that the issuer prominently and comprehensively discloses these conflicts in offering documents or mitigating them by removing financial incentives to recommend a private offering over other investments).
- ▶ **Responsibility for Reasonable Investigation and Compliance:** Assigning responsibility for private placement reasonable investigation and compliance with filing requirements to specific individual(s) or team(s), and conducting targeted, in-depth training about the firms’ policies, process and filing requirements.
- ▶ **Review of Offering Terms: Reviewing offering terms to determine if they are reasonably structured for compliance with applicable rules (e.g., analyzing the escrow arrangements and termination provisions in contingency offerings).**
- ▶ **Post-Closing Assessment:** When reasonable, conducting reviews after the offering closes to ascertain whether offering proceeds were used in a manner consistent with the offering memorandum and maintaining supporting records of the firm’s reasonable investigation efforts.



## Additional Resources

### ▶ FINRA

- [Private Placements Key Topics Page](#)
- [Corporate Financing Private Placement Filing System User Guide](#)
- [FAQs about Private Placements](#)
- [Regulation Best Interest Key Topics Page](#)
- [Report Center - Corporate Financing Report Cards](#)
- *Regulatory Notices*
  - **[Regulatory Notice 23-08 \(FINRA Reminds Members of Their Obligations When Selling Private Placements\)](#)**
  - [Regulatory Notice 21-26](#) (FINRA Amends Rules 5122 and 5123 Filing Requirements to Include Retail Communications That Promote or Recommend Private Placements)
  - [Regulatory Notice 21-10](#) (FINRA Updates Private Placement Filer Form Pursuant to FINRA Rules 5122 and 5123)
  - [Regulatory Notice 20-21](#) (FINRA Provides Guidance on Retail Communications Concerning Private Placement Offerings)
  - [Regulatory Notice 10-22](#) (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings)

### ▶ SEC

- [Regulation Best Interest Guidance Page](#)
- **[Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings and Related Disclosure Requirements \(September 19, 2013\)](#)**

### FINRA Provides Update on Targeted Exam Focused on SPACs

- ▶ In October 2023, FINRA provided an [update](#) to its targeted exam sweep to review firms’ offering of, and services provided to, Special Purpose Acquisition Companies (SPACs) and their affiliates (*e.g.*, sponsors, principal stockholders, board members and related parties). FINRA’s review focuses on a cross-section of firms that participated in SPAC offerings and included, among other things, reasonable investigation, best interest, disclosure of outside activities or potential conflicts, net capital and supervision.
- ▶ The update highlights several initial themes from our reviews of firms’ offering of, and services provided to, SPACs and their affiliates (*e.g.*, sponsors, principal stockholders, board members and related parties), and includes questions for firms to consider as they evaluate whether their supervisory systems are reasonably designed to address risks of their SPAC-related activities, including:
  - reasonable investigation of the issuers and the securities they recommend, including SPACs;
  - underwriting compensation and disclosures;
  - identifying, addressing and disclosing potential or actual conflicts of interest when underwriting or recommending transactions in SPACs; and
  - firms’ supervisory systems, procedures, processes and controls for underwriting and recommending transactions in SPACs.

## Variable Annuities

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [2330](#) (Members' Responsibilities Regarding Deferred Variable Annuities) establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities. To the extent that a broker-dealer or associated person is making recommendations concerning a variable annuity to a retail customer, Reg BI's obligations, discussed above, also would apply.

In addition, FINRA Rule 2330 requires member firms to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule. Member firms must implement surveillance procedures to determine if any associated person is effecting deferred variable annuity exchanges at a rate that might suggest conduct inconsistent with FINRA Rule 2330 and any other applicable FINRA rules or the federal securities laws.

#### Related Considerations

- ▶ How does your firm review for rates of variable annuity exchanges (e.g., does your firm use any automated tools, exception reports or surveillance reports)?
- ▶ Does your firm have standardized review thresholds for rates of variable annuity exchanges?
- ▶ Does your firm have a process to confirm its variable annuity data integrity with insurance carriers and third-party data providers?
- ▶ How do your firm's WSPs support a determination that a recommendation of a variable annuity exchange has a reasonable basis? How do you obtain, evaluate and record relevant information, such as:
  - loss of existing benefits;
  - increased fees or charges;
  - surrender charges, or the establishment or creation of a new surrender period;
  - consistency of customer liquid net worth invested in the variable annuity with their liquidity needs;
  - whether a share class is in the customer's best interest, given his or her financial needs, time horizon and riders included with the contract; and
  - prior exchanges within the preceding 36 months?
- ▶ Do your firm's policies and procedures require registered representatives to inform customers of the various features of recommended variable annuities, such as surrender charges, potential tax penalties, various fees and costs, and market risk?
- ▶ What is the role of your registered principals in supervising variable annuity transactions, including verifying how the customer would benefit from certain features of deferred variable annuities (e.g., tax-deferral, annuitization, a death or living benefit)? What processes, forms, documents and information do your firm's registered principals rely on to make such determinations?
- ▶ What is your firm's process to supervise registered representatives who make recommendations regarding buyout offers?
- ▶ What is your firm's process for supervisory review when a registered representative recommends additional deposits into existing variable annuity contracts? What is your firm's process for documenting the rationale for the additional deposit?
- ▶ Does your firm maintain records of retail customers' investment objectives, risk tolerance and other information that support the rationale for recommending particular investment options?

## Findings and Effective Practices

### Findings

- ▶ **Exchanges:** Not reasonably supervising recommendations of exchanges for compliance with FINRA Rule 2330 and Reg BI, leading to exchanges that were inconsistent with the customer's investment objectives and time horizon and resulted in, **among other consequences:**
  - increased fees to the customer (**e.g., surrender fees for early liquidation of the customer's existing product**); or
  - the loss of material, paid-for accrued benefits (**e.g., loss of living benefit rider**).
- ▶ **Inadequate Surveillance: Inadequate procedures and systems that do not detect rates of exchanges that may indicate a violation of FINRA Rule 2330 and Reg BI (e.g., recommending the same replacement of a variable annuity to many customers with different investment objectives).**
- ▶ **Insufficient Training:** Not conducting training for registered representatives and supervisors regarding how to assess and compare costs and fees, surrender charges and long-term income riders to determine whether exchanges complied with the standards of FINRA Rule 2330 and Reg BI.
- ▶ **Poor and Insufficient Data Quality:** Not collecting and retaining key information on variable annuity transactions, particularly in connection with exchange transactions; relying on processes for data collection and retention in situations where the volume of variable annuity transactions renders these processes ineffective; and failing to address inconsistencies in available data for variable annuities, as well as data formats and reporting processes.
- ▶ **Issuer Buyouts:** Not reasonably supervising recommendations related to issuer buyout offers (e.g., registered representatives' recommendations that investors surrender the contract to generate an exchange or new purchase) for compliance with FINRA Rule 2330 and Reg BI.
- ▶ **Additional Deposits:** Failing to evaluate and supervise registered representatives' recommendations of additional deposits into existing VA contracts, including review of disclosure, any applicable surrender fees related to this transaction and rationale for the addition.
- ▶ **Reasonably Available Alternatives:** Pursuant to Reg BI, insufficient consideration of reasonably available alternatives to the recommended VA purchase, surrender or exchange.

### Effective Practices

- ▶ **Automated Surveillance:** Using automated tools, exception reports and surveillance to review variable annuity exchanges; and implementing second-level supervision of supervisory reviews of exchange-related exception reports and account applications.
- ▶ **Detailed Rationales for VA Exchanges:** Confirming that registered representatives'—and, where applicable, supervisory principals'—written rationales for variable annuity exchanges for each customer address the specific circumstances for each customer and do not replicate rationales provided for other customers; and requiring supervisory principals to verify the information in these rationales that registered representatives provide, including product fees, costs, rider benefits and existing product values.
- ▶ **Clear Guidance for Retail Customers: Requiring registered representatives, when recommending variable annuities to retail customers, to provide them with clear, accessible materials that allow them to compare the fees, benefits lost or gained and surrender periods for different variable annuities.**
- ▶ **Review Thresholds:** Standardizing review thresholds for rates of variable annuity exchanges; and monitoring for emerging trends across registered representatives, customers, products and branches.
- ▶ **Automated Data Supervision:** Creating automated solutions to synthesize variable annuity data (including general product information, share class, riders and exchange-based activity) in situations warranted by the volume of variable annuity transactions.

- ▶ **Data Integrity:** Engaging with insurance carriers (affiliated and non-affiliated) and third-party data providers (e.g., Depository Trust and Clearing Corporation (DTCC), consolidated account report providers) to:
  - confirm their variable annuity data integrity (including general product information, share class, riders and exchange-based activity); and
  - address inconsistencies in available data, data formats and reporting processes for variable annuities.
- ▶ **Data Acquisition:** Establishing a supervisory system that collects and uses key transaction data, including, but not limited to:
  - transaction date;
  - representative name;
  - customer name;
  - customer age;
  - investment amount;
  - whether the transaction is a new contract or an additional investment;
  - contract type (qualified vs. non-qualified);
  - contract number;
  - product issuer;
  - product name;
  - source of funds;
  - exchange identifier;
  - share class; and
  - commissions.
- ▶ **Data Analysis:** Considering the following data points when conducting a review of a recommended exchange transaction under FINRA Rule 2330 and Reg BI:
  - branch location;
  - customer state of residence;
  - policy riders;
  - policy fees;
  - issuer of exchanged policy;
  - exchanged policy product name;
  - date exchanged policy was purchased;
  - whether the customer has had another variable annuity exchange within the preceding 36 months;
  - living benefit value, death benefit value or both, that was forfeited;
  - surrender charges incurred; and
  - any additional benefits surrendered with forfeiture.

## Additional Resources

### ▶ FINRA

- [Variable Annuities Key Topics Page](#)
- [Regulation Best Interest \(Reg BI\) Key Topics Page](#)
- *Regulatory Notices and Notices to Members*
  - *Regulatory Notice [20-18](#)* (FINRA Amends Its Suitability, Non-Cash Compensation and Capital Acquisition Broker (CAB) Rules in Response to Regulation Best Interest)
  - *Regulatory Notice [20-17](#)* (FINRA Revises Rule 4530 Problem Codes for Reporting Customer Complaints and for Filing Documents Online)
  - *Regulatory Notice [10-05](#)* (FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities)
  - *Notice to Members [07-06](#)* (Special Considerations When Supervising Recommendations of Newly Associated Registered Representatives to Replace Mutual Funds and Variable Products)
  - *Notice to Members [99-35](#)* (The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities)

### ▶ SEC

- [Investor Testing Report on Registered Index-Linked Annuities \(September 2023\)](#)
- [Regulation Best Interest, Form CRS and Related Interpretations](#)

# Market Integrity

## Consolidated Audit Trail (CAT)

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA and the national securities exchanges have adopted rules requiring their members to comply with Exchange Act Rule 613 and the CAT NMS Plan FINRA Rule [6800 Series](#) (Consolidated Audit Trail Compliance Rule) (collectively, CAT Rules), which cover reporting to the CAT; clock synchronization; time stamps; connectivity and data transmission; development and testing; recordkeeping; and timeliness, accuracy and completeness of data requirements. *Regulatory Notice 20-31* (FINRA Reminds Firms of Their Supervisory Responsibilities Relating to CAT) describes practices and recommended steps member firms should consider when developing and implementing their CAT Rules compliance program **and related supervisory responsibilities pursuant to FINRA Rule [3110](#) (Supervision)**.

