Gamification, Mobile Apps and Digital Engagement

Tuesday, May 17, 2022
1:45 p.m. – 2:45 p.m.

Attend this session to hear how regulatory and industry experts are evaluating the rapidly changing world of digital communications and digital engagement practices. Panelists discuss risks and benefits of gamification features on broker-dealers' apps and websites. They address how firms can effectively supervise digital communications.

Moderator: Amy Sochard
Vice President
FINRA Advertising Regulation

Panelists: Surabhi Ahmad
Vice President, Compliance
Ameriprise Financial Services, LLC

Alexander Gavis
Professor
Suffolk University Law School

Alicia Goldin
Senior Special Counsel, Office of Chief Counsel, SEC Division of Trading and Markets
U.S. Securities and Exchange Commission (SEC)

Haimera Workie
Vice President, Financial Innovation
FINRA Office of Financial Innovation (OFI)

Gamification, Mobile Apps and Digital Engagement Panelists Bios:

Moderator:

Amy C. Sochard is Vice President of FINRA's Advertising Regulation Department. The department helps protect investors by ensuring members of FINRA use communications including social media, digital advertising and other marketing material that are fair, balanced, and not misleading. Ms. Sochard oversees the department's regulatory review programs and business operations, including the development of technology to facilitate the review of communications. Ms. Sochard provides expertise and policy guidance to other FINRA departments concerning FINRA, SEC, MSRB and SIPC rules pertaining to communications with the public. She also oversees the development of new rules, published guidance, and interpretations regarding communications, and she routinely speaks at industry events on these topics. Prior to joining FINRA, Ms. Sochard worked with a real estate syndication firm in Washington, DC. She received a bachelor's degree with distinction in English from the University of Virginia and studied poetry writing at Columbia University.

Panelists:

Surabhi Ahmad is Vice President, Compliance at Ameriprise Financial. She leads a global team charged with the compliance review of advertising, marketing and communication materials for Ameriprise and its insurance and asset management businesses, RiverSource and Columbia Threadneedle Investments. She also leads a team of compliance professionals supporting the distribution of U.S. and global products for Columbia Threadneedle through intermediary and institutional channels. Based in Boston, Ms. Ahmad joined Ameriprise Financial in 2011. She has spent the last 24 years in risk- and compliance-related roles within the financial services industry including leadership roles at State Street Global Advisors and Fidelity Investments. She has also worked at international firms in Singapore and India supporting clients with trade finance, immigration and corporate law needs. Her diverse and international experience has enabled her to provide a global perspective to the multiple organizations she's been a part of. Ms. Ahmad received a B.S. from Calcutta University and a Professional Law Certification from the Delhi C.S. Institute in India. She holds the Series 7 and Series 24 securities license with FINRA.

Alexander C. Gavis recently retired as Senior Vice President and Deputy General Counsel in the Corporate Legal Department of FMR LLC, the parent company of Fidelity Investments, one of the largest brokerage and mutual fund companies in the United States and the leading provider of workplace retirement savings plans. He managed a team of attorneys and professionals responsible for providing legal services to the firm's retail brokerage, stock plan and workplace retirement businesses. He also managed legal services for Fidelity's businesses involved in electronic and mobile commerce, start-up innovation, and social media. Mr. Gavis provided legal advice on all of Fidelity's national advertising and marketing initiatives. Prior to joining Fidelity in 1997, Mr. Gavis served as Assistant Counsel at the Investment Company Institute and as Senior Counsel in the Office of General Counsel at the U.S. Securities and Exchange Commission, both in Washington, DC. He also served as a judicial law clerk for The Honorable William T. Allen, Chancellor of the Court of Chancery for the State of Delaware. He has worked in investment banking in New York at Salomon Brothers Inc, handling mergers and acquisitions. Mr. Gavis received his J.D., *cum laude*, from the University of Pennsylvania Law School, where he served as Editor-in-Chief of the *University of Pennsylvania Law Review*, and his bachelor's degree, with High Honors and *Phi Beta Kappa,* from Swarthmore College. As an adjunct professor at Suffolk University Law School, he currently teaches the class "Designing Thinking for Lawyers and Business Professionals" and has taught at the Stanford University Design and Law Schools and at Harvard Law School. He also holds a patent in the area of blockchain technologies. Mr. Gavis currently serves on FINRA's FinTech Industry Committee and as chair of the Public Communications Committee, and as a past member of the E-Brokerage (chair) and Membership Committees and the Social Media (chair) and New Account Form Task Forces.

Alicia Goldin is Senior Special Counsel in the Division of Trading and Markets, Office of Chief Counsel, specializing in broker-dealer sales practices, with a particular focus on issues relating to Regulation Best Interest, Form CRS, advertising, supervision and arbitration. Ms. Goldin previously served as Counsel to former SEC Commissioner Elisse B. Walter. Prior to joining the Commission in 2007, Ms. Goldin spent four years in private practice. She earned her law degree from the University of Michigan Law School and her undergraduate degree from the University of Virginia.

Haimera Workie, Vice President and Head of Financial innovation, oversees the Office of Financial Innovation. In this capacity, he is responsible for leading FINRA's Office of Financial Innovation, which focuses on analyzing financial technology (FinTech) innovations and emerging risks and trends related to the securities market. As part of these responsibilities, Mr. Workie works to foster an ongoing dialogue with market participants in order to build a better understanding of FinTech innovations and their impact on the securities markets. Previously, Mr. Workie served as Deputy Associate Director in the Division of Trading and Markets at the U.S. Securities and Exchange Commission. Mr. Workie also previously served as Counsel in the SEC's Office of the Chairman. Prior to joining the SEC, he was an associate at the law firm of Skadden, Arps, Slate, Meagher & Flom, with a practice focusing on corporate law. Mr. Workie is a graduate of the Massachusetts Institute of Technology (B.S., M.S.) and Harvard Law School (J.D.).

Gamification, Mobile Apps and Digital Engagement

Panelists

- **Moderator**
  - Amy Sochard, Vice President, FINRA Advertising Regulation
- **Panelists**
  - Surabhi Ahmad, Vice President, Compliance, Ameriprise Financial Services, LLC
  - Alexander Gavis, Professor, Suffolk University Law School
  - Alicia Goldin, Senior Special Counsel, Office of Chief Counsel, SEC Division of Trading and Markets, U.S. Securities and Exchange Commission (SEC)
  - Haimera Workie, Vice President, Financial Innovation, FINRA Office of Financial Innovation (OFI)

Agenda

01 | Digital Engagement Practices Overview

02 | Mobile App Considerations

03 | Data Analytics

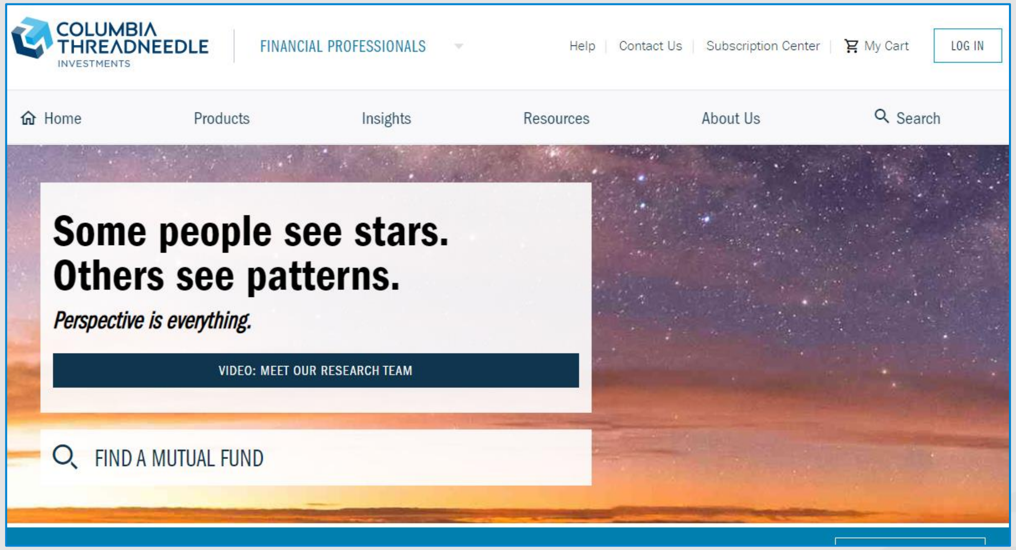
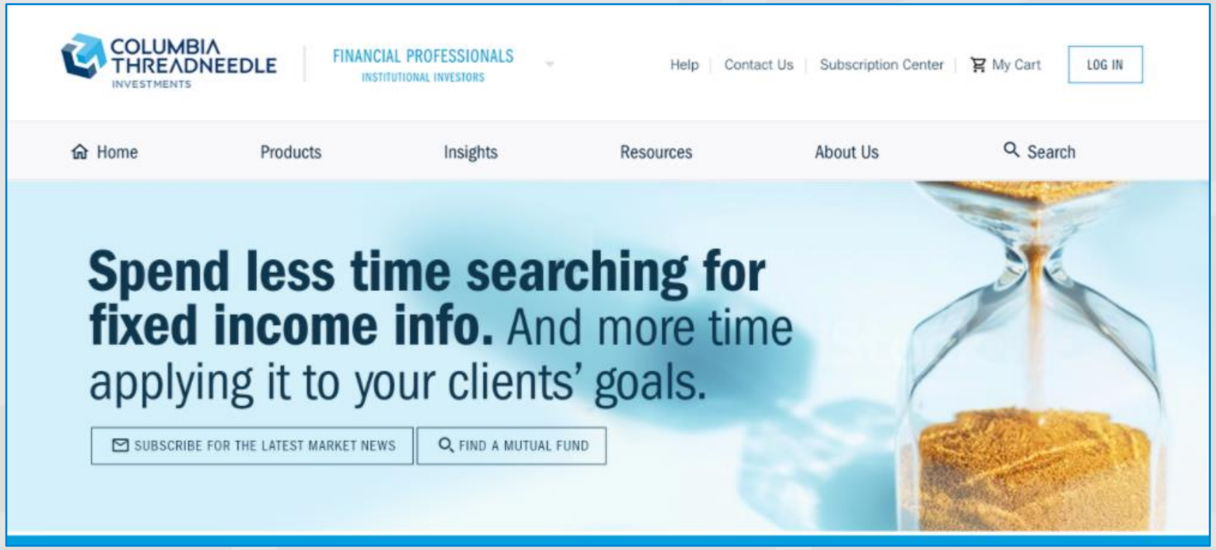
04 | Future Developments

1 | Digital Engagement Practices Overview

Digital Engagement Practices Overview

- *SEC Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools, etc.* Release Nos. 34-92766; IA-5833; File No. S7-10-21
- Digital Engagement Practices and Gamification Definitions
- Pros and Cons of Digital Engagement Practices
- Responses to SEC Request
- FINRA Observations

Customizing the Website Experience

From: Static Website	To: Customized Website Experience
	

Our digital capabilities and marketing programs support the Ameriprise Client Experience

Our **clients' expectations have changed**, especially when it comes to the online client experience. **They want and expect a compelling digital experience** that allows them to **collaborate** with advisors; they want to **see** their investments and performance, as well as their financial goals and their **progress** towards these goals **at any time**, any place, from any device they choose.

GOAL-BASED ADVICE THROUGH THE *CONFIDENT RETIREMENT*® APPROACH

We will understand and **document your financial goals**, provide you with **advice** to help achieve them and **track your progress** toward them.

INVESTMENTS AND SOLUTIONS ALIGNED TO GOALS

We will **recommend investments and solutions based on your goals**, and we will use a robust **asset allocation process** to manage those investments.

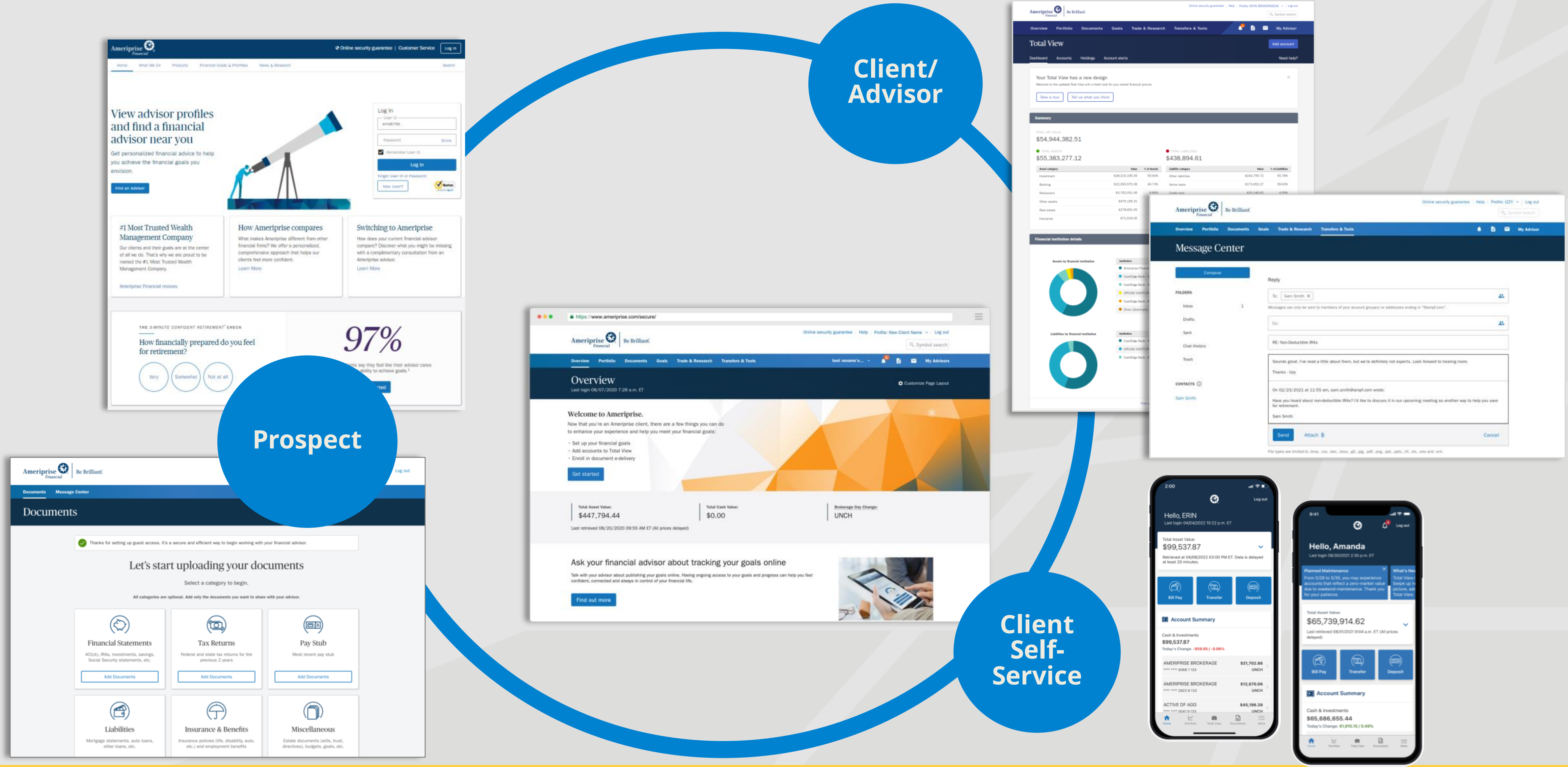
COMPELLING DIGITAL EXPERIENCE

You will be able to **see the investments and solutions** you own and **how they are performing**, as well as your financial goals and your progress toward those goals, at **any time, any place, from any device you choose.**

REFERABLE SERVICE EXPERIENCE

Your advisor will **reach out proactively** at least four times each year, including at least one face-to-face or screen-to-screen meeting. And we will **always return your call or e-mail the same day.**

We shape the online experience for prospects and clients



FINRA®

2 | Mobile App Considerations

Mobile App Considerations

- *[2022 Report on FINRA's Examination and Risk Monitoring Program, Communications with the Public]*
- Broker Dealers' Approaches to Use and Marketing of Mobile Apps
- Supervision of Mobile Apps
- Challenges

3 | Data Analytics

Data Analytics

- Regulatory Observations
- Personalization
- Reg BI
- Privacy Considerations

4 | Future Developments

Future Developments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A

FINRA

FEBRUARY 2022

2022 Report on FINRA's Examination and Risk Monitoring Program

Introduction

The 2022 Report on FINRA's Examination and Risk Monitoring Program (the Report) provides firms with information that may help inform their compliance programs. For each topical area covered, the Report identifies the relevant rule(s), highlights key considerations for member firms' compliance programs[1], summarizes noteworthy findings from recent examinations, outlines effective practices that FINRA observed during its oversight, and provides 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 firms. To that end, the Report builds on the structure and content in the 2021 Report by adding new topics (*e.g.,* Disclosure of Order Routing Information, Funding Portals) denoted **NEW FOR 2022** and new material (*e.g.,* new exam findings, effective practices) to existing sections where appropriate. (New material in existing sections is in **bold** type.) In addition, those general findings that are also particularly relevant for firms in their first year of operation are denoted with a star (★).