#### Related Considerations

- ▶ Do your firm's CAT-related WSPs: (1) identify the individual, by name or title, responsible for the review of CAT reporting; (2) describe specifically what type of review(s) your firm will conduct of the data posted on the CAT Reporter Portal; (3) specify how often your firm will conduct the review(s); and (4) describe how your firm will evidence the review(s)?
- ▶ **Does your firm periodically evaluate its supervisory controls to ensure they are reasonably designed to ensure compliance with CAT requirements, including, but not limited to, recordkeeping, reporting and clock synchronization?**
- ▶ How does your firm confirm that the data your firm reports, or data that is reported on your firm's behalf, is transmitted in a timely fashion and is complete and accurate?
- ▶ How does your firm determine how and when clocks are synchronized; are the firm's procedures clear as to who is responsible for clock synchronization; how does your firm evidence that clocks have been synchronized; and how will your firm self-report clock synchronization violations?
- ▶ Does your firm conduct daily reviews of the Industry Member CAT Reporter Portal (CAT Reporter Portal) to review its file status to confirm the file(s) sent by the member or by its reporting agent was accepted by CAT, and to identify and address any file submission or integrity errors?
- ▶ Does your firm conduct periodic comparative reviews across all business lines of accepted CAT data against order and trade records and the [CAT Reporting Technical Specifications](#)?
- ▶ **Are the number of periodic comparative reviews performed sufficiently representative of the firm's overall CAT reporting volume?**
- ▶ Does your firm communicate regularly with its CAT reporting agent, review relevant CAT guidance and announcements, and report CAT reporting issues to the FINRA CAT Help Desk?
- ▶ For any firms that have an agreement with a CAT reporting agent, has the firm confirmed that such agreement is evidenced in writing that specifies the respective functions and responsibilities of each party?
- ▶ Does your firm maintain the required CAT order information as part of its books and records in compliance with FINRA Rule [6890](#) (Recordkeeping)?
- ▶ How does your firm oversee its clearing firm and third-party vendors to maintain CAT compliance, including clock synchronization?

- ▶ When your firm identifies a reporting issue (**e.g., reporting of erroneous events and CAT reporting errors that are not identified in data integrity validations, and that fall outside the scope of sections 7.6 (Corrections) and 6.4.3 (Deadline for Firm Initiated Corrections and Deletions) of the CAT Reporting Technical Specifications for Industry Members**), does your firm self-report the issue identified via the Self-Reporting Erroneous Events form?
- ▶ Does your firm conduct periodic reviews of its compliance metrics (*e.g.*, CAT Report Cards, error rates, CAT Compliance Thresholds)?
- ▶ Does your firm participate in testing related to the Central Repository, including any industry-wide disaster recovery testing following the schedule established under the CAT NMS Plan?

## Findings and Effective Practices

### Findings

- ▶ **Incomplete Submission of Reportable Events:** Failing to report certain Reportable Events, as defined by CAT, in a timely manner to the Central Repository (*e.g.*, new order events, route events, execution events).
- ▶ **Failure to Repair Errors Timely:** Not repairing errors by the T+3 correction deadline.
- ▶ **Failure to Submit Corrections:** Not submitting corrections for previously inaccurately reported data, including data that did not generate error feedback from CAT.
- ▶ **Inaccurate or Incomplete Reporting of CAT Orders:** Submitting information that was incorrect, incomplete or both to the Central Repository, including but not limited to Event Timestamp, Event Type Code, Time in Force, Account Holder Type, Handling Instructions, Trading Session ID and Firm Designated ID (FDID).
- ▶ **Unreasonable Vendor Supervision:** Not establishing and maintaining reasonable WSPs or supervisory controls regarding both CAT reporting and clock synchronization that are performed by third-party vendors.
- ▶ **Recordkeeping:** Not maintaining or providing to regulators upon request, data reported to CAT, including but not limited to Time in Force (TIF), Customer Handling Instructions, Department Type, Trading Session, Firm Designated ID, Order ID and Route Destination.

### Effective Practices

- ▶ **Mapping Internal Records to CAT-Reported Data:** Maintaining a “map” that shows how the firm’s internal records and blotters correspond to various fields reported to CAT.
- ▶ **Archiving CAT Feedback:** Archiving CAT feedback within a 90-day window so that firms can submit corrections, if necessary.
- ▶ **CAT Supervision:** Implementing WSPs requiring a comparative review of CAT submissions versus firm order and trade records (including for firms that rely on third-party submitters), conducting a daily review of the CAT Reporter Portal, regardless of the error rate percentage; utilizing CAT Report Cards and CAT FAQs to design an effective and reasonable supervision process; and, when relying on a CAT reporting agent, maintaining a written agreement that specifies the respective functions and responsibilities for exception management and error correction.
- ▶ **CAT Clock Synchronization:** When relying on third-party non-broker-dealer vendors for synchronization of business clocks, obtaining synchronization logs daily from such parties and reviewing them to ensure that the clock drifts are within acceptable thresholds (*i.e.*, 50 milliseconds).<sup>32</sup>
- ▶ **Customer and Account Information System (CAIS) Supervision:** Establishing reasonable supervisory processes and procedures that address, for example:
  - monitoring both CAIS Reporter Portal and CAIS notifications for data formatting and inconsistencies;
  - monitoring that customer and account information is reported in an appropriately secure manner pursuant to CAT reporting requirements (*e.g.*, customer input identifiers are not submitted to CAT or CAIS unless they have been properly transformed into a “hashed” Transformed Input ID (TID) prior to submission, customer account identifiers (FDIDs) do not reflect actual account numbers);



- confirming that CAIS data is consistent with prior submissions for the same customer; and
- repairing CAIS inconsistencies within the required time period (*i.e.*, no later than 5 p.m. ET on the third CAT Trading Day after the Customer or Account Information became available to the firm).

### CAIS Reporting Deadline Extension

- ▶ In August 2023, CAT NMS announced revised CAIS reporting deadlines of May 24, 2024, for Interim Reporting Obligation 4; and May 31, 2024, for Full CAIS Compliance.
  - ▶ Firms can find updates and additional information related to the CAIS reporting and compliance schedule on the [CAT NMS Plan website](#).
- ▶ **Self-Reporting:** Self-reporting CAT reporting issues when your firm discovers them via the FINRA [CAT Self-Reporting Erroneous Events Form](#) or through the FINRA CAT Help Desk.

### Additional Resources

- ▶ [Consolidated Audit Trail \(CAT\) Key Topics Page](#)
- ▶ [CAT NMS Plan Website](#)
- ▶ *Regulatory Notices*
  - [Regulatory Notice 21-21](#) (FINRA Eliminates the Order Audit Trail System (OATS) Rules)
  - [Regulatory Notice 20-41](#) (FINRA Amends Its Equity Trade Reporting Rules Relating to Timestamp Granularity)
  - [Regulatory Notice 20-31](#) (FINRA Reminds Firms of Their Supervisory Responsibilities Relating to CAT)
  - [Regulatory Notice 20-20](#) (FINRA Provides Updates on Regulatory Coordination Concerning CAT Reporting Compliance)
  - [Regulatory Notice 19-19](#) (FINRA Reminds Firms to Register for CAT Reporting by June 27, 2019)
  - [Regulatory Notice 17-09](#) (The National Securities Exchanges and FINRA Issue Joint Guidance on Clock Synchronization and Certification Requirements Under the CAT NMS Plan)
- ▶ [CAT NMS Clock Synchronization](#)

### SEC Establishes T+1 Settlement Date

- ▶ On February 15, 2023, the [SEC adopted rule changes](#) to shorten the standard settlement cycle for most broker-dealer transactions from two business days after the trade date (T+2) to one business day after the trade date (T+1). The SEC set May 28, 2024, as the compliance date for the rule changes.
- ▶ May 28, 2024, also will be the date for firms to begin to comply with [updates to FINRA rules](#) conforming to the T+1 settlement cycle.
- ▶ The move to T+1 has implications for compliance with numerous rules and regulations, including, but not limited to, Regulation SHO, SEC financial responsibility rules, the payment period for purchases under Regulation T, FINRA rules related to clearly erroneous transactions, FINRA's Uniform Practice Code (UPC) and recordkeeping requirements.
- ▶ FINRA encourages all member firms to review closely the rule changes related to the move to the T+1 settlement cycle and to take all necessary steps—technological or otherwise—to ensure they are prepared to comply with all applicable rule changes on May 28, 2024.
- ▶ For additional guidance related to Regulation T and extension of time requests under Exchange Act Rule 15c3-3 under T+1, please see [Regulatory Notice 23-15](#) (Regulation T and SEA Rule 15c3-3 Extension of Time Requests Under a T+1 Settlement Cycle).

## Best Execution

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [5310](#) (Best Execution and Interpositioning) requires that, in any transaction for or with a customer or a customer of another broker-dealer, a member firm and persons associated with a member firm shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. A member firm must have procedures in place to ensure it conducts “regular and rigorous” reviews of the execution quality of its customers’ orders if it doesn’t conduct an order-by-order review. **(MSRB Rule [G-18](#) (Best Execution) sets forth similar obligations with respect to transactions in municipal securities.)**

Best execution obligations apply to any member firm that receives customer orders for purposes of handling and execution, including firms that receive customer orders from other firms for handling and execution.<sup>33</sup> These obligations apply whether a member firm acts in a principal or an agency capacity. A member firm cannot transfer its duty of best execution to another person. Additionally, any member firm that routes all its customer orders to another firm without conducting an independent review of execution quality would violate its duty of best execution.

#### Related Considerations

##### ▶ Execution Quality Reviews

- How does your firm determine the appropriate method and frequency of its execution quality reviews?
- If applicable, does your firm conduct “regular and rigorous” reviews of the quality of the executions of its customers’ orders and customer orders from other broker-dealers, including a comparison of the execution quality available at competing markets?
- If applicable, how does your firm document its “regular and rigorous” reviews, including the data and other information considered, order routing decisions and the rationale for such decisions, and actions to address any deficiencies?
- **If applicable, does your firm conduct an independent review of the execution quality obtained by another firm to which your firm routes all of its customer orders?**

##### ▶ Payment for Order Flow

- If your firm provides payment for order flow (PFOF) to, or receives PFOF from, another broker-dealer, how does your firm prevent those payments from interfering with your firm’s best execution obligations?