As always, FINRA welcomes feedback on how we can improve future publications of this Report. Please contact Steve Polansky, Senior Director, Member Supervision at (202) 728-8331 or by email; or Rory Hatfield, Associate Principal Research Analyst, Member Supervision at (240) 386-5487 or by email.

Selected Highlights

In 2021, considerable industry, and in some cases public, attention was focused on topics that FINRA also addressed through its exam and risk monitoring program. These topics include newer SEC Rules (*e.g.,* Regulation Best Interest (Reg BI), Form CRS, amendments to Rule 606), recent increases in the number and sophistication of cybersecurity threats, and the proliferation of securities trading through mobile apps.

Reg BI and Form CRS

During Reg BI's and Form CRS' first full calendar year of implementation in 2021, FINRA expanded the scope of its reviews and testing relative to 2020 to execute a more comprehensive review of firms' processes, practices and conduct in areas such as establishing and enforcing adequate written supervisory procedures (WSPs); filing, delivering and tracking accurate Forms CRS; making recommendations that adhere with Reg BI's Care Obligation; identifying and mitigating conflicts of interest; and providing effective training to staff. In this Report, FINRA notes its initial findings from its Reg BI and Form CRS reviews during the past year and will share additional findings at a future date.

CAT

FINRA continues to evaluate member firms that receive or originate orders in National Market System (NMS) stocks, over-the-counter (OTC) equity securities and listed options for compliance with Securities Exchange Act of 1934 (Exchange Act) Rule 613 and the CAT NMS Plan FINRA Rule 6800 Series (Consolidated Audit Trail Compliance Rule) (collectively, CAT Rules). This year's Report addresses compliance with certain CAT obligations, such as reporting CAT information to the Central Repository and maintaining an effective supervision process (including clock synchronization performed by third-party vendors).

Order Handling, Best Execution and Conflicts of Interest

Assessing firms' compliance with their best execution obligations under FINRA Rule 5310 (Best Execution and Interpositioning) is one of the cornerstones of FINRA's oversight activities. This oversight has evolved with changes in firms' business models, for example the advent of the "zero commission" model.

As noted in last year's Report, FINRA launched a targeted exam to "evaluate the impact that not charging commissions has or will have on the member firms' order-routing practices and decisions, and other aspects of member firms' business." FINRA will share its findings with member firms at a future date.

In addition, FINRA is focusing on firms' compliance with Rule 606 of Regulation NMS, which requires broker-dealers to disclose information regarding the handling of their customers' orders in NMS stocks and listed options. This information provides transparency to customers and can help them: better understand how their firm routes and handles their orders; assess the quality of order handling services provided by their firm; and determine whether their firm is effectively managing potential conflicts of interest that may impact their firm's routing decisions.

Mobile Apps

Advances in technology and its application continue to reshape the way some firms attract and interact with customers on mobile apps. These innovations can benefit investors in several ways, including increasing their market participation, expanding the types of products available to them and educating them on financial concepts. At the same time, however, these apps raise novel questions and potential concerns, such as whether they encourage retail investors to engage in trading activities and strategies that may not be consistent with their investment goals or risk tolerance, and how the apps' interface designs could influence investor behavior.

FINRA has identified significant problems with some mobile apps' communications with customers and firms' supervision of activity on those apps (particularly controls around account openings). FINRA has also observed mobile apps making use of social media to acquire customers, and recently initiated a targeted exam to assess firms' practices in this area, including with respect to firms' management of their obligations related to information collected from those customers and other individuals who may provide data to firms; FINRA will share its findings from this review after its completion.

Special Purpose Acquisition Companies (SPACs)

Another topic that has received significant attention is the increased use of Special Purpose Acquisition Companies (SPACs) to bring companies public. For example, in 2019, approximately 25 percent of initial public offerings were accomplished through SPACs; in the first quarter of 2021, this figure was over 70 percent.

FINRA recognizes how SPACs can provide companies with access to diverse funding mechanisms and allow investors to access new investment opportunities; however, as SPAC activity has increased, so too has FINRA's focus on broker-dealers' compliance with their regulatory obligations in executing SPAC transactions. In October 2021, FINRA launched a targeted exam to explore a range of issues, including how firms manage potential conflicts of interest in SPACs, whether firms are performing adequate due diligence on merger targets and if firms are providing adequate disclosures to customers. At a future date, FINRA will share with member firms its findings from this review.

Cybersecurity

Cybersecurity threats are one of the primary risks firms and their customers face. Over the past year, FINRA has continued to observe increases in the number and sophistication of these threats. For example, in 2021, FINRA has alerted firms about phishing campaigns involving fraudulent emails purporting to be from FINRA, as well as new customers opening online brokerage accounts to engage in Automated Clearing House (ACH) "instant funds" abuse. FINRA has issued additional regulatory guidance concerning the increase of bad actors using compromised registered representative or employee email accounts to execute transactions or move money; using customer information to gain unauthorized entry to customers' email accounts, online brokerage accounts or both (*i.e.,* customer account takeover (ATO) incidents); and using synthetic identities to fraudulently open new accounts. FINRA will continue to assess firms' programs to protect sensitive customer and firm information, as well as share effective practices firms can employ to protect their customers and themselves. Where appropriate, FINRA will also share information about cybersecurity threats to firms.

Complex Products

FINRA will continue to review firms' communications and disclosures made to customers in relation to complex products, and will review customer account activity to assess whether firms' recommendations regarding these products are in the best interest of the retail customer given their investment profile and the potential risks, rewards and costs associated with the recommendation. In addition, in August of last year, FINRA launched a targeted exam to review members' practices and controls related to the opening of options accounts which, in some instances, may be used to engage in complex strategies involving multiple options (such as spreads). FINRA will share its findings from this review at a future date.

How to Use This Report

FINRA's Risk Monitoring and Examination Programs evaluate member firms for compliance with relevant obligations and consider specific risks relating to each firm, including those relating to a firm's business model, supervisory control system and prior exam findings, among other considerations. While the topics addressed in this Report are selected for their interest to the largest number of member firms, 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 practices 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; it does not represent a complete inventory of regulatory obligations, compliance considerations, examination 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 to update their WSPs and compliance programs on an ongoing basis, as new regulatory obligations may be part of future examinations. 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 FINRA may ask or consider when examining your firm for compliance with such obligations.

- **Exam Findings and Effective Practices**
  - Noteworthy findings that FINRA has noted at some—but not all—member firms, including:
    - new findings from recent examinations;
    - findings we highlighted in prior Reports and that we continue to note in recent examinations;
    - in certain sections, topics noted as "Emerging Risks" representing potentially concerning practices that FINRA has observed and which may receive increased scrutiny going forward; 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 are not specific rule violations.
  - Select effective practices FINRA observed in recent exams, as well as those we noted in prior Exam Findings 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.,* Exam Findings Reports, Priorities Letters) in their compliance programs.

As a reminder, the Report—like our previous Exam Findings Reports and Priorities Letters—does not create any new legal or regulatory requirements or new interpretations of existing requirements. 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.

Firm Operations

Anti-Money Laundering

Regulatory Obligations and Related Considerations

Regulatory Obligations:

The Bank Secrecy Act (BSA) and implementing regulations form the foundation for member firms' Anti-Money Laundering (AML) obligations. (The BSA has been amended several times, including by the USA PATRIOT ACT of 2001 and the Anti-Money Laundering Act of 2020.) **The implementing regulations impose a number of requirements on broker-dealers, which include implementing and maintaining both AML programs and Customer Identification Programs (CIPs); filing reports of suspicious activity; verifying the identity of legal entity customers; maintaining procedures for conducting ongoing customer due diligence; 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 the Financial Crimes Enforcement Network (FinCEN) within specified timeframes.**

FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires that members develop and implement a written AML program reasonably designed to comply with the requirements of the BSA and its implementing regulations. **FINRA Rule 3310 also requires FINRA member firms to, among other things, establish and implement policies, procedures and internal controls that can be reasonably expected to detect and cause the reporting of suspicious activity; provide for an independent test of the AML program each calendar year (or every two years in some specialized cases); and provide ongoing training for appropriate personnel.**

Related Considerations:

- Does your firm's AML program reasonably address your business model, new and existing business lines, products, customers, geographic locations and associated AML risks?
- **Has your firm experienced substantial growth or changes to its business? If so, has its AML program reasonably grown and evolved alongside the business?**
- **Do your firm's AML procedures recognize that the suspicious activity reporting obligation may apply to any transactions conducted by, at or through the firm, even transactions that do not originate with your firm's customers?**
- **Does your firm have appropriately designed AML procedures to identify and respond to known indicators of suspicious activity involving low-priced securities, such as those detailed in FINRA *Regulatory Notices* 19-18 and 21-03?**
- Does your firm's independent AML testing confirm that it maintains and implements reasonably designed procedures for suspicious activity detection and reporting?
- Does your firm collect identifying information and verify the identity of all individuals and entities that would be considered customers under the CIP Rule, and beneficial owners of legal entity customers under the Customer Due Diligence (CDD) Rule?
- **If your firm uses automated surveillance systems for suspicious activity monitoring, does 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, how does your firm coordinate with your clearing firm, including with respect to the filing of Suspicious Activity Reports (SARs)?

- **Has your firm established and implemented appropriate procedures to: communicate cyber events to its AML department, Compliance department or both; fulfill regulatory obligations, such as the filing of SARs; and inform reviews of potentially impacted customer accounts?**
- **Has your firm reviewed FinCEN's first government-wide priorities for AML and countering the financing of terrorism (AML/CFT) policy ("AML/CFT Priorities"), and considered how the AML/CFT Priorities will be incorporated into its risk-based AML program?**

Emerging Low-Priced Securities Risk

FINRA has observed an increase in several types of activity in low-priced securities that could be indicative of fraud schemes—including an increase in such activity through foreign financial institutions (FFIs) that open omnibus accounts at U.S. broker-dealers. Recent trends indicate that FFIs may be "nesting"[2] within omnibus accounts of financial institutions based in jurisdictions that are generally considered to be lower risk, such as Canada or the United Kingdom.

To assist member firms in detecting and preventing these schemes—as well as mitigating the harm they cause to investors and the market—FINRA is sharing some of the signs of potentially illicit trading activity in low-priced securities that it has recently observed, which include:

- trading that coincides with a sudden increase in share price or trading volume, in the absence of legitimate news surrounding the company;
- investors depositing large blocks of shares of low-priced securities originating from convertible debt acquired from the issuer or a third party, immediately selling the shares and then transferring the proceeds out of the account;
- transactions in securities of issuers making questionable claims regarding their products or services related to a recent, major event (*e.g.,* the COVID-19 pandemic) or a new trend (*e.g.,* cryptocurrency or non-fungible tokens (NFTs)) or both; and
- increased trading that overlaps with a surge in relevant promotional activity on social media, investor chat rooms and message boards.

Firms can find additional resources concerning potential warning signs of fraudulent activity:

- FINRA's Investor Alerts and Investor Insights webpages
- *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)
- SEC's Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities
- SEC's Risk Alert on Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers

Exam Findings and Effective Practices

Exam Findings:

- **Inadequate Ongoing Monitoring and Reporting of Suspicious Transactions – Failing to establish and implement an AML program reasonably expected to detect and report suspicious activity in compliance with FINRA Rule 3310(a) by, for example:**
  - **not using AML reports or systems that accurately and reasonably capture potentially suspicious activity, and are free of data integrity issues;**
  - **not conducting and accurately documenting AML surveillance reviews;**
  - **not implementing appropriate risk-based procedures to understand the nature and purpose of customer relationships in order to develop a customer risk profile;**
  - **not implementing procedures that are reasonably designed to investigate inquiries from clearing firms that concern "red flags" of potentially suspicious activity;**
  - **not tailoring AML programs to risks presented by products, customers, business lines and transactions (*e.g.,* cash management products, low-priced securities trading) and wire and ACH transfers; and**
  - **not notifying AML departments of events that involve suspicious transactions (*e.g.,* cybersecurity events, account compromises or takeovers, new account fraud, fraudulent wires and ACH transfers).**
- **Inadequate AML Independent Tests – Failing to comply with FINRA Rule 3310(c) by conducting AML tests that fail to review key aspects of the AML program, are not performed within the required timeframe, are not completed by persons with the requisite independence or are not completed at all.**
- **Insufficient Compliance With Certain Requirements of the BSA – Failing to establish a risk-based CIP to verify the identity of each customer in compliance with FINRA Rule 3310(b), failing to verify the identity of the beneficial owners of legal entity customers in compliance with FINRA Rule 3310(f) or failing to conduct due diligence on correspondent accounts of foreign financial institutions in compliance with FINRA Rule 3310(b).**

Update on Initial Public Offerings (IPOs) of China-Based Issuers

FINRA has observed that some firms are underwriting IPOs and subsequent trading of issuers based in the People's Republic of China (China-based issuers), raising concerns that the investors in the IPOs may be serving as nominees for an undisclosed control person or persons. These IPOs are typically smaller in size (*i.e.,* less than $100 million) and listed on the lower qualification tiers of U.S. stock exchanges.

FINRA has observed red flags of potentially manipulative trading associated with how these investors open new accounts and trade these securities after the IPO is completed, including:

- numerous unrelated accounts being opened at the same time, including with similar banking information, physical addresses, email address domains and current employer (which is often associated with the IPO issuer);
- documents investors provide in order to open an account or verify source of funds that may have been altered or could be fictitious;
- wire transfers received into these accounts that exceed the financial wherewithal of the investor as indicated on their new account documents, exceed the value of the shares purchased in the IPO and are either sent from similar banks, or bank accounts that share certain identifying information (*e.g.,* employer of account holder, email domain);
- investor accounts being accessed by a different Internet Protocol (IP) or Media Access Control (MAC) address[3] than is known for the customer, granting log in and trading capabilities to a third party or both;
- multiple orders with substantial similar terms being placed at or around the same time by seemingly unrelated investors in the same security that is indicative of "spoofing" or "layering"; and
- investors engaging in trading activity that does not make economic sense.

Given the potential risks, firms underwriting these IPOs and whose customers trade in these securities after the IPO should carefully evaluate whether they have controls in place necessary to identify and report market manipulation, other abusive trading practices and potential AML concerns. Firms can find additional information regarding the risks associated with China-based issuers in recent statements from the SEC:

- Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited
- Disclosure Considerations for China-Based Issuers
- [Chairman Gensler's] Statement on Investor Protection Related to Recent Developments in China

Effective Practices:

- **Risk Assessments** – Conducting an initial, formal written risk assessment and updating it based on the results of AML tests, audits and changes in size or risk profile of the firm (*e.g.,* business lines, products and services, registered representatives and customers).
- **Verifying Customers' Identities When Establishing Online Accounts – In meeting their CIP obligations, validating identifying information or documents provided by applicants (*e.g.,* Social Security number (SSN), address, driver's license), including, for example, through "likeness checks"; asking follow-up questions or requesting additional documents based on information from credit bureaus and credit reporting agencies, or digital identity intelligence (*e.g.,* automobile and home purchases); contracting third-party vendors to provide additional support (*e.g.,* databases to help verify the legitimacy of suspicious information in customers' applications); limiting automated approval of multiple accounts**

by a single customer; reviewing account applications for repetition or commonalities amongst multiple applications; and using technology to detect indicators of automated scripted attacks.[4]

- **Delegation and Communication of AML Responsibilities – When AML programs rely on other business units to escalate red flags of suspicious activity, establishing clearly delineated written escalation procedures and recurring cross-department communication with AML and compliance staff.**
- **Training – In meeting their obligations to provide ongoing AML training for appropriate personnel under FINRA Rule 3310(e), establishing and maintaining AML training programs that are tailored for the respective roles and responsibilities of the AML department, as well as departments that regularly work with AML; that address regulatory and industry developments impacting AML risk or regulatory requirements; and that, where applicable, leverage trends and findings from quality assurance controls.**
- Detection and Mitigation of Wire and ACH Fraud – In meeting their obligations to conduct ongoing monitoring to identify and report suspicious transactions under FINRA Rule 3310(f), monitoring outbound money movement requests post-ACH setup and restricting fund transfers in certain situations (*e.g.,* identity theft is detected in an investor's account).[5]

Additional Resources

- SEC
  - **Risk Alert: Compliance Issues Related to Suspicious Activity Monitoring and Reporting**
  - **Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities**
- FinCEN
  - **Advisory on Cybercrime and Cyber-Enabled Crime Exploiting the Coronavirus Disease 2019 (COVID-19) Pandemic**
  - **Advisory on Cyber-Events and Cyber-Enabled Crime**
  - **Advisory on Ransomware and the Use of the Financial System to Facilitate Ransom Payments**
  - **Anti-Money Laundering and Countering the Financing of Terrorism National Priorities**
  - **Frequently Asked Questions (FAQs) regarding the Reporting of Cyber-Events, Cyber-Enabled Crime, and Cyber-Related Information through Suspicious Activity Reports (SARs)**
- FINRA
  - Anti-Money Laundering (AML) Topic Page, which includes:
    - Anti-Money Laundering (AML) Template for Small Firms
    - ***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* 21-03 (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)

FinCEN National AML/CFT Priorities

As noted in *Regulatory Notice* *21-36*, on June 30, 2021, FinCEN issued the AML/CFT Priorities, which identify and describe the most significant AML/CFT threats currently facing the United States (*e.g.,* cybercrime, domestic and international terrorist financing, securities and investment fraud).

The publication of the AML/CFT Priorities does not create an immediate change in BSA requirements or supervisory expectations for member firms, and FINRA is not currently examining for the incorporation of the AML/CFT Priorities into member firms' AML programs. Nevertheless, in preparation for any new requirements when the final regulations are effective, broker-dealers may wish to start considering how they will incorporate the AML/CFT Priorities into their risk-based AML programs.

Cybersecurity and Technology Governance

Regulatory Obligations and Related Considerations

Regulatory Obligations:

Rule 30 of the SEC's Regulation S-P requires firms to have written policies and procedures that are reasonably designed to safeguard customer records and information. FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information) also applies to denials of service and other interruptions to members' operations. In addition to 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 reasonably designed cybersecurity programs and controls that are consistent with their risk profile, business model and scale of operations.

Technology-related problems, such as problems in firms' change- and problem-management practices or issues related to an increase in trading volumes, can expose firms to operational failures that may compromise firms' ability to comply with a range of rules and regulations, including FINRA Rules 4370, 3110 (Supervision) and 4511 (General Requirements), as well as Securities Exchange Act of 1934 (Exchange Act) Rules 17a-3 and 17a-4.

Related Considerations:

Cybersecurity

- **What is the firm's process for continuously assessing cybersecurity and technology risk?**
- What kind of governance processes has your firm developed to identify and respond to cybersecurity risks?
- What is the scope of your firm's Data Loss Prevention program, including encryption controls and scanning of outbound emails to identify sensitive information?
- How does your firm identify and address branch-specific cybersecurity risks?
- What kind of training does your firm conduct on cybersecurity, including phishing?
- What process does your firm have to evaluate your firm's vendors' cybersecurity controls?
- **What types of penetration ("PEN") testing, if any, does your firm do to test web-facing systems that allow access to customer information or trading?**
- **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 are your firm's procedures to communicate cyber events to AML or compliance staff related to meeting regulatory obligations, such as the filing of SARs and informing reviews of potentially impacted customer accounts?**

Cybercrime

- FINRA continues to observe fraudsters and other bad actors engaging in cybercrime that increases both fraud risk (*e.g.,* synthetic identity theft, customer account takeovers, illegal transfers of funds, phishing campaigns, imposter websites) and money laundering risk (*e.g.,* laundering illicit proceeds through the financial system).
- Events involving, or enabled by, cybercrime are expected to be reported via SARs. FINRA has also published *Regulatory Notice* 21-18 (FINRA Shares Practices Firms Use to Protect Customers From Online Account Takeover Attempts), which discusses cybersecurity practices firms may find effective in mitigating risks related to ATOs and funds transfers.

Technology Governance

- What controls does your firm implement 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 document system change requests and approvals?
- What type of testing does your firm perform prior to system or application changes being moved into a production environment and post-implementation?
- What are your firm's procedures for tracking information technology problems and their remediation? Does your firm categorize problems based on their business impact?

Exam Findings and Effective Practices

Exam Findings:

- **Inadequate Risk Assessment Process – Not having an adequate and ongoing process to assess cyber and IT risks at the firm, including, for example, failing to test implemented controls or conducting PEN testing regularly.**
- **Data Loss Prevention Programs – Not encrypting all confidential data, including a broad range of non-public customer information in addition to Social Security numbers (such as other account profile information) and sensitive firm information.**
- **Branch Policies, Controls and Inspections** – Not maintaining branch-level written cybersecurity policies; inventories of branch-level data, software and hardware assets; and branch-level inspection and automated monitoring programs.
- **Training** – Not providing ongoing comprehensive training to registered representatives, other firm personnel, third-party providers and consultants on cybersecurity risks relevant to individuals' roles and responsibilities (*e.g.,* phishing).
- **Vendor Controls** – Not implementing and documenting formal policies and procedures to review prospective and existing vendors' cybersecurity controls and managing the lifecycle of firms' engagement with all vendors (*i.e.,* from onboarding, to ongoing monitoring, through off-boarding, including defining how vendors will dispose of non-public client information).

Emerging Vendor Risk

Due to the recent increase in the number and sophistication of cyberattacks during the COVID-19 pandemic, FINRA reminds firms of their obligations to oversee, monitor and supervise cybersecurity programs and controls provided by third-party vendors.

Firms can find guidance in this area in *Regulatory Notice 21-29* (FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors) and the Cybersecurity and Infrastructure Security Agency's (CISA) Risk Considerations for Managed Service Provider Customers.

- **Access Management** – Not implementing access controls, including developing a "policy of least privilege" to grant system and data access only when required and removing it when no longer needed; not limiting and tracking individuals with administrator access; and not implementing multi-factor authentication (MFA) for registered representatives, employees, vendors and contractors.
- **Inadequate Change Management Supervision** – Insufficient supervisory oversight for application and technology changes (including upgrades, modifications to or integration of firm or vendor systems), which lead to violations of other regulatory obligations, such as those relating to data integrity, cybersecurity, books and records, and confirmations.
- **Limited Testing and System Capacity** – Order management system, online account access and trading algorithm malfunctions due to a lack of testing for changes or system capacity issues.

Effective Practices:

- **Insider Threat and Risk Management** – Collaborating across technology, risk, compliance, fraud and internal investigations/conduct departments to assess key risk areas, monitor access and entitlements, and investigate potential violations of firm rules or policies regarding data access or data accumulation.
- **Incident Response Planning** – Establishing and regularly testing (often using tabletop exercises) a written formal incident response plan that outlines procedures for responding to cybersecurity and information security incidents; and developing frameworks to identify, classify, prioritize, track and close cybersecurity-related incidents.
- **System Patching** – Implementing timely application of system security patches to critical firm resources (*e.g.,* servers, network routers, desktops, laptops, mobile phones, software systems) to protect non-public client or firm information.
- **Asset Inventory** – Creating and keeping current an inventory of critical information technology assets—including hardware, software and data—as well as corresponding cybersecurity controls.
- **Change Management Processes** – Implementing change management procedures to document, review, prioritize, test, approve, and manage internal and third-party hardware and software changes, as well as system capacity, in order to protect non-public information and firm services.
- **Online System Capacity – Continuously monitor and test the capacity of current systems, and track average and peak utilization, to anticipate the need for additional resources based on increases in accounts or trading volumes, as well as changes in systems.**
- **Customer Account Access – Requiring customers to use MFA to access their online accounts.**

Additional Resources

FINRA's Cybersecurity Topic Page, including:

- ***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)**
- *Information Notice* *03/26/20* (Measures to Consider as Firms Respond to the Coronavirus Pandemic (COVID-19))
- *Regulatory Notice* *20-13* (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic)
- Report on Selected Cybersecurity Practices – 2018
- Report on Cybersecurity Practices – 2015
- Small Firm Cybersecurity Checklist
- Core Cybersecurity Controls for Small Firms
- Firm Checklist for Compromised Accounts
- Customer Information Protection Topic Page
- Cross-Market Options Supervision: Potential Intrusions Report Card
- Non-FINRA Cybersecurity Resources

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 representatives to notify their firms in writing of proposed outside business activities (OBAs), and all associated persons to notify their firms in writing of proposed private securities transactions (PSTs), so firms can determine whether to limit or allow those activities. A 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 notification or pre-approval is required to engage in an 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 they will interfere with or otherwise compromise the registered person's responsibilities to the firm and the firm's customers, be viewed by customers or the public as part of the member's business or both? 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 representative's Form U4 with activities that meet the disclosure requirements of that form?
- Does your firm take into account the unique regulatory considerations and characteristics of digital assets when reviewing digital asset 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, including digital asset PSTs, and document its compliance with the supervisory obligations?

Exam Findings and Effective Practices

Exam Findings:

- **Incorrect Interpretation of Compensation** – Interpreting "compensation" too narrowly (by focusing on only direct compensation, such as salary or commissions, rather than evaluating all direct and indirect financial benefits from PSTs, such as membership interests, receipt of preferred securities and tax benefits); and as a result, erroneously determining that certain activities were not PSTs.
- **Inadequate Consideration of Need to Supervise** – Approving participation in proposed transactions without adequately considering whether the firms need to supervise the transaction as if it were executed on their own behalf.
- **No Documentation** – Not retaining the documentation necessary to demonstrate the firm's compliance with the supervisory obligations for PSTs and not recording the transactions on the firm's books and records because certain PSTs were not consistent with the firm's electronic systems (such as where securities businesses conducted by a registered representative 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 notify their firms in writing of OBAs or 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 limitations placed on OBAs or PSTs, such as prohibiting registered representatives from soliciting firm clients to participate in an OBA or PST.
- **No Review and Recordkeeping of Digital Asset Activities** – Failing to conduct the required assessment of OBAs that involve digital assets or incorrectly assuming all digital assets are not securities and therefore, not evaluating digital asset activities, including activities performed through affiliates, to determine whether they are more appropriately treated as PSTs; and for certain digital asset or other activities that were deemed to be PSTs for compensation, not supervising such activities or recording such transactions on the firm's books and records.

Effective Practices:

- **Questionnaires** – Requiring registered representatives 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 (including asking questions relating to 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 or other payments they receive from any entities other than the member firm, including affiliates).

- **Due Diligence** – Conducting due diligence to learn about all OBAs and PSTs at the time of a registered representative's initial disclosure to the firm and periodically thereafter, including interviewing the registered representative 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 raising capital or directing securities transactions with investment advisers or fund companies in order to identify potential PSTs.** ★
- **Monitoring** – Monitoring significant changes in, or other red flags relating to, registered representatives' 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; and
  - financial records (including bank statements and tax returns).
- **Affiliate Activities** – Considering whether registered representatives' 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 subject to disclosure/approval or not, 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 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.
- **Digital Asset Checklists** – Creating checklists with a list of considerations to confirm whether digital asset activities would be considered OBAs or PSTs (including reviewing private placement memoranda or other materials and analyzing the underlying products and investment vehicle structures).

Additional Resources

- *Regulatory Notice 21-25* (FINRA Continues to Encourage Firms to Notify FINRA if They Engage in Activities Related to Digital Assets)
- *Regulatory Notice 18-08* (FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions)
- *Notice to Members 96-33* (NASD Clarifies Rules Governing RRs/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, as well as FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) and the FINRA 4510 Rule Series (Books and Records Requirements) (collectively, Books and Records Rules) require a firm to, among other things, create and preserve, in an easily accessible place, originals of all communications received and sent relating to its "business as such."[6]

Additionally, firms must file a Financial Notification when selecting or changing an archival service provider, and are reminded to document the review of correspondence and confirm that individuals are not conducting supervisory reviews of their own correspondence. ★

Related Considerations:

- What kind of vendors, such as cloud service providers (Cloud Vendors), does your firm use to comply with Books and Records Rules requirements, including storing required records on electronic storage media (ESM)? How does it confirm compliance with the Books and Records Rules, ESM Standards and ESM Notification Requirements?
- Has your firm reviewed its Books and Records Rules policies and procedures to confirm they address all vendors, including Cloud Vendors?
- **If your firm emails its clients and customers links to Virtual Data Rooms (VDRs)—online data repositories that secure and distribute confidential information—does the firm retain and store documents embedded in those links once the VDRs are closed?**

Exam Findings and Effective Practices

Exam Findings:

- **Misinterpreted Obligations** – Not performing due diligence to verify vendors' ability to comply with Books and Records Rules requirements if they use that vendor; or not confirming that service contracts and agreements comply with ESM Notification Requirements because firms did not understand that all required records must comply with the Books and Records Rules, including records stored using Cloud Vendors' storage services.
- **No ESM Notification** – Not complying with the ESM Notification Requirements, including obtaining the third-party attestation letters required by Exchange Act Rule 17a-4(f)(3)(vii).

Effective Practices:

- **Contract Review** – Reviewing vendors' contracts and agreements to assess whether firms will be able to comply with the Books and Records Rules, ESM Standards and ESM Notification Requirements.
- **Testing and Verification** – Testing all vendors'—including Cloud 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 Books and Records Rules, ESM Standards and ESM Notification Requirements (and in some cases engaging the consultant to provide the third-party attestation).
- **Attestation Verification** – Confirming with vendors, including Cloud Vendors, whether the vendors will provide the third-party attestation.

Additional Resources

- Frequently Asked Questions about the 2001 Amendments to Broker-Dealer Books and Records Rules Under the Securities Exchange Act of 1934
- Books and Records Requirements Checklist
- Books and Records Topic Page

Direct Mutual Fund Business Risk

FINRA observed that some firms did not adequately supervise their direct mutual fund business (*i.e.,* selling mutual fund shares via "check and app" that are held directly by the mutual fund companies) because, for example, they were:

- maintaining blotters that did not include sufficient information to adequately supervise direct mutual fund transactions (*e.g.,* not all transactions are captured or key information is missing, such as customer name, fund symbol and share class);
- miscoding new mutual fund transactions as reinvestments or recurring contributions, which prevented them from going through firms' surveillance and supervision systems; and
- relying on *ad hoc* supervisory reviews by an insufficient number of designated principals.