##### ▶ Fixed Income and Options Trading

- If your firm engages in fixed income and options trading, has it established targeted policies and procedures to address its best execution obligations for these products?
- Does your firm consider differences among security types within these products, such as the different characteristics and liquidity of U.S. Treasury securities compared to other fixed income securities?
- **If applicable, how does your firm monitor options exchange order exposure requirements, auction mechanism usage and venue routing? How does your firm monitor such requirements when routing orders to an affiliated entity or another broker-dealer that provides PFOF?**

##### ▶ Other Best Execution Considerations

- How does your firm meet its best execution obligations with respect to trading conducted in both regular and extended trading hours?
- What data sources does your firm use for its routing decisions and execution quality reviews for different order types and sizes, including odd lots?

- How does your firm handle fractional share investing in the context of its best execution obligations?
- **Does your firm consider liquidity priced better than the National Best Bid and Offer (NBBO), including liquidity available via Retail Liquidity Programs and odd lot liquidity displayed via direct feeds?**
- **How does your firm assess order routing arrangements to ensure that third parties are not interpositioned between the firm and the best market in a manner that is inconsistent with your firm's best execution obligations?**

## Findings and Effective Practices

### Findings

- ▶ **No Assessment of Execution in Competing Markets:** Not comparing the quality of the execution obtained via firms' existing order-routing and execution arrangements against the quality of execution they could have obtained from competing markets; failing to modify routing arrangements or justify why routing arrangements are not being modified; and using routing logic that is not based on execution quality.
- ▶ **No Review of Certain Order Types:** Not conducting adequate reviews on a type-of-order basis, including, for example, for market, marketable limit, or non-marketable limit orders.
- ▶ **Unreasonable "Regular and Rigorous Reviews":** Not conducting periodic "regular and rigorous reviews" or, when conducting such reviews, not considering certain execution quality factors set forth in Rule 5310, Supplementary Material .09.
- ▶ **Conflicts of Interest:** Not considering and addressing potential conflicts of interest relating to routing or exposing orders to affiliated broker-dealers, affiliated ATSS, or market centers that provide routing inducements, such as PFOF from wholesale market makers and exchange liquidity rebates.

### Effective Practices

- ▶ **Exception Reports:** Using exception reports and surveillance reports to support firms' efforts to meet their best execution obligations.
- ▶ **Full and Prompt Execution of Marketable Customer Orders:** Regularly evaluating the thresholds your firm uses to generate exceptions as part of the firm's supervisory systems designed to achieve compliance with the firm's "full and prompt" obligations; and modifying such thresholds to reflect current promptness standards for marketable order execution, including statistics available from FINRA, other relevant indicators of industry standards and the firm's internal data.
- ▶ **PFOF Order Handling Impact Review:** Reviewing how PFOF affects the order-handling process, including the following factors: any explicit or implicit contractual arrangement to send order flow to a third-party broker-dealer; terms of these agreements; whether it is on a per-share basis or per-order basis; and whether it is based upon the type of order, size of order, type of customer or the market class of the security.
- ▶ **Risk-Based "Regular and Rigorous Reviews":** Conducting "regular and rigorous" reviews, at a minimum, on a quarterly or more frequent basis (such as monthly), depending on the firm's business model, that consider the potential execution quality available at various trading centers, including those to which a firm does not send order flow.
- ▶ **Support of Analysis:** Being prepared to explain and evidence the firm's best execution analysis, including internalized orders, on a "regular and rigorous" or order-by-order basis, as applicable.
- ▶ **Continuous Updates:** Updating WSPs and best execution analysis to address market and technology changes.
- ▶ **Best Execution Committees:** Establishing committees that meet quarterly or more frequently to conduct "regular and rigorous" reviews, and determine, if necessary, to modify the firm's order routing and execution arrangements.

- ▶ **Supervision:** Ensuring supervisory procedures, systems and controls address the execution of the entirety of the firm's marketable order flow, including order types such as activated stop orders, all or none orders, and odd lot orders.
- ▶ **Monitoring Orders:** Monitoring the handling of marketable orders of all types fully and promptly, including market orders, marketable limit orders, activated stop orders, all or none orders, odd lot orders, marketable orders in illiquid securities, and marketable orders in preferred securities.

## Additional Resources

- ▶ [FINRA Report Center](#)
  - [Best Execution Outside-of-the-Inside Report Card](#)
  - [Equity Report Cards](#)
  - [Market Order Timeliness Statistical Report](#)
- ▶ *Regulatory Notices*
  - *Regulatory Notice [22-04](#)* (FINRA Reminds Member Firms of Obligation to Execute Marketable Customer Orders Fully and Promptly)
  - *Regulatory Notice [21-23](#)* (FINRA Reminds Member Firms of Requirements Concerning Best Execution and Payment for Order Flow)
  - *Regulatory Notice [21-12](#)* (FINRA Reminds Member Firms of Their Obligations Regarding Customer Order Handling, Margin Requirements and Effective Liquidity Management Practices During Extreme Market Conditions)
  - *Regulatory Notice [15-46](#)* (Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets)
  - *Notice to Members [01-22](#)* (NASD Regulation Reiterates Member Firm Best Execution Obligations And Provides Guidance to Members Concerning Compliance)

## Disclosure of Routing Information

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Rule 606 of Regulation NMS requires broker-dealers to disclose information regarding the handling of their customers' orders in NMS stocks and listed options. These disclosures are designed to help customers better understand how their firm routes and handles their orders, assess the quality of order handling services provided by their firm, and ascertain whether the firm is effectively managing potential conflicts of interest that may impact their firm's routing decisions.

#### New FINRA Rules 6151 and 6470

On August 2, 2023, the SEC approved new FINRA Rules [6151](#) (Disclosure of Order Routing Information for NMS Securities) and [6470](#) (Disclosure of Order Routing Information for OTC Equity Securities). Among other things, these new rules will require members to:

- ▶ on a quarterly basis, publish new monthly order routing disclosures for orders in OTC Equity Securities; and
- ▶ submit both the new order routing reports for OTC Equity Securities and their order routing reports for NMS securities under Rule 606 to FINRA for centralized publication on the FINRA website.

## Related Considerations

- ▶ Does your firm publish accurate, properly formatted quarterly routing reports on its website for the required retention period as specified under Rule 606(a), including use of the SEC's most recently published PDF and XML schema?
- ▶ If your firm is not required to publish a quarterly report under Rule 606(a), does the firm have an effective supervisory system to periodically confirm that your firm has no orders subject to quarterly reporting?
- ▶ If, pursuant to SEC guidance, your firm adopts by reference the Rule 606(a) report of another firm, such as your firm's clearing firm, does your firm have an effective supervisory system to ensure that it meets the requirements of the SEC's guidance (including examining such report and not having a reason to believe it materially misrepresents the order routing practices)?
- ▶ If your firm routes orders to non-exchange venues, does your firm adequately assess whether such venues are venues to which orders are "routed for execution" under Rule 606(a)?
- ▶ Does your firm obtain and retain sufficient information to properly report the material terms of its relationships with venues to which it routes orders for execution, including specific quantitative and qualitative information regarding PFOF and any profit-sharing relationship?
- ▶ **Does your firm monitor and incorporate SEC guidance<sup>34</sup> on the classification of customer orders (including fractional share orders) as held orders, where customers reasonably expect immediate execution?**
- ▶ If your firm claims an exemption from providing not held order reports under Rule 606(b)(3) (pursuant to Rule 606(b)(4) or (5)), what supervisory system does your firm have in place to determine if your firm's or a customer's order activity falls below the relevant *de minimis* thresholds?
- ▶ If your firm is required to provide customer-specific disclosures for not held orders in NMS stocks under Rule 606(b)(3), does your firm provide accurate, properly formatted disclosures for the prior six months to requesting customers within seven business days of receiving the request?

## Findings and Effective Practices

### Findings

- ▶ **Inaccurate Quarterly Reports:** Publishing incomplete or otherwise inaccurate information in the quarterly report on order routing, such as:
  - inaccurately classifying orders (*e.g.*, classifying orders as "other orders" without considering whether such orders involve a customer request for special handling);<sup>35</sup>
  - incorrectly stating that the firm does not receive PFOF from execution venues;
  - not including payments, credits or rebates (whether received directly from an exchange or through a pass-through arrangement) in the "Net Payment Paid/Received" and "Material Aspects" sections of the quarterly report;
  - not including exchange pricing arrangements (*e.g.*, tiered pricing) in the "Net Payment Paid/Received" and "Material Aspects" sections of the quarterly report;
  - not disclosing any amounts of "Net Payment Paid/Received," when the firm receives PFOF for at least one of the four order types (*i.e.*, Market Orders, Marketable Limit Orders, Non-Marketable Limit Orders, Other Orders);
  - reporting only held orders in listed options, instead of both held and not held orders;
  - inaccurately identifying reported execution venues as "Unknown";
  - inaccurately identifying an entity as an execution venue when that entity does not execute trades (*e.g.*, identifying a routing broker-dealer as an execution venue, where the broker-dealer re-routes but does not execute orders; options consolidator that does not provide liquidity); and

- not posting the quarterly report on their firm’s website in both required formats (*i.e.*, PDF and XML schema).
- ▶ **Incomplete Disclosures:** Not adequately describing material aspects of their relationships with disclosed venues in the Material Aspects disclosures portion of the quarterly report, such as:
  - inadequate descriptions of specific terms of PFOF and other arrangements (*e.g.*, “average” amounts of PFOF rather than specific disclosure noting the payment types, specific amount received for each type of payment, terms and conditions of each type of payment);
  - ambiguous descriptions of receipt of PFOF (*e.g.*, firm “may” receive payment);
  - inadequate or incomplete descriptions of PFOF received through pass-through arrangements;
  - incomplete descriptions of exchange credits or rebates; and
  - incomplete descriptions of tiered pricing arrangements, including the specific pricing received by the firm.
- ▶ **Incomplete Disclosure When Incorporating by Reference:** Incorporating by reference another firm’s Rule 606(a)(1) quarterly report with incomplete disclosure of:
  - the firm’s relationship with the referenced firm, including clearing or execution relationship;
  - the amount and type of order flow routed to the referenced firm;
  - **the material terms of PFOF received from the referenced firm;**
  - payment from any profit-sharing relationship received from the referenced firm; and
  - transaction rebates received from the referenced firm.
- ▶ **Deficient Communications:** Not notifying customers in writing of the availability of information specified under Rule 606(b)(1), as required by Rule 606(b)(2).<sup>36</sup>
- ▶ **Not Held Customer Reports:** Failing to provide Rule 606(b)(3) Not Held reports to customers in a timely manner.
- ▶ **Insufficient WSPs:** Either not establishing or not maintaining WSPs reasonably designed to achieve compliance with the requirements of Rule 606, including:
  - not updating Disclosure of Order Routing Information WSPs to include requirements detailed in Rule 606(a)(1) or Rule 606(b)(3);
  - not describing the steps taken to review whether firms verified the integrity of information sent to, or received from, their vendor—or not stating how the review would be evidenced;
  - not articulating a supervisory method of review to verify the accuracy, format, completeness, timely processing and details of the Rule 606(b)(3) report, if requested, as well as documenting the performance of that review; and
  - when incorporating by reference another firm’s Rule 606(a)(1) quarterly report, not examining the report and having a reasonable basis to believe that the report does not materially misrepresent the order routing practices.

### Effective Practices

- ▶ **Supervision:** Conducting regular, periodic supervisory reviews of the public quarterly reports and customer-specific order disclosure reports, if applicable, for accuracy (*e.g.*, assuring that per-venue disclosures of net aggregate PFOF and other payments are accurately calculated) and completeness (*e.g.*, assuring that the Material Aspects section adequately describes the firm’s PFOF and other payment arrangement for each execution venue, including all material aspects that may influence the firm’s order routing decisions).

- ▶ **Due Diligence on Identifying Execution Venues: Conducting due diligence to confirm that a routing-only firm (a broker-dealer that re-routes but does not execute orders) is not inaccurately reported as an execution venue.**
- ▶ **Due Diligence on Vendors:** Performing due diligence to assess the accuracy of public quarterly reports and customer-specific order disclosure reports provided by third-party vendors by, for example, reviewing content of reports, comparing order samples against vendor-provided information and confirming with the vendor that all appropriate order information is being received (particularly when the firm has complex routing arrangements with execution venues).

## Additional Resources

- ▶ FINRA
  - [SR-FINRA-2022-031 \(Proposed Rule Change to Adopt FINRA Rules 6151 \(Disclosure of Order Routing Information for NMS Securities\) and 6470 \(Disclosure of Order Routing Information for OTC Equity Securities\)\) \(August 2, 2023\)](#)
- ▶ SEC
  - [Division of Examinations Risk Alert: Observations Related to Regulation NMS Rule 606 Disclosures \(November 10, 2022\)](#)
  - [Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS<sup>37</sup>](#)
  - [SEC Adopts Rules That Increase Information Brokers Must Provide to Investors on Order Handling \(November 2, 2018\)](#)

## Regulation SHO—Bona Fide Market Making Exemptions

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Rules 203(b) (Short sales) and 204 (Close-out requirement) of Regulation SHO provide exceptions for bona fide market making activity. The SEC has provided guidance on what constitutes “bona fide market making activities” as well as examples of what does not. Member firms must also confirm and be able to demonstrate that any transaction for which they rely on a Regulation SHO bona fide market making exception qualifies for the exception, consistent with Regulation SHO and guidance.<sup>38</sup> For example, reliance on and compliance with an exchange’s market making designation and quoting requirements does not *per se* qualify a market maker for the bona fide market maker exception. **Additionally, a bona fide market maker must regularly and continuously place quotations in a quotation medium on both the bid and ask side of the market.** Only market makers engaged in bona-fide market making in the security at the time they effect the short sale may rely on the exception.<sup>39</sup>

**Rule 204 of Regulation SHO requires that member firms close out fails-to-deliver within established timeframes by purchasing or borrowing the relevant security by market open on the relevant close out date. Pursuant to SEC guidance, a member firm may use exchange-traded funds (ETF) conversion activity to meet the purchase requirement of the rule under certain circumstances as detailed in a [2017 SEC No-Action Letter](#). This position is limited to ETF conversion activity and does not extend to using American Depositary Receipts (ADR) conversion activity to comply with the purchase requirements of Rule 204.**



## Related Considerations

- ▶ How do your firm’s supervisory systems ensure that short sales your firm executes in reliance on a Regulation SHO bona fide market making exception qualify for that exception?
- ▶ **What is your firm’s process for determining that it is reasonably closing out fails-to-deliver in compliance with the purchase or borrow requirements of Rule 204?**

## Findings and Effective Practices

### Findings

- ▶ **Non-Bona Fide Market Making:** Failing to distinguish bona fide market making from other proprietary trading activity that is not eligible to rely on Regulation SHO’s bona fide market making exceptions, which includes:
  - quoting only at maximum allowable distances from the inside bid/offer (e.g., using peg orders);
  - posting quotes at or near the inside ask but not at or near the inside bid;
  - only posting bid and offer quotes near the inside market when in possession of an order; and
  - displaying quotations that are not firm and are only accessible to a small set of subscribers to a firm’s trading platform.
- ▶ **Use of ADR Conversions for Close Out of Fails: Impermissibly extending the SEC guidance regarding Rule 204 and closing out fails using ETF conversions to ADR conversions.**

### Effective Practices

- ▶ **Supervision of Bona Fide Market Making:** Developing supervisory systems for, and conducting supervisory reviews of, market making activity to ensure that any reliance on Regulation SHO bona fide market making exceptions is appropriate by considering, for example:
  - where the firm’s quotes are placed and how (e.g., market participants vs. ATS visible or non-visible orders);
  - the frequency or timing of the firm’s quoting activity (e.g., morning or evening vs. throughout the trading day); and
  - the level of the firm’s proprietary trades compared to customer transactions filled.
- ▶ **Supervision of Rule 204 Close Out Activity: Developing appropriate policies and procedures to ensure that the firm’s close out actions consistently adhere to the purchase or borrowing requirements of Rule 204.**

## Additional Resources

- ▶ SEC
  - [No-Action Letter – Relief under Rule 204 of Reg SHO \(April 26, 2017\)](#)
  - [Amendments to Regulation SHO, Exchange Act Rel. No. 58775](#) (October 14, 2008)

## Fixed Income—Fair Pricing

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

The fair pricing obligations under FINRA Rule [2121](#) (Fair Prices and Commissions) apply to transactions in all securities—including fixed income securities—and MSRB Rule [G-30](#) imposes similar obligations for transactions

in municipal securities. In addition, FINRA Rule 2121 and MSRB Rule G-30 also include specific requirements for transactions in debt securities. These rules generally require a dealer that is acting in a principal capacity in a debt security transaction with a customer, and charging a mark-up or mark-down, to mark up or mark down the transaction from the prevailing market price (PMP). The PMP is presumptively established by referring to the dealer's contemporaneous cost as incurred or proceeds as obtained. Where the dealer's cost is no longer contemporaneous, or the dealer has overcome the contemporaneous cost presumption, member firms are required to continue down the "waterfall" within FINRA Rule 2121 or MSRB Rule G-30, as applicable, to determine the PMP.

### Related Considerations

- ▶ Does your firm have a reasonable supervisory system for compliance with the fair pricing rules tailored to your firm's specific business model for fixed income securities?
- ▶ **Do your firm's WSPs detail the firm's mark-up/mark-down guidelines, if your firm employs them, as well as the supervisory system and review process related to mark-ups/mark-downs (i.e., personnel responsible for compliance, how often the review is conducted, the resources used to conduct the review and how the review is evidenced)?**
- ▶ If your firm requires the use of exception reports to perform supervision for fair pricing of fixed income products, do these reports include information sufficient to make such a determination (e.g., mark-up/mark-down percentage, maturity, coupon, rating, yield)?
- ▶ Does your firm conduct a reasonable supervisory review to confirm that mark-ups/mark-downs are not based on expenses that are excessive?
- ▶ If your firm sells bonds to customers from inventory, what methodology is your firm using to determine the PMP for the security? Is the methodology employed consistent with the "waterfall" described in FINRA Rule 2121 and MSRB Rule G-30?
- ▶ If your firm engages in transactions in different types of fixed income products, does your firm have targeted fair pricing supervisory procedures to address its fair pricing obligations for each type of product?

## Findings and Effective Practices

### Findings

- ▶ **Incorrect Determination of PMP:** Not following the contemporaneous cost presumption or the waterfall required by FINRA Rule 2121 and MSRB Rule G-30, but rather:
  - using other methods, such as obtaining quotations from a limited number of market participants without considering contemporaneous inter-dealer or institutional transaction prices; or
  - referring to acquisition costs that are no longer contemporaneous.
- ▶ **Outdated Mark-Up/Mark-Down Grids:** Employing mark-up/mark-down grids without periodically reviewing and updating them as needed.
- ▶ **Failure to Consider Impact of Mark-Up on Yield to Maturity:** Charging substantial mark-ups in short-term fixed-income securities that may significantly reduce the yield received by the investor.
- ▶ **Unreasonable Supervision:** Solely relying on grids or on fixed mark-up/mark-down thresholds in assessing fair pricing in fixed income securities without performing a facts and circumstances analysis as required by FINRA Rule 2121 or MSRB Rule G-30.

### Effective Practices

- ▶ **PMP Documentation:** Documenting the PMP for each transaction, even if it does not require a mark-up/mark-down disclosure pursuant to FINRA Rule [2232](#) (Customer Confirmations) or MSRB Rule [G-15](#).

- ▶ **Mark-Up/Mark-Down Reviews:** Conducting periodic reviews of the firm’s mark-ups/mark-downs and comparing them with industry data provided in the TRACE and MSRB Mark-Up/Mark-Down Analysis Reports.
- ▶ **Exception Reports:** Using exception reports or outside vendor software to ensure compliance with FINRA Rule 2121 or MSRB G-30; and periodically reviewing and updating the reports’ parameters so they perform as intended, even as market conditions change.

## Additional Resources

- ▶ FINRA
  - [FINRA Data](#)
    - [Fixed Income Data](#)
  - [Fixed Income Confirmation Disclosure: Frequently Asked Questions \(FAQ\)](#)
  - [MSRB Markup/Markdown Analysis Report](#)
  - [TRACE Markup/Markdown Analysis Report](#)
  - [Regulatory Notices](#)
    - [Regulatory Notice 21-29](#) (FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors)
    - [Regulatory Notice 17-08](#) (SEC Approves Amendments to Require Mark-Up/Mark-Down Disclosure on Confirmations for Trades With Retail Investors in Corporate and Agency Bonds)
- ▶ MSRB
  - [Resource on Disclosing Mark-ups and Determining Prevailing Market Price](#) (July 2018)
  - [Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions](#) (March 19, 2018)

## OTC Quotations in Fixed Income Securities **NEW FOR 2024**

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Exchange Act Rule 15c2-11 (the “Rule”) governs the publication or submission of quotations by broker-dealers in a quotation medium other than a national securities exchange (*i.e.*, the OTC market).<sup>40</sup> The Rule generally prohibits a broker-dealer from publishing a quotation for any security in a quotation medium unless the broker-dealer has reviewed current and publicly available information about the issuer whose security is the subject of the quotation, and the broker-dealer believes this information is accurate and obtained from a reliable source. Municipal securities and other “exempt securities” (*e.g.*, government securities, Treasury securities) are not subject to the Rule.

In September 2020, the SEC adopted amendments to the Rule and issued a series of no-action letters providing relief for fixed income securities with defined criteria. The most recent of these no-action letters, issued on November 30, 2022, continues to provide relief for fixed income securities with defined criteria until January 4, 2025.

FINRA Rule [3110](#) (Supervision) requires that members establish and maintain a system to supervise, including written procedures, reasonably designed to achieve compliance with the requirements of the Rule.