As a result of these arrangements, many firms were unaware of, or had inadequate information about, direct mutual fund transactions that their registered representatives recommended or processed, and were not able to supervise them adequately. In some cases, this inability to supervise direct mutual fund business effectively resulted in firms not being able to identify inappropriate sales charge discounts, unsuitable share class recommendations and short-term mutual fund switching.

As part of their obligations under FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2110 (Recommendations), 3110 (Supervision) and Reg BI, firms must supervise all activity of their registered representatives related to direct mutual fund transactions. Additionally, Exchange Act Rules 17a-3 and 17a-4 require firms to maintain and keep current purchase and sale blotters that contain relevant information for all direct mutual fund transactions, including redemptions. When evaluating your firm's supervision of its direct mutual fund business, consider these questions:

- What portion of your firm's mutual fund business is application-based directly with mutual fund companies (in terms of dollar volume and number of accounts)?
- How do your firm's policies and procedures address supervision of your firm's direct mutual fund business? What processes (*e.g.,* regularly reviewing exception reports) does your firm use to review direct mutual fund transactions for compliance with applicable FINRA rules and securities regulations? Are such policies and procedures reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules?
- What information does your firm gather from mutual fund companies or clearing entities (*e.g.,* National Securities Clearing Corporation, Depository Trust and Clearing Corporation) to support its ability to adequately supervise its direct mutual fund business?

For additional guidance, please refer to *Regulatory Notice 21-07* (FINRA Provides Guidance on Common Sales Charge Discounts and Waivers for Investment Company Products).

Regulatory Events Reporting

Regulatory Obligations and Related Considerations

Regulatory Obligations:

FINRA Rule 4530 (Reporting Requirements) requires firms to promptly report to FINRA, and associated persons to promptly report to firms, specified events, including, for example, violations of securities laws and FINRA rules, certain written customer complaints and certain disciplinary actions taken by the firm. Firms must also report quarterly to FINRA statistical and summary information regarding certain written customer complaints.

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 that associated persons reported to your firm's compliance department?
- How does your firm determine the problem and product codes it uses for its statistical reporting of written customer complaints to FINRA?

Exam Findings and Effective Practices

Exam Findings:

- **No Reporting to the Firm** – Associated persons not reporting written customer complaints, judgments concerning securities, commodities- or financial-related 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.
- **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:

- **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 have received any written customer complaints).
- **Email Surveillance** – Conducting email surveillance 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 civil litigation and other reportable events.

Additional Resources

- *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)
- FINRA's Rule 4530 Reporting Requirements
- FINRA's Rule 4530 Reporting Codes
- FINRA Report Center – 4530 Disclosure Timeliness Report Card

Firm Short Positions and Fails-to-Receive in Municipal Securities NEW FOR 2022

Regulatory Obligations and Related Considerations

Regulatory Obligations:

As detailed in *Regulatory Notice* *15-27*, customers may receive taxable, substitute interest instead of the tax-exempt interest they were expecting when a firm effects sales to customers of municipal securities that are not under the firm's possession or control.[7] This can occur when firm trading activity inadvertently results in a short position or a firm fails to receive municipal securities it purchases to fulfill a customer's order.

Firms must develop and implement adequate controls and procedures for detecting, resolving and preventing these adverse tax consequences to customers. Such procedures must include closing out fails-to-receive within the time frame prescribed within Municipal Securities Rulemaking Board (MSRB) Rule G-12(h) and confirming that their communications with customers regarding the tax status of paid or accrued interest for municipal securities are neither false nor misleading, in accordance with MSRB Rule G-17.

Related Considerations:

- Does your firm use exception reports to manage its municipal securities' short positions or fails-to-receive? If so, how does your firm use such reports, and which departments are responsible for managing them?
- When municipal securities short positions are identified, does your firm begin to cover the shorts, or do they wait until the trades have settled?
- What is your firm's process to close out fails-to-receive in accordance with the methods and time frame prescribed under MSRB G-12(h)?
- How does your firm detect instances that would require them to pay customers substitute interest? In those circumstances, what is the firm's process for notifying impacted customers and paying them substitute interest in a timely manner? If a customer does not want to receive substitute interest, what alternatives does the firm offer (*e.g.,* offering to cancel the transaction and purchasing a comparable security that would provide tax-exempt interest)?
- How does your firm handle inbound or outbound account transfers sent through the Automated Customer Account Transfer Service (ACAT) that are delivered with no corresponding municipal bonds in possession or control?

Exam Findings and Effective Practices

Exam Findings:

- **Inadequate Controls and Procedures** – Not maintaining adequate procedures and controls for preventing, identifying and resolving adverse consequences to customers when a firm does not maintain possession or control of municipal securities that a customer owns.
- **Inadequate Lottery Systems** – Opting to use a random lottery system to allocate municipal short positions to certain customer accounts, but the system did not fairly or adequately account for or allocate substitute accrued interest payments.

Effective Practices:

- **Preventative Controls** – Maintaining processes to prevent or timely remediate municipal positions from settling short (*e.g.,* covering these positions, finding a suitable alternative, cancelling the customer's purchase).
- **Operational and Supervisory Reports** – Developing operational and supervisory reports to identify customer long positions for which the firm has not taken possession and control of the security.
- **Review of Fail Reports** – Municipal securities principals performing regular, periodic reviews of Fail Reports to comply with the close-out requirements of MSRB Rule G12-(h).

Additional Resource

- *Regulatory Notice 15-27* (Guidance Relating to Firm Short Positions and Fails-to-Receive in Municipal Securities)

Trusted Contact Persons NEW FOR 2022

Regulatory Obligations and Related Considerations

Regulatory Obligations:

FINRA Rule 4512(a)(1)(F) (Customer Account Information) requires 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 firms and their associated persons are authorized to contact the TCP and disclose information about the customer account.

Related Considerations:

- Has your firm established an adequate supervisory system, including WSPs, related to seeking to obtain and using the names and contact information for TCPs?
- Does your firm educate registered representatives about the importance of collecting and using trusted contact information, where possible?

Exam Findings and Effective Practices

Exam 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 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 new non-institutional account is opened or when the firm updates an existing account's information (in accordance with FINRA Rule 4512(b))).

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; and (3) fraud perpetrated on the customer.
- **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.
- **Senior Investor Specialists** – Establishing specialized groups or appointing individuals to handle situations involving elder abuse or diminished capacity; contact 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

- SEC's, NAASA's and FINRA's Investor Resources for Establishing a Trusted Contact
- FINRA's Frequently Asked Questions Regarding FINRA Rules Relating to Financial Exploitation of Senior Investors
- *Regulatory Notice 20-34* (Proposed Amendments to FINRA Rule 2165 and Retrospective Rule Review Report)

Emerging Customer Account Information Risks

Effective February 15, 2021, 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 firm and receiving approval. The rule requires the 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.

Registered persons face potential conflicts of interest when they are named a customer's beneficiary, executor or trustee, or hold a power of attorney for their customer. These conflicts of interest can take many forms and can include a registered person benefiting from the use of undue and inappropriate influence over important financial decisions to the detriment of a customer.

When assessing your firm's compliance with Rule 3241, consider these questions:

- Do your firm's policies and procedures establish criteria for determining whether to approve a registered person assuming either status or acting in either capacity?
- Does your firm perform a reasonable assessment of the risks created by a registered person being named a customer's beneficiary or holding a position of trust for a customer?
- If your member firm imposes conditions or limitations on its approval, does it reasonably supervise the registered person's compliance with the corresponding conditions or limitations?
- Does your firm have WSPs, and deliver training, reasonably designed to make registered persons aware of the obligations under the rule and the firm's related procedures?

Funding Portals and Crowdfunding Offerings NEW FOR 2022

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 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-dealers contemplating engaging in the sale of securities in reliance on the crowdfunding exemptions must notify FINRA in accordance with FINRA Rule 4518 (Notification to FINRA in Connection with the JOBS Act).

Related Considerations:

- What steps is your firm taking to confirm all required issuer information, pursuant to Regulation Crowdfunding Rules 201 and 203(a), is publicly available on your firm's platform?
- Does your firm plan to undergo or has it already undergone an operational or structural change that impacts the capitalization of the firm, pursuant to Funding Portal Rule 110(a)(4)? Has your firm reviewed the membership rules to confirm a Continuing Membership Application (CMA) is not required?

Exam Findings and Effective Practices

Exam Findings:

- **Failure to Obtain Attestation** – Not obtaining the attestation 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 held by these individuals 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 FINRA Funding Portal Rule 300(c).
- **Untimely Required 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).

Effective Practices:

- **Compliance Resources** – Developing annual compliance questionnaires to verify the accuracy of associated persons' disclosures, including follow-up questions (such as whether they have ever filed for bankruptcy, have any pending lawsuits, are subject to an 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 tailored to funding portal 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 Resource

- FINRA's Funding Portals Topic Page

Communications and Sales

Reg BI and Form CRS

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.**

In addition, whether or not they make recommendations, firms that offer services to retail investors must provide them with a Form CRS, a brief relationship summary that discloses material information in plain language (*e.g.,* investment services provided, fees, conflicts of interest, legal and disciplinary history of the firms and financial professionals).

Reg BI and Form CRS became effective on June 30, 2020, and 2021 marked the first full calendar year during which FINRA examined firms' implementation of related obligations. The findings presented here are thus an initial look at firms' practices. FINRA will share further findings as we continue to conduct exams and gather additional information on firms' practices.

Related Considerations:

- **When your firm determines whether it is obligated to comply with Reg BI, does your firm consider the following key definitions in the context of the rule?**
  - **"Retail customer" is defined as "a natural person, or the legal representative of such natural person, who:**
    - **receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and**
    - **uses the recommendation primarily for personal, family, or household purposes."**
  - **A retail customer "uses" a recommendation of a securities transaction or investment strategy involving securities when, as a result of the recommendation[8]:**
    - **the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation;**
    - **the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation[9]; or**
    - **the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.**
- **Do your firm and your associated persons adhere to the Care Obligation of Reg BI when making recommendations by:**
  - **exercising reasonable diligence, care and skill to understand the potential risks, rewards and costs associated with a recommendation and having a reasonable basis to believe, based on that understanding, that the recommendation is in the best interest of at least some retail investors;**

- **considering those risks, rewards and costs in light of the retail customer's investment profile and having a reasonable basis to believe that a recommendation is in that particular customer's best interest and does not place the broker-dealer's interest ahead of the customer's interest; and**
- **having a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile?**

- **Do your firm and your associated persons consider costs and reasonably available alternatives when making recommendations to retail customers?**
- **Are your firm's policies and procedures reasonably designed to identify and disclose or eliminate conflicts, as well as to mitigate conflicts that create an incentive for an associated person of the firm to place his or her interests or the interest of the firm ahead of the retail customer's interest?**
- **How does your firm test its policies and procedures to determine if they are adequate and performing as expected?**
- Does your firm place any material limitations on the securities or investment strategies involving securities that may be recommended to a retail customer? If so, does your firm identify and disclose such limitations and prevent those limitations from causing the firm or its associated persons to make recommendations that place the firm's or associated person's interests ahead of the retail customer's interest?
- **Are your firm's policies and procedures reasonably designed to identify and eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time, or mitigate conflicts for those not required to be eliminated?**
- **Do your firm's disclosures include a full and fair disclosure of all material facts relating to the scope and terms of the firm's relationship with retail customers (*e.g.,* material fees and costs associated with transactions or accounts, material limitations involving securities recommendations) and all material facts relating to conflicts of interest that are associated with the recommendation?**
- **What controls does your firm have to assess whether disclosures are provided timely, and if provided electronically, in compliance with the SEC's electronic delivery guidance?**
- **Do your firm's policies and procedures address Reg BI, including new obligations that did not exist prior to Reg BI?**
- **Do your firm's policies and procedures: (1) identify specific individual(s) who are responsible for supervising compliance with Reg BI; (2) specify the supervisory steps and reviews appropriate supervisor(s) should take and their frequency; and (3) note how supervisory reviews should be documented?**
- If your firm is not dually registered as an investment adviser, commodity trading advisor, municipal advisor or advisor to a special entity, do the firm or any of its associated persons who are not dually registered use "adviser" or "advisor" in their name or title?
- **Does the firm provide dually-registered associated persons with adequate guidance on how to determine and disclose the capacity in which they are acting?**
- Has your firm provided adequate Reg BI training to its associated persons, including supervisory staff?
- **If your firm offers services to retail investors:**
  - **does it deliver Form CRS to each new or prospective customer who is a retail investor before the earliest of: (i) a recommendation of an account type, securities transaction or investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) opening a brokerage account for the investor?**

- **for existing retail investor customers, does the firm deliver Form CRS before or at the time the firm: (i) opens a new account that is different from the retail customer's existing account; (ii) recommends that the retail customer roll over assets from a retirement account; or (iii) recommends or provides a new service or investment outside of a formal account (*e.g.,* variable annuities or a first-time purchase of a direct-sold mutual fund through a ''check and application'' process)?**
- **does it file a relationship summary with the SEC through the Central Registration Depository (CRD), if the firm is registered as a broker-dealer; through the Investment Adviser Registration Depository (IARD), if the firm is registered as an investment adviser; or both CRD and IARD, if the firm is a dual-registrant?**
- **does your firm have processes in place to update and file the amended Form CRS within 30 days whenever any information becomes materially inaccurate and to communicate, without charge, any changes in the updated relationship summary to retail investors who are existing customers within 60 days after the updates are required to be made (a total of 90 days to communicate the changes to customers after the information becomes materially inaccurate)?**

Exam Findings and Effective Practices

Exam Findings:

Reg BI and Form CRS

- **WSPs That Are Not Reasonably Designed To Achieve Compliance with Reg BI and Form CRS –**
  - **Providing insufficiently precise guidance by:**
    - **not identifying the specific individuals responsible for supervising compliance with Reg BI; and**
    - **stating the rule requirements, but failing to detail how the firm will comply with those requirements (*i.e.,* stating "what" but failing to address "how").**
  - **Failing to modify existing policies and procedures to reflect Reg BI's requirements by:**
    - **not addressing how costs and reasonably available alternatives should be considered when making recommendations;**
    - **not addressing recommendations of account types;**
    - **not addressing conflicts that create an incentive for associated persons to place their interest ahead of those of their customers; and**
    - **not including provisions to address Reg BI-related recordkeeping obligations and the testing of the firms' Reg BI and Form CRS policies, procedures and controls.**
  - **Failing to develop adequate controls or developing adequate controls but not memorializing these processes in their WSPs.**
- **Inadequate Staff Training – Failing to adequately prepare associated persons to comply with the requirements of Reg BI beyond previous suitability obligations or Form CRS by:**
  - **failing to deliver initial training before the June 30, 2020, compliance date;**
  - **delivering training without making clear Reg BI's new obligations; or**
  - **delivering training that focused on Reg BI and Form CRS requirements in general, without addressing the specific steps associated persons should take to comply with these requirements.**

- **Failure to Comply With Care Obligation –**
  - **Making recommendations that were not in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation.**
  - **Recommending a series of transactions that were excessive in light of a retail customer's investment profile and placing the broker-dealer's or associated person's interest ahead of those of retail customers.**
- **Failure to Comply with Conflict of Interest Obligation – Not identifying conflicts or, if identified, not adequately addressing those conflicts.**
- **Improper Use of the Terms "Advisor" or "Adviser" – Associated persons, firms or both, using the terms "advisor" or "adviser" in their titles or firm names, even though they lack the appropriate registration.[10]**
- **Insufficient Reg BI Disclosures – Not providing retail customers with "full and fair" disclosures of all material facts related to the scope and terms of their relationship with these 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 rollover qualified accounts);**
  - **potential conflicts of interest (*e.g.,* associated persons trading in the same securities in their personal account(s) or outside employment); and**
  - **material limitations in securities offerings.**

Form CRS

- **Deficient Form CRS Filings – Firms' Form CRS filings significantly departing from the Form CRS instructions or guidance from the SEC's FAQ on Form CRS by:**
  - **exceeding prescribed page lengths;**
  - **omitting material facts (*e.g.,* description of services offered; limitations of the firm's investment services);**
  - **inaccurately representing their financial professionals' disciplinary histories;**
  - **failing to describe types of compensation and compensation-related conflicts;**
  - **incorrectly stating that the firm does not provide recommendations;**
  - **changing or excluding language required by Form CRS; and**
  - **not resembling a relationship summary, as required by Form CRS.[11]**
- **Form CRS Not Posted Properly on Website – 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).**
- **Inadequate Form CRS Amendments – Firms not in compliance with Form CRS in relation to material changes because they:**
  - **failed to re-file in CRD in a timely manner (*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 investor customers (*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 Form CRS –**
  - **Incorrectly determining that filing Form CRS hinges solely on making recommendations, rather than offering services to a retail investor.**
  - **Incorrectly claiming 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.,* investment company products held directly by an issuer, self-directed accounts)**

Effective Practices:

- **Identifying and Mitigating Conflicts of Interest – Identifying, disclosing, and eliminating or mitigating conflicts of interest across business lines, compensation arrangements, relationships or agreements with affiliates, and activities of their associated persons by:**
  - **establishing and implementing policies and procedures to identify and address conflicts of interest, such as through the use of 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;**
  - **sampling recommended transactions to evaluate how costs and reasonably available alternatives were considered;**
  - **providing resources to associated persons making recommendations that account for reasonably available alternatives with comparable performance, risk and return that may be available at a lower cost, such as:**
    - **worksheets, in paper or electronic form, to compare costs and reasonably available alternatives; or**
    - **guidance on relevant factors to consider when evaluating reasonably available alternatives to a recommended product (*e.g.,* similar investment types from the issuer; less complex or risky products available at the firm);**
  - **updating client relationship management (CRM) tools that automatically compare recommended products to reasonably available alternatives;**
  - **revising commission schedules within product types to flatten the percentage rate; and**
  - **broadly prohibiting all sales contests.**

- **Limiting High-Risk or Complex 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;**
  - **limiting high-risk or complex product, transaction or strategy recommendations to specific customer types; and**
  - **applying heightened supervision to recommendations of high-risk or complex products.**

- **Implementing Systems Enhancements for Tracking Delivery of Required Customer Documents – Tracking and delivering Form CRS and Reg BI-related documents to retail investors and retail customers in a timely manner by:**
  - **automating tracking mechanisms to determine who received Form CRS and other relevant disclosures; and**
  - **memorializing delivery of required disclosures at the earliest triggering event.**
- **Implementing New Surveillance Processes – Monitoring associated persons' compliance with Reg BI by:**
  - **conducting monthly reviews to confirm that their recommendations meet Care Obligation requirements, including system-driven alerts or trend criteria to identify:**
    - **account type or rollover recommendations that may be inconsistent with a customer's best 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; and**
  - **incorporating Reg BI-specific reviews into the branch exam program as part of overall Reg BI compliance efforts, focusing on areas such as documenting Reg BI compliance and following the firms' Reg BI protocols.**

Additional Resources

- FINRA's SEC Regulation Best Interest Key Topics Page
- SEC's Regulation Best Interest Guidance Page
- SEC's Staff Statement Regarding Form CRS Disclosure
- 2021 FINRA Annual Conference: Regulation Best Interest and Form CRS: Recent Observations and What to Expect Panel
- 2021 Small Firm Virtual Conference: Regulation Best Interest and Form CRS Panel
- You may submit a question by email to IABDQuestions@sec.gov. Additionally, you may contact the SEC's Division of Trading and Markets' Office of Chief Counsel at (202) 551-5777.

Areas of Concern Regarding SPACs

Over the past year, FINRA's review of firms participating in SPAC offerings has focused on the following.

Due Diligence – When firms and associated persons act as underwriter, qualified independent underwriter or syndicate member for a SPAC offering, the due diligence conducted at the IPO and merger stages, including as to the relevant officers, directors and control persons of the SPAC and SPAC-sponsor(s) and pre-identified acquisition targets.

Reg BI – Written policies and procedures or guidance on recommendations to retail customers, and supervisory systems designed to identify and address conflicts of interest presented by the involvement of the firm, their associated persons or both.

Disclosure – Firms' supervision of associated persons who hold positions with, advise or personally invest in SPACs or SPAC sponsors, and whether the associated persons are disclosing their involvement if required by FINRA rules governing OBAs, PSTs and Form U4 amendments.

Net Capital – In firm-commitment underwritings, whether firms are correctly taking net capital charges relative to the size of their commitment or using a written agreement with another syndicate member (*i.e.,* "backstop provider").

WSPs and Supervisory Controls – whether firms are maintaining and regularly updating their WSPs and supervisory controls to address risks related to SPACs (*e.g.,* Reg BI, due diligence, information barrier policies, conflicts of interest).

In October 2021, FINRA initiated a targeted review to explore the above areas and other issues relating to SPACs. Additional review areas include training; the use of qualified independent underwriters; underwriting compensation; services provided to SPACs, their sponsors or affiliated entities; and potential merger targets. It is anticipated that, at a future date, FINRA will share with member firms its findings from this review.

Communications with the Public

Regulatory Obligations and Related Considerations

Regulatory Obligations:

FINRA Rule 2210 (Communications with the Public) defines all communications into 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 retail communications with FINRA's Advertising Regulation Department during their first year of membership.** ★

FINRA Rule 2220 (Options Communications) governs members' 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 Standards –**
  - Do your firm's communications contain false, misleading 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 investment benefits from a securities 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 –**
  - **Has your firm established and implemented a comprehensive 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 readily understandable, based on the experience level of your customers?**
  - **Do your mobile apps provide investors with readily available information to explain complex strategies and investments and associated risks?**
  - **If your firm offers an app to retail customers, does the information provided to customers 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?**
- **Digital Communication Channels –**
  - Does your firm's digital communication policy address all permitted and prohibited digital communication channels and features available to your customers and associated persons?
  - Does your firm review for red flags that may indicate a registered representative is communicating through unapproved communication channels, and does your firm follow up on such red flags? For example, red flags might include email chains that copy unapproved representative email addresses, references in emails to communications that occurred outside approved firm channels or customer complaints mentioning such communications.
  - How does your firm supervise and maintain books and records in accordance with SEC and FINRA Books and Records Rules for all approved digital communications?
  - Does your firm have a process to confirm that all business-related communications comply with the content standards set forth in FINRA Rule 2210?
- **Digital Asset Communications** – If your firm or an affiliate engages in digital asset activities:
  - does your firm provide a fair and balanced presentation in marketing materials and retail communications, including addressing risks presented by digital asset investments and not misrepresenting the extent to which digital assets are regulated by FINRA or the federal securities laws or eligible for protections thereunder, such as Securities Investor Protection Corporation (SIPC) coverage?

  - do your firm's communications misleadingly imply that digital asset services offered through an affiliated entity are offered through and under the supervision, clearance and custody of a registered broker-dealer?

- **Cash Management Accounts Communications** – If your firm offers Cash Management Accounts, does it:
  - clearly communicate the terms of the Cash Management Accounts?
  - disclose that the Cash Management Accounts' deposits are obligations of the destination bank and not cash balances held by your firm?
  - assure that its communications do not state or imply that:
    - brokerage accounts are similar to or the same as bank "checking and savings accounts" or other accounts insured by the Federal Deposit Insurance Corporation (FDIC); and
    - FDIC insurance coverage applies to funds when held at a registered broker-dealer?
  - review whether communications fairly explain the:
    - nature and structure of the program;
    - relationship of the brokerage accounts to any partner banks in the Cash Management Accounts;
    - amount of time it may take for customer funds to reach the bank accounts; and
    - benefits and risks of participating in such programs?
- **Municipal Securities Communications – If your firm offers municipal securities, does it confirm that advertisements for such securities include the necessary information to be fair, balanced and not misleading, and do not include:**
  - **exaggerated claims about safety or misleading comparisons to US Treasury Securities;**
  - **statements claiming "direct access" to bonds in the primary market if the firm is not an underwriter; and**
  - **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 advertises a "taxable equivalent" yield on a municipal security offering, does it provide sufficient information regarding the tax bracket used to make the calculation?**

Exam Findings and Effective Practices

Exam Findings:

- **False, Misleading and Inaccurate Information in Mobile Apps –**
  - **Incorrect or misleading account balances or inaccurate information regarding accounts' historical performance.**
  - **Sending margin call warnings to customers whose account balances were not approaching, or were below, minimum maintenance requirements.**
  - **Falsely informing customers that their accounts were not enabled to trade on margin, when the accounts were, in fact, margin enabled.**
  - **Misstating the risk of loss associated with certain options transactions.**
  - **Distributing false and misleading promotions through social media and "push" notifications on mobile apps that made promissory claims or omitted material information.**

- **Deficient Communications Promoting Digital Assets –**
  - **Falsely identifying the broker-dealer as the entity from whom digital assets may be purchased or creating confusion about which entity is offering digital assets by using identical or substantially similar names to the broker dealer's name.**
- **Misrepresentations in Cash Management Account Communications –**
  - **Misleading statements or claims that either state or imply the broker-dealer is a bank.**
  - Misleading or false claims that state or imply the Cash Management Accounts are "checking and savings accounts."
  - Inaccurate or misleading statements concerning the amount of FDIC insurance coverage provided to investor funds when they are held at a partner bank.
  - Incomplete or inaccurate claims concerning the amount of time it may take for customer funds to reach the bank accounts or be available to investors once deposited at a partner bank.
  - Inaccurate or misleading claims about the actual terms of the Cash Management Accounts.
  - **Failure to balance promotional claims with the risks of participating in such programs.**
- **Insufficient Supervision and Recordkeeping for Digital Communications** – Not maintaining policies and procedures to reasonably identify and respond to red flags—such as customer complaints, representatives' email, OBA reviews or advertising reviews—that registered representatives used business-related digital communications methods not controlled by the firm, including texting, messaging, social media, collaboration apps or "electronic sales seminars" in chatrooms.
- **No WSPs and Controls for Communication That Use Non-Member or OBA Names (so-called "Doing Business As" or "DBA" Names) –**
  - Not maintaining WSPs to identify the broker-dealer clearly and prominently as the entity through which securities were offered in firm communications, such as websites, social media posts, seminars or emails that promote or discuss the broker-dealer's securities business and identify a non-member entity, such as a representative's OBA.
  - Not including a "readily apparent reference" and hyperlink to FINRA's BrokerCheck in such communications.
- **Municipal Securities Advertisements – Using 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.**

Effective Practices:

- **Comprehensive Procedures for Mobile Apps – Maintaining and implementing comprehensive 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.**
- **Comprehensive Procedures for Digital Communications** – Maintaining and implementing procedures for supervision of digital communication channels, including:
  - **Monitoring of New Tools and Features** – Monitoring new communication channels, apps and features available to their associated persons and customers.

  - **Defining and Enforcing What is Permissible and Prohibited** – Clearly defining permissible and prohibited digital communication channels and blocking prohibited channels, tools or features, including those 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.
  - **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.

- **Digital Asset Communications** – Maintaining and implementing procedures for firm digital asset communications, including:
  - **Risk Disclosure** – Prominently describing the risks associated with digital assets that are needed to balance any statements or claims contained in a digital asset communication, including that such investments are speculative, involve a high degree of risk, are generally illiquid, may have no value, have limited regulatory certainty, are subject to potential market manipulation risks and may expose investors to loss of principal.
  - **Communication Review** – Reviewing firms' communications to confirm that they were not exaggerating the potential benefits of digital assets or overstating the current or future status of digital asset projects or **platforms.**
  - **Communication to Differentiate Digital Assets From Broker-Dealer Products** – Identifying, segregating and differentiating firms' broker-dealer products and services from those offered by affiliates or third parties, including digital asset affiliates; and clearly and prominently identifying entities responsible for non-securities digital 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).

- **Reviews of Firms' Capabilities for Cash Management Accounts** – Requiring new product groups or departments to conduct an additional review for proposed Cash Management Accounts to confirm that the firms' existing business processes, supervisory systems and compliance programs—especially those relating to communications—can support such programs.
- **Use of Non-Member or OBA Names (so-called DBAs)** – Maintaining and implementing procedures for OBA names, including:
  - **Prior Approval** – Prohibiting the use of OBA communications that concern the broker-dealer's securities business without prior approval by compliance and creating a centralized system for the review and approval of such communications, including content and disclosures.
  - **Training** – Providing training on relevant FINRA rules and firm policies and requiring annual attestations to demonstrate compliance with such requirements.
  - **Templates** – Requiring use of firm-approved vendors to create content or standardized templates populated with approved content and disclosures for all OBA communications (including websites, social media, digital content or other communications) that also concern the broker-dealer's securities business.
  - **Notification and Monitoring** – Requiring registered representatives to notify compliance of any changes to approved communications and conducting periodic, at least annual, monitoring and review of previously approved communications for changes and updates.

- **Municipal Securities Advertisements – Maintaining and implementing procedures for firm municipal securities communications, including:**
  - **Prior Approval – Requiring prior approval of all advertisements concerning municipal securities by an appropriately qualified principal to confirm the content complies with applicable content standards.**
  - **Training – Providing education and training for firm personnel on applicable FINRA and MSRB rules and firm policies.**
  - **Risk Disclosure – 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.**
  - **Review – Reviewing firms' communications to confirm that the potential benefits of tax features are accurate and not exaggerated.**

Additional Resources

- *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)
- Advertising Regulation Topic Page
- FINRA's Social Media Topic Page
- ***MSRB Notice 2019-07***
- ***MSRB Notice 2018-18***

Private Placements

Regulatory Obligations and Related Considerations

Regulatory Obligations:

In *Regulatory Notice 10-22* (Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings), FINRA noted that members that recommend private offerings have obligations under FINRA Rule 2111 (Suitability) and FINRA Rule 3110 (Supervision) to conduct reasonable diligence by evaluating "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, it no longer applies to recommendations to retail customers. Instead, the SEC's Reg BI applies to recommendations to retail customers of any securities transaction or investment strategy involving securities, including recommendations of private offerings.**

Additionally, firms must make timely filings for specified private placement offerings with FINRA's Corporate Financing Department under FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities), and should also be aware of recent amendments to these rules.[12] ★

Related Considerations:

- 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 diligence prior to recommending private placement offerings, including conducting further inquiry into red flags?
- How does your firm address red flags regarding conflicts of interest identified during the reasonable diligence process and in third-party due diligence reports?
- How does your firm manage the transmission of funds and amended terms in contingency offerings, including ensuring compliance with Securities Exchange Act Rules 10b-9 and 15c2-4, as applicable?

Exam Findings and Effective Practices

Exam Findings:

- **Late Filings** – Not having 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 closing date).
- **No Reasonable Diligence** – Failing to perform reasonable diligence of private placement offerings prior to recommending them to retail investors, including:
  - **failing to conduct an appropriate level of research, particularly when the firm lacks experience or specialized knowledge pertaining to an issuer's underlying business or when an issuer lacks an operating history;**
  - **relying unreasonably on the firm's experience with the same issuer in previous offerings;** and
  - failing to inquire into and analyze red flags identified during the reasonable-diligence process or in third-party due diligence reports.

Effective Practices:

- **Private Placement Checklist** – Creating checklists with—or adding to existing due diligence checklists—all steps, filing dates and related documentation requirements, noting staff responsible for performing functions and tasks and evidence of supervisory principal approval for the reasonable diligence process and the filing requirements of FINRA Rules 5122 and 5123.
- **Independent Research** – Conducting and documenting independent research on material aspects of the offering; 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).
- **Independent Verification** – Verifying information that is key to the performance of the offering (such as unrealistic costs projected to execute the business plan, coupled with aggressively projected timing and overall rate of return for investors), in some cases with support from law firms, experts and other third-party vendors.