## Related Considerations

- ▶ Does your firm publish or submit for publication “quotations” in fixed income securities in a “quotation medium” as these terms are defined in the Rule?
- ▶ Do your firm’s systems and controls, and written procedures, reasonably address quoting in fixed income securities and the requirements of the Rule?
- ▶ Does your firm use a third-party vendor for data or supervisory tools to comply with the Rule? How is your firm supervising this arrangement to ensure compliance with the Rule?
- ▶ Does your firm sufficiently evidence its review of current and publicly available information concerning issuers of fixed income securities (*i.e.*, FINRA would be able to test your review for compliance with the Rule)?
- ▶ Does your firm conduct training on the requirements of the Rule?

## Findings and Effective Practices

### Findings

- ▶ **Inadequate Supervisory Controls and Procedures:** Not maintaining controls and procedures reasonably designed to monitor quoting activity in fixed income securities; and not reviewing the firm’s activity to determine applicability of the Rule.
- ▶ **Failing to Test Applicability:** Stating that the firm only quotes in exempt securities without conducting an analysis.
- ▶ **Failing to Prevent Potential Quotations:** Not implementing procedures and controls—including a process for complying with the Rule—to ensure that the firm does not quote a covered security prior to confirming the availability of public financial information (unless an exception under the Rule is available).

### Effective Practices

- ▶ **Supervisory Controls and Procedures:** Maintaining reasonable controls and procedures designed to fit the firm’s specific business, including training firm personnel who are impacted.
- ▶ **Front-End Surveillance:** Identifying non-exempt securities and quotation mediums; blocking non-exempt securities from quotation on specific trading platforms determined to be quotation mediums; and warning users when accessing non-exempt securities.
- ▶ **Self-Assessment:** Conducting an analysis of the firm’s business and systems in quoting fixed income securities.
- ▶ **Third-Party Vendors:** Contracting with third-party vendors to help:
  - confirm the availability of current information regarding the issuer of the fixed income security—or the availability of an exemption—prior to quoting; and
  - identify and prevent quoting in non-exempt securities where such information (or exemption) is not available.

## Additional Resources

- ▶ FINRA
  - [Regulatory Notice 21-29](#) (Vendor Management and Outsourcing)
- ▶ SEC
  - [No-Action Letter to FINRA re: Amended Rule 15c2-11 in Relation to Fixed Income Securities](#) (November 30, 2022)

## Advertised Volume **NEW FOR 2024**

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [5210](#) (Publication of Transactions and Quotations) prohibits member firms from publishing or circulating, or causing to be published or circulated, any communication which purports to report any transaction as a purchase or sale of any security unless such member believes that such transaction was a bona fide purchase or sale of such security. Firms may, on a discretionary basis, communicate or advertise their trading activity to the market through one or more service providers that disseminate that information to subscribers and the market. Firms that do so must ensure that such information is truthful, accurate and not misleading, consistent with the requirements of Rule 5210.

#### Related Considerations

- ▶ Do your firm's supervisory procedures provide for a method to verify and assess the accuracy of the firm's published trading volume, including when such trading volume is disseminated through one or more third-party service providers?

### Findings and Effective Practices

#### Findings

- ▶ **Inflating Trading Volume:** Overstating, or inflating, the firm's trading volume due to technological or procedural failures or errors.
- ▶ **Unreasonable Supervision:** Failing to establish and maintain supervisory systems that are reasonably designed to achieve compliance with Rule 5210, including with respect to trading information disseminated by third-party service providers.

#### Effective Practices

- ▶ **Monitoring and Reviewing Reported Trade Data:** Monitoring internal systems and responsible personnel to ensure that trade information transmitted to third-party service providers for dissemination is consistently complete, accurate and not misleading.
- ▶ **Monitoring and Reviewing Disseminated Trade Volume Data:** Monitoring trade volume information for the firm that is disseminated by service providers to subscribers and the market to ensure that the disseminated data accurately reflects trade data reported by the firm.

#### Additional Resource

- ▶ *Notice to Members [06-50](#) (NASD Reminds Members of Their Obligation to Provide Accurate Information to Services that Disseminate Trading Volume and Trading Interest)*

## Market Access Rule **NEW FOR 2024**

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Exchange Act Rule 15c3-5 (Market Access Rule) requires firms with market access or that provide market access to their customers to appropriately control the risks associated with market access so **as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets and the stability of the financial system**. The Market Access Rule applies generally to securities traded on an exchange or alternative trading system, including equities, equity options, ETFs, debt securities, security-based swaps and security futures products, as well as crypto assets that meet the Exchange Act's definition of a security.

#### Related Considerations

- ▶ If your firm has or provides market access, does it have reasonably designed risk-management controls and WSPs to manage the financial, regulatory or other risks associated with this business activity?
- ▶ If your firm is highly automated, how does it manage and deploy technology changes for systems associated with market access; and what controls does it use, such as kill switches, to monitor and respond to aberrant behavior by trading algorithms or other impactful market-wide events?
- ▶ How does your firm adjust credit limit thresholds for customers, including institutional customers (whether temporary or permanent)?
- ▶ Does your firm utilize "soft" block controls? If so, does your firm maintain procedures surrounding order reviews and overrides, including supervisory reviews?
- ▶ Does your firm make special provisions (e.g., different parameters) for any specific order types (e.g., limit on close)? If so, how does your firm document these provisions?
- ▶ Does your firm use any automated controls to timely revert *ad hoc* credit limit adjustments?
- ▶ If your firm uses third-party vendor tools to comply with its Market Access Rule obligations, does it review whether the vendor can meet the obligations of the rule?
- ▶ How does your firm maintain direct and exclusive control of applicable thresholds?
- ▶ What type of training does your firm provide to individual traders regarding the steps and requirements for requesting *ad hoc* credit limit adjustments?
- ▶ Does your firm test its market access controls for effectiveness (e.g., does the type of control fit your firm's business model) and reasonableness, including fixed income controls, and how do you use that test for your firm's annual CEO certification attesting to your firm's controls?
- ▶ If your firm operates an ATS that has subscribers that are not broker-dealers, how does your firm comply with the requirements of the Market Access Rule, including establishing, documenting and maintaining a system of controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of this business activity?
- ▶ Does your firm maintain documentation to demonstrate **the reasonableness of its controls and corresponding parameters**?

### Findings and Effective Practices

#### Findings

##### ▶ Insufficient Controls:

- Not establishing pre-trade order limits, pre-set capital thresholds and duplicative and erroneous order controls for accessing ATSs, including those that transact fixed income transactions.

- Setting pre-trade order limits at unreasonable thresholds based on a firm's business model.
  - Not demonstrating, and failing to maintain, documentation demonstrating the reasonability of assigned capital, credit and erroneous order pre-trade financial controls.
  - Not establishing adequate policies and procedures to govern intra-day changes to firms' credit and capital thresholds, including requiring or obtaining approval prior to adjusting credit or capital thresholds, documenting justifications for any adjustments and ensuring thresholds for temporary adjustments revert back to their pre-adjusted values.
- ▶ **Failure to Consider Additional Data:** Failing to consider a firm's business model when setting pre-trade order limits or other regulatory requirements (e.g., Limit Up-Limit Down (LULD) thresholds and exchanges' Limit Order Price Protection thresholds), as well as historical and available liquidity, and the time required for liquidity replenishment, when determining erroneous price and size control thresholds.
  - ▶ **Impermissible Exclusions:** Excluding certain orders from a firm's pre-trade erroneous controls based on order types (e.g., excluding limit on close orders from a firm's price controls).
  - ▶ **Inadequate Financial Risk Management Controls:** For firms with market access, or those that provide it, unreasonable capital thresholds for trading desks and unreasonable aggregate daily limits or credit limits for institutional customers and counterparties.
  - ▶ **Reliance on Vendors:** Relying on third-party vendors' tools, including those of an ATS or exchange, to apply their financial controls without performing adequate due diligence, not understanding how vendors' controls operate, or both; and not maintaining direct and exclusive control over controls by allowing the ATS to unilaterally set financial thresholds for firms' fixed income orders without the involvement of the firm, instead of establishing their own thresholds.
  - ▶ **Failure to Document Annual Review of Effectiveness:** Failure to document the firm's review, conducted at least annually, of the effectiveness of its risk management controls and supervisory procedures (e.g., no inventory of the specific systems, controls, thresholds or functionality that were reviewed), including the reasonableness of the firm's market access controls applicable to each business/product line in which the firm provides market access.

### Effective Practices

- ▶ **Pre-Trade Fixed Income Financial Controls:** Implementing systemic pre-trade "hard" blocks to prevent fixed income orders from reaching an ATS that would cause the breach of a threshold.
- ▶ **Intra-Day Ad Hoc Adjustments:** Implementing processes for requesting, approving, reviewing and documenting ad hoc credit threshold increases and returning limits to their original values as needed.
- ▶ **Soft Blocks:**
  - Implementing detailed and reasonable WSPs that list the steps that firm personnel should take when determining how to handle orders that trigger soft controls; and requiring staff to document their findings and rationale for releasing an order following a review.
  - Conducting a separate supervisory review to ensure that release rationales are appropriate; and requiring the incorporation of review results when assessing the effectiveness of the firm's controls.
- ▶ **Tailored Erroneous or Duplicative Order Controls:**
  - Tailoring erroneous or duplicative order controls to particular products, situations or order types; and preventing the routing of market orders based on impact (e.g., Average Daily Volume Control) that are set at reasonable levels (particularly in thinly traded securities); and calibrating to reflect, among other things, the characteristics of the relevant securities, the business of the firm and market conditions.
  - Ensuring that controls apply to all order flow and all trading sessions.



- ▶ **Market Impact:** Developing reasonable complementary controls (e.g., a market impact check, a liquidity check, an average daily volume control) based upon the firm's business model and historical order flow; and using a benchmark when pricing child orders for a larger parent market order (e.g., the NBBO or last sale at the time of the initial child order route) to monitor the cumulative market impact of subsequent child orders over a short period-of-time.
- ▶ **Reference Data:** Using a reasonable process for choosing reference data in developing various controls, so if one piece of data is not obtained another could be substituted (e.g., the NBBO vs. the last sale or the previous day's closing price).
- ▶ **Post-Trade Controls and Surveillance:** When providing direct market access via multiple systems, including sponsored access arrangements, employing reasonable controls to confirm that those systems' records were aggregated and integrated in a timely manner, and conducting holistic post-trade and supervisory reviews for, among other things, potentially manipulative trading patterns.
- ▶ **Testing of Risk Management Controls:** Regularly testing market access controls, such as:
  - performing a review at least annually of the business activity of the firm in connection with market access (and an annual CEO certification attesting to firms' controls);
  - maintaining data and documents that evidence the rationale for continued use of implemented controls and parameters;
  - focusing on the parameters for controls and analyzing whether they are reasonable and would prevent the entry of erroneous orders under different scenarios (e.g., the entry of a large order in a thinly-traded or high-priced security) and product types;
  - determining whether hard blocks are working (e.g., triggered when a parameter is triggered);
  - determining whether soft blocks are an effective control (e.g., by outlining specific steps for, and appropriately documenting, those reviews); and
  - documenting reviews and retaining information used in decisions to adjust, maintain, or create new controls (e.g., change in business lines may result in short-period-of-time controls in addition to order-by-order controls).

## Additional Resources

- ▶ FINRA
  - [Algorithmic Trading Key Topics Page](#)
  - [Market Access Key Topics Page](#)
  - *Regulatory Notices*
    - *Regulatory Notice 16-21* (SEC Approves Rule to Require Registration of Associated Persons Involved in the Design, Development or Significant Modification of Algorithmic Trading Strategies)
    - *Regulatory Notice 15-09* (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies)
- ▶ SEC
  - [Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access](#) (April 15, 2014)

# Financial Management

## Net Capital

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Exchange Act Rule 15c3-1 (Net Capital Rule) requires that member firms must at all times have and maintain net capital at no less than the levels specified pursuant to the rule to protect customers and creditors from monetary losses that can occur when firms fail. Exchange Act Rule 17a-11 requires member firms to notify FINRA **and the SEC** in the event their net capital falls below the minimum amount required by the Net Capital Rule.

If member firms have an affiliate **or parent** paying any of their expenses, *Notice to Members 03-63* (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers) provides guidance for establishing an expense-sharing agreement that meets the standards set forth in Exchange Act Rule 17a-3;<sup>41</sup> firms with office leases should apply the guidance in *Regulatory Notice 19-08* (Guidance on FOCUS Reporting for Operating Leases) for reporting lease assets and lease liabilities on their FOCUS reports. Additionally, member firms must align their revenue recognition practices with the requirements of the Financial Accounting Standards Board's Topic 606 (Revenue from Contracts with Customers) **and other applicable accounting standards**.

#### Related Considerations

- ▶ **Does your firm have a process to assess the completeness and accuracy of its accounting entries, including for contractual or contingent obligations and their impact on net capital?**
- ▶ How does your firm review its net capital treatment of assets **and liabilities** to confirm that they are correctly classified for net capital purposes?
- ▶ **How does your firm confirm that it properly calculated the applicable net capital charges, including operational and financing charges, in its net capital calculation?**
- ▶ For firms with expense-sharing agreements, what kind of allocation methodology does your firm use, and what kind of documentation does your firm maintain to substantiate its methodology for allocating specific broker-dealer costs to your firm or an affiliate **or parent?**
- ▶ How does your firm assess the potential impact to net capital from new, complex or atypical transactions, **other business arrangements or events (including contractual obligations, losses or contingencies)?** Does your firm involve regulatory reporting staff in the process to assess these types of transactions, **other arrangements or events?**

## FINRA's Recent Net Capital Examinations

During 2023 examinations focused on financial controls and net capital compliance at some member firms, FINRA observed some minor deficiencies as well as some more material findings, including:

- ▶ **Supervision:** Lack of supervisory review of various key functions, such as wire movements and financial report preparation;
- ▶ **Designation of a Financial and Operations Principal:** Not properly designating a qualified financial and operations principal ("FINOP") per FINRA Rule [1220](#) (Registration Categories);
- ▶ **Inaccurate Books and Records:** Misclassification of assets and liabilities, inadequate reconciliations and not adequately accruing liabilities, leading to inaccurate financial reporting and, in some cases, net capital deficiencies;
- ▶ **Expense Sharing Agreements:** Expense sharing and service level agreements that failed to adequately outline the allocation of expense as required by SEC rules and addressed in *NASD Notice to Members 03-63* (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers); and
- ▶ **Bank Account Access:** Providing persons not associated with the broker-dealer with authority over firm bank accounts, thereby allowing them to perform certain covered functions without proper registration, as defined in FINRA Rule 1220.

Firms should take these findings into consideration when evaluating their internal financial controls. Some of these findings, along with effective practices, are outlined in more detail throughout this section of the Report.

## Findings and Effective Practices

### Findings

- ▶ **Incorrect Capital Charges for Underwriting Commitments:** Not maintaining an adequate process to assess moment-to-moment net capital and open contractual commitment capital charges on underwriting commitments; not establishing and maintaining WSPs for calculating and applying open contractual commitment charges; failing to maintain an accurate record or log of underwritings in which the firm is involved; and not understanding the firm's role in the underwriting (*i.e.*, best efforts or firm commitment).
- ▶ **Inaccurate Net Capital Deductions:** Not maintaining a process to accurately determine allowability and valuation of non-marketable securities (*e.g.*, marketplace blockage); and **for certain firms applying "minimal amount of credit risk standard" despite** not having an adequate process to conduct an internal credit analysis or an independent creditworthiness analysis of corporate and nonconvertible debt securities.
- ▶ **Inadequate WSPs:** Not maintaining adequate WSPs for calculating and applying haircuts for non-marketable inventory and conducting internal credit analysis or conducting an independent creditworthiness analysis of the firms' corporate and nonconvertible debt securities inventory.
- ▶ **Inaccurate Recording of Revenue and Expenses:** Using cash accounting to record revenue and expenses as of the date the money changes hands, rather than accrual accounting (where firms would record revenue **in accordance with Accounting Standards Codification (ASC) 606 or other applicable accounting standards** and expenses when incurred **or, in the case of contingencies, when estimable and probable, in accordance with ASC 450**); and making ledger entries as infrequently as once per month, resulting in firms not having adequate context to determine the proper accrual-based transaction date.

## Effective Practices

- ▶ **Net Capital Assessment:** Performing an assessment of the net capital treatment of assets, to confirm that they were correctly classified for net capital purposes.
- ▶ **Moment-to-Moment and Net Capital Compliance for Underwriting Commitments:** Establishing and maintaining current WSPs for:
  - ensuring the firm's role is clear within the agreement as it relates to its role in the underwriting (*i.e.*, best efforts **(either in a contingent or a firm commitment offering)** or as having a firm commitment);
  - establishing a process to track open contractual commitments in which the firm is involved **at all times**; and
  - calculating and applying open contractual commitment charges, as well as focusing on the product and proper haircut percentage.
- ▶ **Net Capital Deductions:** Establishing a process to determine creditworthiness of corporate or nonconvertible securities inventory if applying the “minimal amount of credit risk standard; and maintaining WSPs for calculating and applying net capital deductions and haircuts for non-marketable inventory.

## Additional Resources

- ▶ **FINRA**
  - [Interpretations to the SEC's Financial and Operational Rules](#)
  - *Regulatory Notices*
    - ***Regulatory Notice 23-21 (FINRA Reminds Member Firms of Net Capital, Recordkeeping, and Financial Reporting Requirements in Connection with Revenue Recognition Practices)***
    - *Notice to Members 03-63 (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers)*
- ▶ **FASB**
  - [Revenue from Contracts with Customers \(Topic 606\)](#)

# Liquidity Risk Management

## Regulatory Obligations and Related Considerations

### Regulatory Obligations

Effective liquidity controls are critical elements in a broker-dealer's risk management framework. Exchange Act Rule 17a-3(a)(23) requires member firms that meet specified thresholds to make and keep current records documenting the credit, market and liquidity risk management controls established and maintained by the firm to assist it in analyzing and managing the risks associated with its business.

FINRA routinely reviews and has shared observations on member firms' liquidity risk management practices, as discussed in *Regulatory Notice 15-33 (Guidance on Liquidity Risk Management Practices)* and *Regulatory Notice 21-12 (FINRA Reminds Member Firms of Their Obligations Regarding Customer Order Handling, Margin Requirements and Effective Liquidity Management Practices During Extreme Market Conditions)*.

As noted in *Regulatory Notice 21-31 (FINRA Establishes New Supplemental Liquidity Schedule (SLS))* **and pursuant to FINRA Rule 4524 (Supplemental FOCUS Information), each member firm must file such additional financial or operational schedules or reports as FINRA may deem necessary or appropriate for the protection of investors or in the public interest.** The SLS is a supplemental filing to the FOCUS Reports and is designed to improve FINRA's ability to monitor for events that signal an adverse change in the liquidity risk of firms **with the largest customer and counterparty exposures.**

## Related Considerations

- ▶ **Is responsibility for liquidity risk management assigned to a specific individual or department?**
- ▶ Do your firm's liquidity management practices include processes for:
  - taking into consideration the type of transactions that are impacting your firm's liquidity needs;
  - **reviewing and adjusting assumptions regarding clearing deposit requirements, including in its stress test framework;**
  - accessing liquidity during **idiosyncratic** stress conditions—such as increases in firm and client activities—as well as **market stress** events;
  - establishing contingency funding sources; and
  - using empirical data from recent stress events to increase the robustness of its stress testing?
- ▶ What kind of stress tests (*e.g.*, market, idiosyncratic) does your firm conduct? Do these tests consider concentrations within securities or sectors, and incorporate holdings across accounts held at other financial institutions? Are these tests conducted and documented on a regular basis? Does your firm institute changes to its funding plan as a result?
- ▶ If your firm's business has grown significantly or has materially changed, or your firm plans to make a material change to its business, has your firm made commensurate changes to its liquidity management and stress test practices and related policies and procedures?

## Observations and Effective Practices

### Observations

- ▶ **Establishing Insufficient Stresses on Clearing Deposit Requirements:** As part of its stress testing, firms are incorrectly basing stresses on clearing deposit requirements on information that doesn't necessarily represent the firm's business operations (*e.g.*, using the amounts reflected on FOCUS reports rather than **actual fluctuations** in deposit requirements that may have occurred intra-month).
- ▶ **No Contingency Funding Plans:** Failing to develop contingency funding plans **that would provide sources of liquidity** for operating under **market or idiosyncratic** stress conditions, including identifying the firm staff responsible for enacting the plan and the process for accessing liquidity during a stress event, as well as setting standards to determine how funding would be used.
- ▶ **Inaccurate SLS Reporting: Providing inaccurate or incomplete information in firms' SLS, such as:**
  - **incorrectly identifying entities such as agent lenders or Fixed Income Clearing Corporation (FICC) members as counterparties to repurchase agreements, reverse repurchase agreements and securities borrowed transactions;**
  - **providing incomplete information regarding non-cash securities lending transactions (*i.e.*, identifying either the received collateral or delivered collateral, but not both); and**
  - **not completing the line item for "Total Available Collateral in Broker-Dealer's Custody" (or entering inaccurate information).**

### Effective Practices

- ▶ **Liquidity Risk Management Updates:** Updating liquidity risk management practices, policies and procedures to conform with the firm's current business activities, including:
  - establishing governance around liquidity risk management, including determining who is responsible for monitoring the firm's liquidity position, the frequency of monitoring, and the communication and coordination protocols; and

- creating a liquidity management plan that considers:
  - liquidity use assumptions that are based on both idiosyncratic and market-wide conditions **and stress scenarios**;
  - sources of funding in both business-as-usual and stressed conditions;
  - **stability and other characteristics** of funding sources;
  - **the type and quantity of available collateral needed to secure funding**;
  - potential mismatches in duration between liquidity sources and uses;
  - **a contingency plan in the event of loss of funding sources**; and
  - early warning indicators of **liquidity loss** and escalation procedures.
- ▶ **Stress Tests:** Conducting stress tests in a manner and frequency that consider the complexity and risk of the firm's business model, including:
  - assumptions specific to the firm's business (*e.g.*, increased haircuts on collateral pledged by firm, availability of funding from a parent firm) and based on historical data;
  - the firm's sources and uses of liquidity;
  - **changes to the stability and quality of liquidity sources relied upon for its funding needs in a stressed environment**;
  - the potential impact of off-balance sheet items (*e.g.*, non-regular way settlement trades, forward contracts) on the firm's liquidity needs; and
  - periodic governance group review of stress test parameters.