- **Identifying Conflicts of Interest** – Using firms' reasonable diligence processes to identify conflicts of interest (*e.g.*, firm affiliates or 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 more appropriate investments).
- **Responsibility for Reasonable Diligence and Compliance** – Assigning responsibility for private placement reasonable diligence 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.
- **Alert System** – Creating a system that alerts responsible individual(s) and supervisory principal(s) about upcoming and missed filing deadlines.
- **Post-Closing Assessment** – Conducting reviews after the offering closes to ascertain whether offering proceeds were used in a manner consistent with the offering memorandum.

Additional Resources

- ***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* (Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings)
- Report Center – Corporate Financing Report Cards
- FAQs about Private Placements
- Corporate Financing Private Placement Filing System User Guide
- Private Placements Topic Page

Conservation Donation Transactions Risks

FINRA is seeing continued syndications of Conservation Donation Transactions (CDTs) investment programs among broker-dealers. CDTs commonly involve private placement offerings where investor returns are based on a share of tax savings from a charitable donation. In practice, CDTs involve unrelated investors acquiring an interest in a passthrough entity (*i.e.,* a partnership or limited liability company) owning unimproved land. Before year-end, the passthrough entity either grants a conservation easement—which forever limits future development of the land—or outright donates the land to a land trust. In exchange, the passthrough entity receives charitable donation tax deductions, which serve as a return on investment to investors and often have values based solely on land appraisals that are predicated on an alternative plan to develop the land, oftentimes the equivalent of four to more than 10 times the price paid to acquire the land. (Common CDTs involve syndicated conservation easement transactions (SCETs) or substantially similar, fee simple donations of land.)

Firms that engage in CDTs should consider the following questions to determine whether they meet regulatory obligations:

- Do the CDT sponsor, appraiser or other related service providers have any prior, adverse audit history?
- Do your firm's offering disclosures present potential conflicts of interest among sponsors, consultants, land developers, prior landowners, broker-dealers, and registered persons having employment or affiliated relationships?
- In compliance with Reg BI, does your firm:
  - consider reasonably available alternatives to any recommendation of CDTs (*i.e.,* the Care Obligation);
  - have policies and procedures to identify and—at a minimum—disclose or eliminate all conflicts of interest associated with the recommendation (*i.e.,* the Conflicts of Interest Obligation); and
  - have policies and procedures to identify and mitigate any conflicts of interest associated with recommendations of CDTs that create an incentive for an associated person to place the interest of the firm or the associated person ahead of the retail customer's interest?
- In compliance with SEA Rule 15c2-4, does your firm promptly transmit funds to either an escrow agent or a separate bank account (as CDTs are typically associated with contingent offerings)?
- How does your firm establish and document reasonable diligence of CDTs, including further inquiries in the presence of red flags (*e.g.,* CDTs resulting in donation deductions that are more than two-and-one-half times an investor's investment, concerns surfaced in third-party due diligence reports, large markups associated with land acquisition, certain types of fees to related parties, marketing communications promoting CDTs solely on their tax benefits)?

For additional guidance, please refer to these resources:

- FINRA, 2018 Report on Examination Findings – Reasonable Diligence for Private Placements (Dec. 7, 2018)
- United States Senate, Report on Syndicated Conservation-Easement Transactions
- Internal Revenue Service, IRS increases enforcement action on Syndicated Conservation Easements (Nov. 12, 2019)
- Internal Revenue Service, IRS concludes "Dirty Dozen" list of tax scams for 2019: Agency encourages taxpayers to remain vigilant year-round (Mar. 20, 2019)
- Land Trust Alliance, Important Advisory: Tax Shelter Abuse of Conservation Donations (Feb. 1, 2018)
- Internal Revenue Service, Notice 2017-10, Listing Notice – Syndicated Conservation Easement Transactions

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 recommending a purchase or exchange of a deferred variable annuity to a retail customer, Reg BI's obligations, discussed above, also would apply.

In addition, Rule 2330 requires firms to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule. 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 (*i.e.,* 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 (including general product information, share class, riders and exchange-based activity) and engage with affiliate and non-affiliate insurance carriers to address inconsistencies in available data, data formats and reporting processes for variable annuities?
- How do your firm's WSPs support a determination that 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, or a death or living benefit)? What processes, forms, documents and information do the firm's registered principals rely on to make such determinations?
- **What is your firm's process to supervise registered representatives who advise their clients' decisions whether or not to accept a buyout offer?**

Exam Findings and Effective Practices

Exam 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 objectives and time horizon and resulted in, among other consequences, increased fees to the customer or the loss of material, paid-for accrued benefits.
- **Insufficient Training** – Not conducting training for registered representatives and supervisors regarding how to assess costs and fees, surrender charges and long-term income riders to determine whether exchanges were suitable for customers.
- **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.,* associated persons' recommendations that investors surrender the contract in order to generate an exchange or new purchase) for compliance with FINRA Rule 2230 and Reg BI.

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.
- **Rationales** – Requiring registered representatives to provide detailed written rationales for variable annuity exchanges for each customer (including confirming that such rationales address the specific circumstances for each customer and do not replicate rationales provided for other customers); and requiring supervisory principals to verify the information provided by registered representatives, including product fees, costs, rider benefits and existing product values.
- **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.,* DTCC and consolidated account report providers) to address inconsistencies in available data, data formats and reporting processes for variable annuities.
- **Data Acquisition – Establishing a supervisory system that collects and utilizes key transaction data, including, but not limited to:**
  - **transaction date;**
  - **rep 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 an 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;**
  - **living benefit value, death benefit value or both, that was forfeited;**
  - **surrender charges incurred; and**
  - **any additional benefits surrendered with forfeiture.**

Additional Resources

- SEC
  - Regulation Best Interest, Form CRS and Related Interpretations
- FINRA
  - Regulation Best Interest (Reg BI) Topic Page
  - *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)
  - Variable Annuities Topic Page

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 firms should consider when developing and implementing their CAT Rules compliance program.

Related Considerations:

- Do your firm's CAT Rules WSPs: (1) identify the individual, by name or title, responsible for the review of CAT reporting; (2) describe specifically what type of review(s) will be conducted of the data posted on the CAT Reporter Portal; (3) specify how often the review(s) will be conducted; and (4) describe how the review(s) will be evidenced?
- How does your firm confirm that the data your firm reports, or 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, who is responsible for clock synchronization, how your firm evidences that clocks have been synchronized and how your firm will self-report clock synchronization violations?
- Does your firm conduct daily reviews of the Industry Member CAT Reporter Portal (CAT Reporter Portal) to review file status to confirm the file(s) sent by the member or by their reporting agent was accepted by CAT and to identify and address any file submission or integrity errors?
- Does your firm conduct periodic comparative reviews of accepted CAT data against order and trade records and the CAT Reporting Technical Specifications?
- Does your firm communicate regularly with your CAT reporting agent, review relevant CAT guidance and announcements and report CAT reporting issues to the FINRA CAT Help Desk?
- **Does your firm maintain the required CAT order information as part of its books and records and in compliance with FINRA Rule 6890 (Recordkeeping)?**
- **How does your firm work with its clearing firm and third-party vendors to maintain CAT compliance?**

Exam Findings and Effective Practices

Exam Findings:

- **Inaccurate Reporting of CAT Orders – Submitting information that was incorrect, incomplete or both to the Central Repository, such as:**
  - **account holder type;**
  - **buy/sell side;**
  - **cancel quantity;**
  - **route event quantity (*e.g.,* reporting an old quantity that had been modified to a different amount);**

- **trading session code;**
- **new order code;**
- **department type code (*e.g.,* reporting "A" for agent, when the firm does not execute orders);**
- **time in force;**
- **handling instructions (*e.g.,* reporting new order events as Stop on Quote (SOQ) or Stop Limit on Quote (SLQ)); and**
- **representative indicator (*i.e.,* reporting the representative indicator to reflect a representative order when the order in a firm account was not created for the purpose of working one or more customer or client orders).**

- **Late Resolution of Repairable CAT Errors – Not resolving repairable CAT errors in a timely manner (*i.e.,* within the T+3 requirement).**
- **Inadequate Vendor Supervision – Not establishing and maintaining WSPs or supervisory controls regarding both CAT reporting and clock synchronization that are performed by third-party vendors.**

Effective Practices:

- **Supervision – Implementing a comparative review of CAT submissions versus firm order records; and utilizing CAT Report Cards and CAT FAQs to design an effective supervision process.**
- **Clock Synchronization Related to Third Parties – Obtaining adequate information from third parties to meet applicable clock synchronization requirements.[13]**

Additional Resources

- CAT NMS Plan
- FINRA
  - Consolidated Audit Trail (CAT) Topic Page
  - Equity Report Cards
  - *Regulatory Notice* *20-31* (FINRA Reminds Firms of Their Supervisory Responsibilities Relating to CAT)
  - *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)

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. Where a firm may choose to not conduct an order-by-order review—to the extent consistent with Rule 5310 and associated guidance—it must have procedures in place to confirm it periodically conducts "regular and rigorous" reviews of the execution quality of its customers' orders.

Best execution obligations apply to any member firm that receives customer orders—for purposes of handling and execution—including firms that receive orders directly from customers, as well as those that receive customer orders from other firms for handling and execution, such as wholesale market makers.[14] These obligations also apply when a firm acts as agent for the account of its customer and executes transactions as principal. Any firm subject to FINRA Rule 5310 cannot transfer its duty of best execution to another person; additionally, any firm that routes all of its customer orders to another firm without conducting an independent review of execution quality would violate its duty of best execution.

Related Considerations:

- How does your firm determine whether to employ order-by-order or "regular and rigorous" reviews of execution quality?
- If applicable, how does your firm implement and conduct an adequate "regular and rigorous" review of the quality of the executions of its customers' orders and orders from a customer of another broker-dealer?
- If applicable, how does your firm document its "regular and rigorous" reviews, the data and other information considered, order routing decisions and the rationale used, and address any deficiencies?
- **How does your firm compare the execution quality received under its existing order routing and execution arrangements (including the internalization of order flow) to the quality of the executions it could obtain from competing markets (whether or not the firm already has routing arrangements with them), including off-exchange trading venues?**
- **How does your firm address potential conflicts of interest in order routing decisions, including those involving:**
  - **affiliated entities (*e.g.,* affiliated broker-dealers, affiliated alternative trading systems (ATSs));**
  - **market centers, including off-exchange trading venues, that provide payment for order flow (PFOF) or other order-routing inducements; and**
  - **orders from customers of another broker-dealer for which your firm provides PFOF?**
- **If your firm provides PFOF to another broker-dealer, how does your firm prevent those payments from interfering with your firm's best execution obligations (including situations where you provide PFOF and execute the covered orders)?**
- 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?
- How does your firm meet its best execution obligations with respect to trading conducted in both regular and extended trading hours?
- Does your firm consider the risk of information leakage affecting pricing when assessing the execution quality of orders routed to a particular venue?
- 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?

Exam Findings and Effective Practices

Exam 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.

- **No Review of Certain Order Types** – Not conducting adequate reviews on a type-of-order basis, including, for example, on market, marketable limit, or non-marketable limit orders.
- **No Evaluation of Required Factors** – Not considering certain factors set forth in Rule 5310 when conducting a "regular and rigorous review," including, among other things, speed of execution, price improvement and the likelihood of execution of limit orders; and using routing logic that was not necessarily based on quality of execution.
- **Conflicts of Interest** – Not considering and addressing potential conflicts of interest relating to routing 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.

Targeted Reviews of Wholesale Market Makers

FINRA is conducting targeted best execution reviews of wholesale market makers concerning their relationships with broker-dealers that route orders to them as well as their own order routing practices and decisions (with respect to these orders). These targeted reviews are evaluating:

- whether wholesale market makers are conducting adequate execution quality reviews;
- whether order routing, handling and execution arrangements (including PFOF agreements) with retail broker-dealers have an impact on the wholesale marker makers' order handling practices and decisions, and fulfillment of their best execution obligations; and
- any modified order handling procedures that the wholesale market makers implemented during volatile or extreme market conditions.

Effective Practices:

- **Exception Reports** – Using exception reports and surveillance reports to support firms' efforts to meet their best execution obligations.
- **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.
- **Continuous Updates** – Updating WSPs and best execution analysis to address market and technology changes.

Additional Resources

- ***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)
- FINRA Report Center
- Equity Report Cards
- Best Execution Outside-of-the-Inside Report Card

Disclosure of Routing Information NEW FOR 2022

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.

Related Considerations:

- Does the 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 the firm is not required to publish a quarterly report under Rule 606(a), does the firm have an effective supervisory process to periodically confirm that the firm has no orders subject to quarterly reporting?
- If the firm routes orders to non-exchange venues, does the firm adequately assess whether such venues are covered under Rule 606(a)?
- If the firm routes orders to non-exchange venues, does the firm obtain and retain sufficient information from such venues to properly report the material terms of its relationships with such venues, including specific quantitative and qualitative information regarding PFOF and any profit-sharing relationship?
- If the firm claims an exemption from providing not held order reports under Rule 606(b)(3) pursuant to Rule 606(b)(4) or (5), what policies and procedures does the firm have in place to determine if the firm's or a customer's order activity falls below the relevant *de minimis* thresholds?
- If the firm is required to provide customer-specific disclosures under Rule 606(b)(3), does the firm provide accurate, properly formatted disclosures for the prior six months to requesting customers within seven business days of receiving the request?

Exam Findings and Effective Practices

Exam Findings:

- **Inaccurate Quarterly Reports** – Publishing inaccurate information in the quarterly report on order routing, such as:
  - reporting only held orders in listed options, instead of both held and not held orders;
  - incorrectly stating that the firm does not have a profit-sharing arrangement or 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);
  - inaccurately identifying reported execution venues as "Unknown";
  - inaccurately identifying firms as execution venues (*e.g.,* identifying routing broker-dealer as execution venue, rather than the exchange where transactions are actually executed);

- incorrectly listing an entity as an execution venue when that entity does not execute trades (*e.g.,* firm that 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.
- **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).[15]
- **Insufficient WSPs** – Either not establishing or not maintaining adequate WSPs reasonably designed to achieve compliance with the new requirements of Rule 606, including:
  - not updating their Disclosure of Order Routing Information WSPs to include new requirements detailed in amended Rule 606(a)(1) or new Rule 606(b)(3);
  - not describing the steps taken to review whether firms verified the data integrity of information sent to, or received from, their vendor—or not stating how the review would be evidenced by the reviewer;
  - not articulating a supervisory method of review to verify the accuracy, format, completeness, timely processing and details of the new Rule 606(b)(3) report, if requested, as well as documenting the performance of that review; and
  - not requiring the inclusion of detailed information regarding the routing and execution of the firm's customers' listed options orders in quarterly reports or customer-requested order routing disclosures.

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 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, holding periodic meetings with vendors to review 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

- SEC's 2018 Amendments to Rule 606 of Regulation NMS
- SEC's Responses to Frequently Asked Questions Concerning Rule 606 of Regulation NMS
- SEC's Staff Legal Bulletin No. 13A: Frequently Asked Questions About Rule 11Ac1-6
- SEC's Order Routing and Handling Data Technical Specification

Market Access Rule

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, exchange-traded funds (ETFs), debt securities, security-based swaps, security futures products, as well as digital assets that meet the SEC'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 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, 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?**

Exam Findings and Effective Practices

Exam Findings:

- **Insufficient Controls** – No pre-trade order limits, pre-set capital thresholds and duplicative and erroneous order controls for accessing ATSs, including those that transact fixed income transactions; not demonstrating the reasonability of assigned capital and credit pre-trade financial control thresholds; inadequate 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.
- **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 (some firms were not sure what their thresholds were and had no means to monitor their usage during the trading day).

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.
- **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 (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.
- **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 Financial Controls** – Periodically testing their market access controls, which forms the basis for an annual CEO certification attesting to firms' controls.