## Additional Resources

- ▶ [Funding and Liquidity Key Topics Page](#)
- ▶ [Frequently Asked Questions: Supplemental Liquidity Schedule](#)
- ▶ *Regulatory Notices*
  - **[Regulatory Notice 23-11](#)** (FINRA Seeks Comment on Concept Proposal for a Liquidity Risk Management Rule)
  - [Regulatory Notice 21-31](#) (FINRA Establishes New Supplemental Liquidity Schedule (SLS))
  - [Regulatory Notice 21-12](#) (FINRA Reminds Member Firms of Their Obligations Regarding Customer Order Handling, Margin Requirements and Effective Liquidity Management Practices During Extreme Market Conditions)
  - [Regulatory Notice 15-33](#) (Guidance on Liquidity Risk Management Practices)
  - [Regulatory Notice 10-57](#) (Funding and Liquidity Risk Management Practices)

## Credit Risk Management

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA has consistently reminded member firms of the importance of properly managing credit risk. Several *Notices* offer guidance on effective funding and liquidity risk management practices (which are available in the “Additional Resources” section below). Material credit risk exposures can arise, for example, from clearing arrangements, prime brokerage arrangements (especially fixed income prime brokerage), “give up” arrangements and sponsored access arrangements.

Effective credit risk practices include maintaining a control framework where it manages credit risk and identifies and addresses all relevant risks covering the extension of credit to their customers and counterparties. Weaknesses within the firm’s risk management and control processes could result in a member firm incorrectly capturing its exposure to credit risk. In particular, Exchange Act Rule 17a-3(a)(23) requires member firms that meet specified thresholds to make and keep current records documenting the credit, market and liquidity risk management controls established and maintained by the firm to assist it in analyzing and managing the risks associated with its business.

#### Related Considerations

- ▶ Does your firm maintain a robust internal control framework to capture, measure, aggregate, manage, supervise and report credit risk?
- ▶ Does your firm review whether it is accurately capturing its credit risk exposure, maintaining approval and documented processes for increases or other changes to assigned credit limits, and monitoring exposure to affiliated counterparties **(including any concentration of exposure to such)?**
- ▶ Does your firm have a process to confirm it is managing the quality of collateral and monitoring for exposures that would have an impact on its net capital?

### Observations and Effective Practices

#### Observations

- ▶ **Credit Risk Management Reviews:** Firms did not evaluate their risk management and control processes to ensure they were accurately capturing the credit risk exposure at the broker-dealer level.
- ▶ **Monitoring Exposure:** Firms did not monitor for concentration risk or their credit exposure to affiliated counterparties.

#### Effective Practices

- ▶ **Credit Risk Framework:** Developing a comprehensive internal control framework (*e.g.*, systems, policies and procedures) to capture, measure, aggregate, manage and report credit risk, including:
  - establishing house margin requirements **for margin-eligible securities;**
  - identifying and assessing credit exposures in a real-time environment;
  - timely issuing margin calls and margin extensions (and resolving unmet margin calls);
  - establishing the frequency and manner of stress testing of collateral held for margin loans and secured financing transactions; and
  - having a governance process for approving new, material margin loans or other financing activities.
- ▶ **Credit Risk Limit Changes:** Establishing approval and documentation processes for changes to assigned credit limits, including:



- having processes for monitoring limits established at inception and on an ongoing basis, for customers and counterparties;
  - reviewing how customers and counterparties use these credit limits, **whether breaches occur and, if so, how they are handled**; and
  - maintaining a governance structure around credit limit approvals.
- ▶ **Counterparty Exposure:** Monitoring exposure to affiliated counterparties, considering factors including their:
- creditworthiness;
  - overall financial resources, including their liquidity and net worth;
  - **business activities and regulatory history** (e.g., traded products, regulatory history, past arbitration and litigation); and
  - internal risk controls.

## Additional Resources

- ▶ [Funding and Liquidity Key Topics Page](#)
- ▶ *Regulatory Notices*
  - *Regulatory Notice 21-31* (FINRA Establishes New Supplemental Liquidity Schedule (SLS))
  - *Regulatory Notice 21-12* (FINRA Reminds Member Firms of Their Obligations Regarding Customer Order Handling, Margin Requirements and Effective Liquidity Management Practices During Extreme Market Conditions)

## Portfolio Margin and Intraday Trading

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

FINRA Rule [4210\(g\)](#) (Margin Requirements) permits member firms to apply portfolio margin requirements—based on the composite risk of a portfolio’s holdings—in margin accounts held by certain investors as an alternative to “strategy-based” margin requirements. Member firms are required to monitor the risk of the positions held in these accounts during a specified range of possible market movements according to a comprehensive written risk methodology.

#### Related Considerations

- ▶ Do your firm’s policies and procedures for monitoring the risk of their investors’ portfolio margin accounts comply with Rule 4210(g)(1), in particular:
  - maintaining a comprehensive written risk methodology for assessing the potential risk to the member’s capital during a specified range of possible market movements of positions maintained in such accounts;
  - monitoring the credit risk exposure of portfolio margin accounts both intraday and end of day; and
  - maintaining a robust internal control framework reasonably designed to capture, measure, aggregate, manage, supervise and report credit risk exposure to portfolio margin accounts?

## Findings and Effective Practices

### Findings

- ▶ **Inadequate Recordkeeping:** Failing to maintain position records in the required format and in an easily accessible location, as specified in the firm's Portfolio Margin Application approval letter from FINRA.
- ▶ **Incorrect Account Equity:** Incorrectly computing the account equity used to determine the maintenance margin excess or deficiency by incorporating incorrect option prices (*e.g.*, prices supplied by third-party vendors that varied significantly from the prices determined by the Options Clearing Corporation).
- ▶ **Accounts Below Minimum Equity:** Failing to ensure that portfolio margin accounts maintain the required minimum equity.
- ▶ **No Internal Audit Review of Portfolio Margin Process:** Not conducting an internal audit review of the portfolio margin process as part of the firm's portfolio margin approval and as required by its Portfolio Margin Application.

### Effective Practices

- ▶ **Internal Risk Framework:** Developing and maintaining a robust internal risk framework to identify, monitor and aggregate risk exposure within individual portfolio margin accounts and across all portfolio margin accounts, including:
  - **accounting for the risk exposure from prime brokerage and other accounts that trade away;**
  - conducting stress testing of client portfolios;
  - closely monitoring client fund portfolios' NAV, capital, profitability, client redemptions, liquidity, volatility and leverage to determine if higher margin requirements or management actions are required; and
  - monitoring and enforcing limits set by internal risk functions and considering trigger and termination events set forth in the agreement with each client.
- ▶ **Concentration Risk:** Maintaining and following reasonably designed processes (reflected in the firm's WSPs) and robust controls to monitor the credit exposure resulting from concentrated positions within both individual portfolio margin accounts and across all portfolio margin accounts, including processes to:
  - aggregate and monitor total exposure and liquidity risks with respect to accounts under common control;
  - identify security concentration at the single account level and in the aggregate; and
  - measure the impact of volatility risk at the individual security level.
- ▶ **Client Exposure:** Clearly and proactively communicating with clients with large or significantly increasing exposures, according to clearly delineated triggers and escalation channels established by the firm's WSPs; and requesting that clients provide their profit and loss position each month.
- ▶ **Reporting:** Maintaining controls to ensure portfolio margin data reported to FINRA is accurate, and providing FINRA with accurate explanation of significant changes in the reported data.
- ▶ **Global Margin Programs:** For firms that holistically monitor and hedge portfolio margin account exposure across affiliated entities, maintaining and enforcing appropriate inter-affiliate agreements that document a global margin program and provide regulatory transparency regarding the firm's margin calculations.
- ▶ **Staffing and Training:** Maintaining a staff with sufficient subject-matter expertise, and providing training opportunities, related to portfolio margin.

### Additional Resource

- ▶ [Portfolio Margin FAQ](#)

## Segregation of Assets and Customer Protection

### Regulatory Obligations and Related Considerations

#### Regulatory Obligations

Exchange Act Rule 15c3-3 (Customer Protection Rule) imposes requirements on member firms that are designed to protect customer funds and securities. Member firms are obligated to maintain custody of customers' fully paid and excess margin securities, and safeguard customer funds by segregating these assets from the firm's proprietary business activities and promptly delivering them to the customer upon request. Member firms can satisfy these requirements by keeping customer funds in a special reserve bank account and by maintaining customer securities in their physical possession or in a good control location, as specified in Rule 15c3-3.

Member firms are required to maintain a reserve of cash or qualified securities in the special reserve bank account that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities. The amount of net cash owed to customers is computed pursuant to the formula set forth in Exhibit A to Rule 15c3-3.

#### Related Considerations

- ▶ What is your firm's process to prevent, identify, escalate and resolve new or increased possession or control deficits that are in violation of the Customer Protection Rule?
- ▶ What controls does your firm have in place to identify and monitor its possession or control deficits, including their creation, cause and resolution?
- ▶ If your firm claims an exemption from the Customer Protection Rule under paragraph (k)(2)(ii) thereunder, in accordance with the requirements of that rule it is required to promptly forward any customer checks it receives to its clearing firm.
- ▶ Has your firm implemented an effective process for forwarding customers' checks, and does your firm maintain accurate records to evidence that customer checks were promptly forwarded?
- ▶ How does your firm train its staff on the requirements of the Customer Protection Rule?
- ▶ What are your firm's processes to confirm that it correctly computes its **customer and PAB**<sup>42</sup> reserve formula computations and maintains the amounts that must be deposited into its special reserve bank account(s)?

### Findings and Effective Practices

#### Findings

- ▶ **Inaccurate Reserve Formula Computations:** Failing to complete accurate reserve formula computations, due to factors such as:
  - inadequate supervisory procedures and processes;
  - limited coordination between various internal departments;
  - inaccurate account coding; and
  - **adjustments to the initial reserve formula components that are inaccurate, incomplete or both.**
- ▶ **Improper Withdrawals From Reserve Bank Account: Not preparing a reserve formula computation prior to making a withdrawal from the reserve bank account.**
- ▶ **Inaccurate Segregation of Customer Securities:** Failing to maintain possession or control of customer fully paid or excess margin securities due to inadequate supervisory procedures and processes to identify, monitor and resolve possession or control deficits, and inaccurate coding of good control locations.

### Effective Practices

- ▶ **Confirming Control Location Agreements:** Collaborating with legal and compliance departments to confirm that all agreements supporting control locations are finalized and executed before the accounts are established and accurately coded as good control location accounts on the firms' books and records.
- ▶ **Addressing Conflicts of Interest:** Confirming which staff have system access to establish a new good control location, and that they are independent from the business areas to avoid potential conflicts of interest, as well as conducting ongoing review to address emerging conflicts of interest.
- ▶ **Reviews and Exception Reports for Good Control Locations:** Conducting periodic review of and implementing exception reports for existing control locations for potential miscoding, out-of-date paperwork or inactivity.
- ▶ **Check Forwarding Blotter Review:** Creating and reviewing your firm's checks received and forwarded blotters to confirm that they are accurately maintained and include the information required to evidence compliance with the Customer Protection Rule exemption.
- ▶ **Periodic Evaluation of Reserve Formula Computation Process: Performing variance analysis to review material fluctuations and new items to identify potential inaccuracies, and establishing a process to identify system or operational changes that could impact the customer or PAB reserve formula computations.**

### Additional Resource

- ▶ [Interpretations to the SEC's Financial and Operational Rules](#)

## Appendix—Using FINRA Reports in Your Firm's Compliance Program

Firms have shared the following ways they have used prior FINRA publications, such as Exam Findings Reports, Priorities Letters and Reports on FINRA's Examination and Risk Monitoring Program, to enhance their compliance programs. We encourage firms to consider these practices, if relevant to their business model, and continue to provide feedback on how they use FINRA publications.

- ▶ **Assessment of Applicability:** Performed a comprehensive review of the findings, observations and effective practices, and identified those that are relevant to their businesses.
- ▶ **Risk Assessment:** Incorporated the topics highlighted in our reports into their overall risk assessment process and paid special attention to those topics as they performed their compliance program review.
- ▶ **Gap Analysis:** Conducted a gap analysis to evaluate how their compliance programs and WSPs address the questions noted in Priorities Letters and the effective practices in Exam Findings Reports, and determined whether their compliance programs have any gaps that could lead to the types of findings noted in Exam Findings Reports.
- ▶ **Project Team:** Created interdisciplinary project teams and workstreams (with staff from operations, compliance, supervision, risk, business and legal departments, among other departments) to:
  - assign compliance stakeholders and project owners;
  - summarize current policies and control structures for each topic;
  - engage the legal department for additional guidance regarding regulatory obligations;
  - develop plans to address gaps; and
  - implement effective practices that were not already part of their compliance program.
- ▶ **Circulation to Compliance Groups:** Shared copies of the publications or summaries of relevant sections with their compliance departments.
- ▶ **Presentation to Business Leaders:** Presented to business leadership about their action plans to address questions, findings, observations and effective practices from our reports.
- ▶ **Guidance:** Used reports to prepare newsletters, internal knowledge-sharing sites or other notices for their staff.
- ▶ **Training:** Added questions, findings, observations and effective practices from our reports, as well as additional guidance from firms' policies and procedures to their Firm Element and other firm training.

## Endnotes

- 1 **In general, the term “off-channel communications” refers to business-related messages sent and received through applications on personal devices or through other platforms outside of the member firm’s control, including using personal email, chats, or text-messaging applications for business purposes.**
- 2 “Related Considerations” are intended **to serve firms in designing or strengthening their compliance programs related to a topic.** Firms should review relevant rules to understand the full scope of their obligations.
- 3 See 17 CFR 248.201(b)(3), which defines “covered account” as:
  - (i) an account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a brokerage account with a broker-dealer or an account maintained by a mutual fund (or its agent) that permits wire transfers or other payments to third parties; and
  - (ii) any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation, or litigation risks.
- 4 **See CISA Advisory [#StopRansomware: CLOP Ransomware Gang Exploits CVE-2023-34362 MOVEit Vulnerability](#) for an example of a cybersecurity event that negatively impacted critical vendors.**
- 5 Session recordings from the 2023 FINRA Annual Conference are available for viewing by FINRA member firms and CRCP graduates. Please see FINRA’s [Conferences and Events page](#) for a list of recorded sessions, and directions for accessing them.
- 6 **Capital Acquisition Broker (CAB) Rule [331](#) applies AML compliance program requirements to Capital Acquisitions Brokers.**
- 7 **31 CFR § 1023.320 requires broker-dealers to file reports of suspicious transactions (SARs) relevant to a possible violation of law or regulation—such as money laundering, fraud, or sanctions violations—to the extent and in the manner required by that regulation.**
- 8 See 31 C.F.R. Part 1010 and 31 C.F.R. Part 1023.
- 9 **See FinCEN, [Interpretive Release No.2004-02 Unitary Filing of Suspicious Activity and Blocking Reports](#), 69 Fed. Reg. 76847 (December 23, 2004).**
- 10 31 C.F.R. § 1023.220 requires broker-dealers to conduct CIP on their “customers.” A “customer” is defined by 31 C.F.R. § 1023.100(d) as “a person that opens a new account.” An “account” is, in turn, defined by 31 C.F.R. § 1023.100(a)(1) as a “formal relationship with a broker-dealer established to effect transactions in securities.”  
31 C.F.R. § 1010.230 requires broker-dealers to identify and verify the identity of the beneficial owners of its “legal entity customers” when “a new account is opened.” 31 C.F.R. § 1010.230(e) defines a “legal entity customer” as a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account. 31 C.F.R. § 1010.230(c) defines “account” as a “formal relationship with a broker-dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral.”
- 11 **FINRA Rule 3310(c) provides that a member may only conduct its testing every two years (on a calendar-year basis) if the member does not: (i) execute transactions for customers; (ii) otherwise hold customer accounts; or (iii) act as an introducing broker with respect to customer accounts. FINRA Rule 3310(c) also provides two examples of the types of firms that would qualify for two-year testing: firms that engage solely in proprietary trading and firms that conduct business only with other broker-dealers. FINRA Rule 3310.01(a) also requires members to undertake more frequent testing if circumstances warrant.**
- 12 See FinCEN, [Section 314\(a\)](#) for additional guidance.
- 13 An identity verification method where applicants upload a photo or video of themselves, which is then compared with their recently submitted identity documents (*See Regulatory Notice [21-18](#) (FINRA Shares Practices Firms Use to Protect Customers from Online Account Takeover Attempts)*).

- 14 A synthetic identity is a combination of real and fictitious data. For example, synthetic identities may include legitimate Social Security numbers and date of birth combined with fake names, addresses and email addresses.
- 15 See the Private Placements topic for additional findings and effective practices relevant to crypto asset-related private placements.
- 16 See the Report's Outside Business Activities and Private Securities Transactions topic for additional findings and effective practices applicable to reviewing and supervising crypto asset-related OBAs and PSTs.
- 17 See, e.g., [Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#) (July 8, 2019), and [Letter to Ms. Kris Dailey, FINRA, ATS Role in the Settlement of Digital Asset Security Trades](#) (September 25, 2020) (the SEC Staff ATS No-Action Letter).
- 18 See [Commission Statement and Request for Comment: Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#).
- 19 See, e.g., [Regulatory Notice 20-23](#) (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets) and [Regulatory Notice 21-25](#) (FINRA Continues to Encourage Firms to Notify FINRA if They Engage in Activities Related to Digital Assets).
- 20 See the Report's Communications With the Public topic for findings and effective practices concerning crypto asset-related retail communications.
- 21 See the Report's AML, Fraud and Sanctions topic for additional guidance related to developing and implementing a reasonably designed AML compliance program.
- 22 See the Report's Cybersecurity and Technological Management topic, and FINRA's [Cybersecurity Key Topics page](#) and [Industry Risks and Threats – Resources for Member Firms](#) webpages, for additional guidance related to effective cybersecurity practices and controls.
- 23 See the Report's Private Placements topic for additional guidance related to conducting reasonable due diligence on unregistered offerings.
- 24 **Session recordings from the 2023 FINRA Senior Investor Protection Conference are available for viewing by FINRA member firms and CRCP graduates. Please see FINRA's [Conferences and Events page](#) for a list of recorded sessions, and directions for accessing them.**
- 25 **Generally, a member that is already approved by FINRA to engage in private placements or underwriting would not need to file a CMA if they plan to engage in Regulation Crowdfunding activity. For more information, please refer to [Regulatory Notice 16-07](#) (FINRA Rule 4518 (Notification to FINRA in Connection with the JOBS Act)).**
- 26 **This section's findings and effective practices are based on observations regarding funding portals rather than broker-dealer intermediaries.**
- 27 **See the Report's Crypto Assets topic for an update on FINRA's ongoing targeted examination on crypto asset retail communications.**
- 28 **The 2024 Report's Reg BI and Form CRS topic has been streamlined to remove content that solely reflects Reg BI's obligations or is no longer timely (given the rule's initial compliance date).**
- 29 See the Report's Private Placements section for additional findings related to firms and their associated persons recommending private offerings without having a reasonable basis.
- 30 See the Report's Variable Annuities section for additional findings related to firms not reasonably supervising variable annuities recommendations for compliance with Reg BI.
- 31 **See the Report's Reg BI and Form CRS section for additional findings concerning failure to comply with Reg BI's Conflicts of Interest Obligation.**
- 32 See [Regulatory Notice 20-31](#) (FINRA Reminds Firms of Their Supervisory Responsibilities Relating to CAT).
- 33 In this situation, the routing firm and receiving firm may have different best execution obligations. See Supplementary Material .09 to FINRA Rule [5310](#).
- 34 **See SEC [Division of Trading and Markets Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS FAQs #15.01 and #15.02](#).**



- 35 See [SEC Division of Market Regulation, Staff Legal Bulletin No. 13A, Frequently Asked Questions About Rule 11Ac1-6, FAQ #9](#).
- 36 In addition to the order routing disclosures under Rule 606, Rule 607 of Regulation NMS requires firms to disclose their policies regarding PFOF and order routing when customers open accounts, and on an annual basis thereafter, so firms should consistently provide the same information in both types of disclosures.
- 37 See, in particular, SLB 13A Question 4 and SEC FAQ 12.01 regarding adopting another firm's report by reference.
- 38 See e.g., 69 FR 48008 at 48015; and Question 4.7 and 4.8 of the U.S. Securities and Exchange Commission, [Responses to Frequently Asked Questions Concerning Regulation SHO](#) (October 15, 2015) (SEC's Reg SHO FAQs).
- 39 See Question 4.4 of the SEC [Reg SHO FAQs](#).
- 40 Exchange Act Rule 15c2-11(e)(7) broadly defines "quotation" as "any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that wishes to advertise its general interest in buying or selling a particular security." Similarly, Exchange Act Rule 15c2-11(e)(8) broadly defines "quotation medium" to include "any 'interdealer quotation system' or any publication or electronic communications network or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell."
- 41 Firms are reminded that any affiliate obligated to pay firm expenses must have the independent financial means to satisfy those obligations.
- 42 **Exchange Act Rule 15c3-3 defines "PAB account" as "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account. The term does not include an account that has been subordinated to the claims of creditors of the carrying broker or dealer."**

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