Additional Resources

- *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)
- FINRA's Algorithmic Trading Topic Page
- FINRA's Market Access Topic Page
- **SEC's Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access**

Financial Management

Net Capital

Regulatory Obligations and Related Considerations

Regulatory Obligations:

Exchange Act Rule 15c3-1 (Net Capital Rule) requires that 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 firms to notify FINRA in the event their net capital falls below the minimum amount required by the Net Capital Rule.

If firms have an affiliate 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[16]; 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, firms must align its revenue recognition practices with the requirements of the Financial Accounting Standards Board's Topic 606 (Revenue from Contracts with Customers). ★

Related Considerations:

- How does your firm review its net capital treatment of assets to confirm that they are correctly classified for net capital purposes?
- How does your firm confirm that it has correctly identified and aged all failed to deliver contracts, properly calculated the applicable net capital charges and correctly applied the deductions to 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 the firm or an affiliate?

Exam Findings and Effective Practices

Exam Findings:

- **Inaccurate Classification of Receivables, Liabilities and Revenue** – Incorrectly classifying receivables, liabilities and revenues, which resulted in inaccurate reporting of firms' financial positions and in some instances, a capital deficiency; incorrectly classifying non-allowable assets, such as large investments in certificates of deposit (CDs) because firms did not have a process to assess the net capital treatment of CDs pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(E); and not reviewing account agreements for CDs to determine whether they contained stipulations restricting withdrawals prior to maturity, including stipulations giving the bank discretion to permit or prohibit their withdrawal.
- **Failed to Deliver and Failed to Receive Contracts (Fails)** – Not having a process to correctly identify, track and age intra-month and end-of-the-month Fails for firms operating an Exchange Act Rule 15a-6 chaperoning business, including:
  - **Inaccurate Net Capital Charge** – Failing to compute and apply the correct applicable net capital charge for aged Fails;
  - **No Information from Clearing Firm** – Failing to request or confirm receipt of timely information relating to Fails from their clearing firms;
  - **Gaps in Policies and Procedures** – Failing to address monitoring, reporting and aging of Fails in firms' policies and procedures;
  - **Incorrect Balance Sheets and FOCUS Reports** – Failing to record Fails on firms' balance sheets, and as a result, filing incorrect FOCUS reports; and
  - **No Blotters** – Failing to maintain blotters for Fails.

- **Incorrect Capital Charges for Underwriting Commitments** – Not maintaining an adequate process to assess moment-to-moment and open contractual commitment capital charges on underwriting commitments, and not understanding their role as it pertained to the underwriting (*i.e.,* best efforts or firm commitment).
- **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 and expenses as of the date that revenue is earned or expenses are incurred); and making ledger entries as infrequently as once per month, as a result of which firms did not have adequate context to determine the proper accrual-based transaction date.
- **Insufficient Documentation Regarding Expense-Sharing Agreements** – Not delineating a method of allocation for payment; not allocating (fixed or variable) expenses proportionate to the benefit to the broker-dealer; or not maintaining sufficient documentation to substantiate firms' methodologies for allocating specific broker-dealer costs—such as technology fees, marketing charges, retirement account administrative fees and employees' compensation—to broker-dealers or affiliates.

Effective Practices:

- **Net Capital Assessment** – Performing an assessment of net capital treatment of assets, including CDs, to confirm that they were correctly classified for net capital purposes.
- **Agreement Review** – Obtaining from and verifying with banks the withdrawal terms of any assets, with particular focus on CD products, and reviewing all of the agreement terms, focusing on whether withdrawal restrictions may affect an asset's classification and its net capital charge for the terms of all assets, including CDs, and reviewing all of the agreement terms, focusing on whether withdrawal restrictions may affect an asset's classification and its net capital charge.
- **Training and Guidance** – Developing guidance and training for Financial and Operational Principal and other relevant staff on Net Capital Rule requirements for Fails, including how to report Fails on their balance sheets, track the age of Fails and if necessary, calculate any net capital deficit resulting from aged Fails.
- **Aging Review** – Performing reviews to confirm that they correctly aged Fail contract charges and correctly applied a net capital deduction, when applicable, to their net capital calculation.
- **Collaboration With Clearing Firms** – Clarifying WSPs to address clearing firms' responsibilities regarding net capital requirements, including for Fails, and introducing firms engaging their clearing firms to confirm that:
  - introducing firms were receiving a record of all Fails on a daily basis (or at least monthly);
  - clearing firms' reports included all of the required information; and
  - introducing firms were correctly interpreting the clearing firms' reports (especially distinctions between trade date and settlement date and those dates' implications for aging calculations for Fails).

Additional Resources

- **FASB**
  - **Revenue from Contracts with Customers (Topic 606)**
- FINRA
  - Funding and Liquidity Topic Page
  - **Interpretations to the SEC's Financial and Operational Rules**
  - ***Regulatory Notice* *19-08* (Guidance on FOCUS Reporting for Operating Leases)**
  - *Regulatory Notice* *15-33* (Guidance on Liquidity Risk Management Practices)
  - *Regulatory Notice* *10-57* (Funding and Liquidity Risk Management Practices)
  - *Notice to Members* *03-63* (SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers)

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 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 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). Additionally, FINRA has adopted a new filing requirement—the Supplemental Liquidity Schedule—for firms with large customer and counterparty exposures. As noted in *Regulatory Notice* 21-31 (FINRA Establishes New Supplemental Liquidity Schedule (SLS)), the new SLS is designed to improve FINRA's ability to monitor for potential adverse changes in these firms' liquidity risk.

Related Considerations:

- What departments at your firm are responsible for liquidity management?
- How often does your firm review and adjust its assumptions regarding clearing deposits in its liquidity management plan and stress test framework?
- **Does your firm's liquidity management practices include processes for:**
  - **accessing liquidity during common stress conditions—such as increases in firm and client activities—as well as "black swan" events;**
  - **determining how the funding would be used; and**
  - **using empirical data from recent stress events to increase the robustness of its stress testing?**
- Does your firm's contingency funding plan take into consideration the amount of time needed to address margin calls from both customers and counterparties? Does your firm also take into consideration the type of transactions that are impacting the firm's liquidity?
- What kind of stress tests (*e.g.,* market or idiosyncratic) does your firm conduct? Do these tests include concentration limits within securities or sectors, and incorporate holdings across accounts held at other financial institutions?

Exam Observations and Effective Practices

Exam Observations:

- **Not Modifying Business Models** – Failing to incorporate the results of firms' stress tests into their business model.
- **Establishing Inaccurate Clearing Deposit Requirements – Incorrectly basing clearing deposit requirements on information that doesn't accurately represent their business operations (*e.g.,* using the amounts listed on FOCUS reports rather than spikes in deposit requirements that may have occurred on an intra-month basis).**
- **No Liquidity Contingency Plans** – Failing to develop contingency plans for operating in a stressed environment with specific steps to address certain 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 liquidity funding would be used.

Effective Practices:

- **Liquidity Risk Management Updates** – Updating liquidity risk management practices to take into account a firm's current business activities, including:
  - establishing governance around liquidity management, determining who is responsible for monitoring the firm's liquidity position, how often they monitor that position and how frequently they meet as a group; and
  - creating a liquidity management plan that considers:
    - quality of funding sources;
    - potential mismatches in duration between liquidity sources and uses;
    - potential losses of counterparties;
    - how the firm obtains funding in a business-as-usual condition and stressed conditions;
    - assumptions based on idiosyncratic and market-wide conditions;
    - early warning indicators and escalation procedures if risk limits are neared or breached; and
    - **material changes in market value of firm inventory over a short period of time.**
- **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, and if these sources can realistically fund its uses in a stressed environment;
  - the potential impact of off-balance sheet items (*e.g.,* non-regular way settlement trades, forward contracts) on liquidity; and
  - periodic governance group review of stress tests.

Additional Resources

- ***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)
- FINRA's Funding and Liquidity Topic Page

Credit Risk Management

Regulatory Obligations and Related Considerations

Regulatory Obligations:

FINRA has consistently reminded firms of the importance of properly managing credit risk and published *Notices* that offer guidance on effective funding and liquidity risk management practices (which are available in the "Additional Resources" section below). Risk exposures can arise from clearing arrangements, prime brokerage arrangements (especially fixed income prime brokerage), "give up" arrangements and sponsored access arrangements (discussed in the Market Access Rule section).

Further, firms should maintain a control framework where they manage credit risk and identify and address 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 firm incorrectly capturing its exposure to credit risk. In particular, Exchange Act Rule 17a-3(a)(23) requires 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, maintain approval and documented processes for increases or other changes to assigned credit limits, and monitor exposure to affiliated counterparties?
- 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 capital?

Exam Observations and Effective Practices

Exam Observations:

- **No Credit Risk Management Reviews** – Not evaluating firms' risk management and control processes to confirm whether they were accurately capturing their exposure to credit risk.
- **No Credit Limit Assignments** – Not maintaining approval and documentation processes for assignment, increases or other changes to credit limits.
- **No Monitoring Exposure** – Not monitoring exposure to firms' affiliated counterparties.

Effective Practices:

- **Credit Risk Framework** – Developing comprehensive internal control frameworks to capture, measure, aggregate, manage and report credit risk, including:
  - establishing house margin requirements;
  - identifying and assessing credit exposures in real-time environments;
  - issuing margin calls and margin extensions (and resolving unmet margin calls);
  - establishing the frequency and manner of stress testing for collateral held for margin loans and secured financing transactions; and
  - having a governance process for approving new, material margin loans.
- **Credit Risk Limit Changes** – Maintaining approval and documentation processes for increases or other 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 adhere to these credit limits and what happens if these credit limits are breached; and
  - maintaining a governance structure around credit limit approvals.

- **Counterparty Exposure** – Monitored exposure to affiliated counterparties, considering their:
  - creditworthiness;
  - liquidity and net worth;
  - track record of past performance (*e.g.,* traded products, regulatory history, past arbitration and litigation); and
  - internal risk controls.

Additional Resources

- *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)
- FINRA's Funding and Liquidity Topic Page

Segregation of Assets and Customer Protection

Regulatory Obligations and Related Considerations

Regulatory Obligations:

Exchange Act Rule 15c3-3 (Customer Protection Rule) imposes requirements on firms that are designed to protect customer funds and securities. Firms are obligated to maintain custody of customer securities and safeguard customer cash by segregating these assets from the firm's proprietary business activities and promptly delivering them to their owner upon request. Firms can satisfy this requirement by either keeping customer funds and securities in their physical possession or in a good control location that allows the firm to direct their movement (*e.g.,* a clearing corporation).

Related Considerations:

- What is your firm's process to prevent, identify, research and escalate new or increased 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 the creation, cause and resolution?
- If your firm claims an exemption from the Customer Protection Rule and it is required to forward customer checks promptly to your firm's clearing firm, how does your firm implement consistent processes for check forwarding and maintain accurate blotters to demonstrate that checks were forwarded in a timely manner?
- How does your firm train staff on Customer Protection Rule requirements?
- What are your firm's processes to confirm that your firm correctly completes its reserve formula calculation and maintains the amounts that must be deposited into the special reserve bank account(s)?
- If your firm is engaging in digital asset transactions, what controls and procedures has it established to assure compliance with the Customer Protection Rule? Has the firm analyzed these controls and procedures to address potential concerns arising from acting as a custodian (*i.e.,* holding or controlling customer property)?

Exam Findings and Effective Practices

Exam Findings:

- **Inconsistent Check-Forwarding Processes** – Not implementing consistent processes for check forwarding to comply with an exemption from the Customer Protection Rule.
- **Inaccurate Reserve Formula Calculations** – Failing to correctly complete reserve formula calculations due to errors in coding because of limited training and staff turnover, challenges with spreadsheet controls, limited coordination between various internal departments and gaps in reconciliation calculations.
- **Omitted or Inaccurate Blotter Information** – Maintaining blotters with insufficient information to demonstrate that checks were forwarded in a timely manner and inaccurate information about the status of checks.

Effective Practices:

- **Confirming Control 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 coded as good control accounts on 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; and 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 Procedures** – Creating and implementing policies to address receipt of customer checks, checks written to the firm and checks written to a third party.
- **Check Forwarding Blotter Review** – Creating and reviewing firms' check received and forwarded blotters to confirm that they are up to date and include the information required to demonstrate compliance with the Customer Protection Rule exemption.

Additional Resources

- Customer Protection – Reserves and Custody of Securities (SEA Rule 15c3-3)
- U.S. Securities and Exchange Commission, Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Exchange Act Release No. 34-90788 (Dec. 23, 2020)
- U.S. Securities and Exchange Commission, No-Action Letter to FINRA re: ATS Role in the Settlement of Digital Asset Security Trades (Sept. 25, 2020)

Portfolio Margin and Intraday Trading NEW FOR 2022

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. 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 Consideration:

- Do the 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?

Exam Findings and Effective Practices

Exam Findings:

- **Inadequate Monitoring Systems** – Systems not designed to consistently identify credit risk exposure intra-day (*e.g.,* do not include defined risk parameters required to produce notifications or exceptions reports to senior management; require manual intervention to run effectively) or end of day (*e.g.,* cannot monitor transactions executed away in a timely manner).
- **Not Promptly Escalating Risk Exposures** – Staff failing to promptly identify and escalate incidents related to elevated risk exposure in portfolio margin accounts to senior management, in part due to insufficient expertise.
- **Insufficient WSPs** – Failing to maintain written supervisory procedures outlining intraday monitoring processes and controls.

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:
  - increasing house margin requirements during volatile markets in real-time;
  - 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 aggregate and single account level; 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.

Additional Resource

- FINRA's Portfolio Margin FAQ

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

Firms have used prior FINRA publications, such as Exam Findings Reports and Priorities Letters (collectively, Reports), 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 and effective practices noted in our Reports and determined whether their compliance programs have any gaps that could lead to the types of findings noted in those 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 Reports, as well as additional guidance from firms' policies and procedures, to their Firm Element and other firm training.

Endnotes

1. "Related Considerations" are intended to serve as a possible starting point in considering a firm's compliance program related to a topic. Firms should review relevant rules to understand the full scope of their obligations.
2. "Nesting" refers to FFIs indirectly gaining access to the U.S. financial system through another FFI's correspondent account at a U.S. financial institution. This practice can facilitate legitimate financial transactions, but member firms that maintain correspondent accounts with FFIs should have policies and procedures to identify and monitor for potentially illegitimate "nested" activity.
3. An IP address is a unique identifier assigned to an Internet-connected device, while a MAC is a unique identifier used to identify a specific hardware device at the network level.
4. *See Regulatory Notice 21-18* (FINRA Shares Practices Firms Use to Protect Customers From Online Account Takeover Attempts)
5. *See Regulatory Notice 20-13* (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic)
6. The SEC is proposing amendments to 17a-4 to allow for electronic records to be preserved in a manner that permits the recreation of an original record if it is altered, over-written, or erased. *See* the SEC's Proposed Rule: Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap Dealers, and Major Security-Based Swap Participants.
7. These regulatory obligations stem from Exchange Act Rule 15c3-3(d)(4) and MSRB Rules G-17 and G-27 (for firm shorts), and MSRB Rule G12-(h) (for fails-to-receive).
8. Reg BI also applies to certain recommendations that were not previously covered under suitability obligations (*e.g.,* account recommendations, implicit hold recommendations in the case of agreed-upon account monitoring).
9. When a retail customer opens or has an existing account with a broker-dealer, the retail customer has a relationship with the broker-dealer and is therefore in a position to "use" the broker-dealer's recommendation.
10. While the SEC presumes that the use of the term "adviser" or "advisor" in a name or title by an associated person of a broker-dealer who is not also a supervised person of an investment adviser is a violation of the Disclosure Obligation under Reg BI, it recognizes that usage may be appropriate under certain circumstances. *See* FINRA's Reg BI and Form CRS Checklist for examples of possible exceptions.
11. *See* the SEC's December 17, 2021 Staff Statement Regarding Form CRS Disclosures for additional observations.
12. *Regulatory Notice 21-10* summarized the recent updates to the 5122/5123 Notification Filing Form that became effective on May 22, 2021, and *Regulatory Notice 21-26* announced that, as of October 1, 2021, FINRA Rules 5122 and 5123 require member firms to file retail communications that promote or recommend a private placement offering that is subject to these rules' filing requirements with FINRA's Corporate Financing Department.
13. *See* CAT NMS Plan, FAQ R.2 for the types of information firms should obtain from third-party vendors to satisfy these requirements.
14. *See, e.g., Regulatory Notice 21-23*.
15. 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.
16. Firms are reminded that any affiliate obligated to pay firm expenses must have the independent financial means to satisfy those obligations.

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Conformed to Federal Register version

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 34-92766; IA-5833; File No. S7-10-21]

RIN 3235-AN00

Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice

AGENCY: Securities and Exchange Commission.

ACTION: Request for information and comment.

SUMMARY: The Securities and Exchange Commission (the "Commission" or the "SEC") is requesting information and public comment ("Request") on matters related to: broker-dealer and investment adviser use of "digital engagement practices" or "DEPs", including behavioral prompts, differential marketing, game-like features (commonly referred to as "gamification"), and other design elements or features designed to engage with retail investors on digital platforms (e.g., websites, portals and applications or "apps"), as well as the analytical and technological tools and methods used in connection with these digital engagement practices; and, investment adviser use of technology to develop and provide investment advice. In addition to or in place of responses to questions in this release, retail investors seeking to comment on their experiences may want to submit a short Feedback Flyer.

DATES: Comments should be received on or before October 1, 2021.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's internet comment form (https://www.sec.gov/rules/submitcomments.htm); or

- Send an email to *rule-comments@sec.gov*. Please include File No. S7-10-21 on the subject line.

Paper comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-10-21. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (*http://www.sec.gov*). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Operating conditions may limit access to the Commission's public reference room. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available. Retail investors seeking to comment on their experiences with online trading and investing platforms may want to submit a short Feedback Flyer, available at Appendix A.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this Request. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Division of Trading and Markets, Office of Chief Counsel, at (202)-551-5550 or tradingandmarkets@sec.gov; Division of Investment Management, Investment Adviser Regulation Office at (202) 551-6787 or IArules@sec.gov.

SUPPLEMENTARY INFORMATION: The Commission is requesting information and public comment on matters related to (1) broker-dealer and investment adviser use of digital engagement practices on digital platforms, as well as the analytical and technological tools and methods used in connection with such practices; and (2) investment adviser use of technology to develop and provide investment advice.

I. INTRODUCTION

A. BACKGROUND

With the advent and growth of digital platforms for investing, such as online brokerages and robo-advisers, and more recently, mobile investment apps and portals, broker-dealers and investment advisers (referred to collectively as "firms") have multiplied the opportunities for retail investors to invest and trade in securities. This increased accessibility has been one of the many factors associated with the increase of retail investor participation in U.S. securities markets in recent years.

As discussed in Section II of this Request, firms employ a variety of digital engagement practices when interacting with retail investors through digital platforms. Examples of digital engagement practices include: social networking tools; games, streaks and other contests with prizes; points, badges, and leaderboards; notifications; celebrations for trading; visual cues; ideas presented at order placement and other curated lists or features; subscriptions and membership tiers; and chatbots.

Various analytical and technological tools and methods can underpin the creation and use of these practices, such as predictive data analytics and artificial intelligence/machine learning

(“AI/ML”) models. Firms may use these tools to analyze the success of specific features and practices at influencing retail investor behavior (e.g., opening new accounts or obtaining additional services, making referrals, increasing engagement with the app, or increasing trading). Based on the results obtained from such AI/ML models and data analytics, firms may tailor the features with which different retail investor segments interact on the firms’ digital platforms, or target advertisements to specific investors based on their known behavioral profiles.

As discussed in Section III of this Request, some investment advisers also use these tools to develop and provide investment advice, including through online platforms or as part of more traditional investment advisory services. Investment advisers can use analytical tools to learn more about their clients and develop and provide investment advice based on that information. These developments may provide potential benefits and risks for investment advisers and their clients.

B. PURPOSE OF REQUEST

The Commission is issuing this Request related to the use and development of digital engagement practices by firms on their digital platforms, in order to:

1. Assist the Commission and its staff in better understanding and assessing the market practices associated with the use of DEPs by firms, including: (1) the extent to which firms use DEPs; (2) the types of DEPs most frequently used; (3) the tools and methods used to develop and implement DEPs; and (4) information pertaining to retail investor engagement with DEPs, including any data related to investor demographics, trading behaviors, and investment performance.
2. Provide a forum for market participants (including investors), and other interested parties to share their perspectives on the use of DEPs and the related tools and methods,

including potential benefits that DEPs provide to retail investors, as well as potential investor protection concerns.[1]

3. Facilitate an assessment by the Commission and its staff of existing regulations and consideration of whether regulatory action may be needed to further the Commission's mission including protecting investors and maintaining fair, orderly, and efficient markets in connection with firms' use of DEPs and related tools and methods.

In addition to addressing the questions below, the Commission encourages commenters to provide or identify any data and other information in furtherance of the purposes articulated in this Request.

II. DIGITAL ENGAGEMENT PRACTICES, RELATED TOOLS AND METHODS, AND REGULATORY CONSIDERATIONS AND POTENTIAL APPROACHES

A. DEPS

The Commission is issuing this Request, in part, to develop a better understanding of the market practices associated with firms' use of DEPs, which broadly include behavioral prompts, differential marketing, game-like features, and other design elements or features designed to engage retail investors. The Commission is aware of a variety of DEPs that may be used by firms, including the following:[2]

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1 To further enable retail investors to share their perspectives, the Commission is issuing a user-friendly "Feedback Flyer." The Commission has determined that this usage is in the public interest and will protect investors, and therefore is not subject to the requirements of the Paperwork Reduction Act of 1995. See Sections 19(e) and (f) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77s(e) and (f). Additionally, for the purpose of developing and considering any potential rules relating to this rulemaking, the agency may gather from and communicate with investors or other members from the public. See Securities Act section 19(e)(1) and (f), 15 U.S.C. 77s(e)(1) and (f).

2 Broker-dealers' and investment advisers' use of DEPs and the related tools and methods must comply with existing rules and regulations. By identifying observed practices and soliciting comment on them, the Commission is not expressing a view as to the legality or

- Social Networking Tools. Digital platforms may be linked to internet content, enabling users to access social sentiment on the platform. Some digital platforms may embed social networking tools into their platforms, or enhance existing tools to allow an investor to create an on-line persona or avatar. Certain digital platforms enable investors to copy the trades of other investors (known as "copy trading") in certain types of investments.[3]
- Games, Streaks and Other Contests with Prizes. Some digital platforms may employ games that use interactive graphics and offer prizes (e.g., slot-machine style interactive graphics, interactive wheels of fortune, or virtual "scratch-off" lottery tickets), for example, in connection with account opening. Some digital platforms may offer prizes to investors for completing certain "to-do lists" or tasks frequently within a specified time period (known as "streaks") or for other types of contests (including performance-based contests). Prizes may include free stock, cash, gaining access to additional features on the platforms, or a free trial period for a subscription to certain market data or levels of service. Tasks that may generate awards include referring others to the platform, engaging in community forums, linking a bank account, funding an account, trading, or promoting the app on social media.
- Points, Badges, and Leaderboards. Some digital platforms may use points or similar "scorekeeping" related to a specific area of activity. For example, some platforms offer "paper trading" (i.e., simulated trading) competitions that enable investors to practice

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conformity of such practices with the federal securities laws and the rules and regulations thereunder, nor with the rules of self-regulatory organizations ("SROs").

3 It is our understanding that copy trading is currently offered in certain investments, such as cryptocurrencies, in the U.S. and may be offered more broadly in other jurisdictions. Copy trading in securities may raise regulatory concerns under the U.S. federal securities laws, including potential broker-dealer and investment adviser status issues.

trading without real money. Certain platforms also offer badges as visual markers of achievement as well as leaderboards to rank individuals based on performance-based criteria developed by the firm.

- Notifications. Some digital platforms may use notifications via email, text, or other means (e.g., push notifications on mobile devices). In some cases, investors can opt-in or opt-out of notifications; in others, notifications may be set by default with no ability to opt-out. Investors may receive notifications indicating a certain stock is up or down, noting a list of stocks qualifying as top "movers" (i.e., largest percentage change in price), or reminding them that it has been a certain number of days since they last engaged in a trade. Notifications may also be used to attempt to reassure investors during periods of market volatility.
- Celebrations for Trading. Some digital platforms may have embedded animations and graphics, such as digital confetti or crowds applauding, that "celebrate" when investors enter orders to purchase stock or options.
- Visual Cues. Interface design elements may provide visual cues, including by displaying certain information more prominently than other information. In some cases, visual cues are targeted specifically to the investor. For example, some digital platforms' user interfaces shift the coloration of the entire screen between green and red based on an investor's portfolio performance. Some digital platforms present relevant news or other pieces of information to the user immediately once the portfolio turns negative.
- Ideas Presented at Order Placement and Other Curated Lists or Features. Some digital platforms may present "ideas" prior to allowing the investor to place an order. These ideas may involve curated lists or features, news headlines, etc.

- Subscriptions and Membership Tiers. Some firms may offer subscriptions or tiered memberships. Examples of additional features that may be provided include access to research reports, briefs, webcasts, and newspaper subscriptions; invitations to sports and industry events; credit line access; and an exemption or reduction of fees. In some cases, investors may be upgraded automatically based on balances and holdings reaching certain thresholds. Some firms may offer free subscription trials.
- Chatbots. Some digital platforms may offer chatbots, or computer programs that simulate live, human conversation. Chatbots may be offered to respond to investor inquiries relating to stock prices, account information, or customer service matters.

DEPs may be designed to encourage account opening, account funding, and trading, or may be designed solely to increase investor engagement with investing apps, as there may be value in the number of investors interacting with the platform, how often they visit, and how long they stay.

The use of DEPs carries both potential benefits and risks for retail investors. Simplified user interfaces and game-like features have been credited with making investment platforms more accessible to retail investors (in particular, younger retail investors),[4] and assisting in the

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4 See, e.g., Evie Liu, The Stock Market is Attracting New Investors. Here Are 3 Trends to Know., Barron's (Apr. 13, 2021), https://www.barrons.com/articles/the-stock-market-is-attracting-new-investors-here-are-3-trends-to-know-51618273799; Broadridge, Insights on the U.S. Investor (2020) ("Zero commission trades, mobile trading applications and the ability to acquire fractional shares are making it more attractive and easier for younger, lower asset investors to trade securities. This is bolstering Millennials' ability to participate more actively in equity investing."); Maggie Fitzgerald, Now Teenagers Can Trade Stocks With Fidelity's New Youth Investing Accounts, CNBC (May 18, 2021), https://www.cnbc.com/2021/05/18/now-teenagers-can-trade-stocks-with-fidelitys-new-youth-investing-accounts.html?&qsearchterm=margin%20debits ("Of the 4.1 million new accounts that Fidelity added in the first quarter of 2021, 1.6 million were opened by retail investors 35 and younger, an increase of more than 222% from a year prior."); Jennifer Sor, Young Investors Drive Increased Use of Investing Apps, Los Angeles Business Journal (Aug. 3, 2020),

development and implementation of investor education tools. Others have noted that DEPs can encourage retail investors to increase their contributions to retirement accounts and to engage in other activities that are traditionally viewed as wealth-building exercises.[5]

On the other hand, DEPs can potentially harm retail investors if they prompt them to engage in trading activities that may not be consistent with their investment goals or risk tolerance. Some have expressed concerns that DEPs encourage: (1) frequent trading;[6] (2) using trading strategies that carry additional risk (e.g., options trading and trading on margin); and (3)

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https://labusinessjournal.com/news/2020/aug/03/young-investors-drive-increased-use-investing-apps/.

5 See, e.g., Chris Carosa, Are You Ready to Play the 401(k) Game? Hint: You Already Are, Forbes (Apr. 14, 2021), https://www.forbes.com/sites/chriscarosa/2021/04/14/are-you-ready-to-play-the-401k-game-hint-you-already-are/?sh=4d6e1b8674ab; Greg Iacurci, MassMutual Turns to Video Games to Boost Retirement Savings, Investment News (July 18, 2016), https://www.investmentnews.com/massmutual-turns-to-video-games-to-boost-retirement-savings-66476.

6 Some have argued that certain compensation practices (such as payment for order flow or "PFOF," in combination with zero commissions) create incentives for firms to use DEPs to encourage frequent trading, and that these incentives may not be transparent to retail investors. See, e.g., Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part II: Hearing Before the H. Comm. on Fin. Servs., 113th Cong. (2021) (statement of Vicki L. Bogan, Associate Professor, Cornell University), https://docs.house.gov/meetings/BA/BA00/20210317/111355/HHRG-117-BA00-Wstate-BoganV-20210317.pdf. One form of PFOF is a practice wherein wholesale broker-dealers (often referred to as "principal trading firms" or "electronic market makers") offer payment to retail broker-dealers in exchange for the right to trade principally with (or "internalize") their customer order flow. See 17 CFR 10b-10(d)(8). Although PFOF is not prohibited, a broker-dealer must not allow PFOF to interfere with its efforts to obtain best execution for its customers' transactions. See Payment for Order Flow, Securities Exchange Act of 1934 ("Exchange Act") Release No. 34902 (Oct. 27, 1994) [59 FR 55006, at 55009 & n.28 (Nov. 2, 1994)]; see also Robinhood Financial, LLC, Exchange Act Release No. 90694 (Dec. 17, 2020) (settled order) (the Commission brought an enforcement action against a broker-dealer for willfully violating Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 17(a) of the Exchange Act and Rule 17a-4 thereunder, for, among other things, failing to take appropriate steps to assess whether its higher PFOF rates were adversely affecting customer execution prices).

trading in complex securities products.[7] DEPs also may employ what some researchers have called "dark patterns," described as user interface design choices that are knowingly designed to "confuse users, make it difficult for users to express their actual preferences, or manipulate users into taking certain actions."[8]

In the questions below, the Commission's request for comment pertains to all DEPs on brokerage and advisory digital platforms, including, but not limited to, those identified above.

Industry practices:

1.1 What types of DEPs do firms use (or in the future expect to use) on digital platforms and what are the intended purposes of each type of DEP used? For example, are particular DEPs designed to encourage or discourage particular investor actions or behaviors, such as opening of accounts, funding of accounts, trading, or increasing engagement with the app or platform? To what extent and how are firms using DEPs

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7 In congressional hearings related to market events in January 2021, investor protection concerns were identified relating to the use of certain types of DEPs, including advertisements targeted towards specific groups of investors on digital platforms and game-like features on mobile apps. See Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the H. Comm. on Fin. Servs., 113th Cong. (2021), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=407107; Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part II: Hearing Before the H. Comm. on Fin. Servs., 113th Cong. (2021), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=406268; Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III: Hearing Before the H. Comm. on Fin. Servs., 113th Cong. (2021), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=407748; Who Wins on Wall Street? GameStop, Robinhood, and the State of Retail Investing: Hearing Before the S. Comm. On Banking, Hous., & Urban Affairs, 113th Cong. (2021), https://www.banking.senate.gov/hearings/who-wins-on-wall-street-gamestop-robinhood-and-the-state-of-retail-investing.

8 See Jamie Luguri and Lior Jacob Strahilevitz, Shining a Light on Dark Patterns, 13 Journal of Legal Analysis 43 (2021), https://academic.oup.com/jla/article/13/1/43/6180579.

such as notifications (e.g., push notifications or text messages) or other design elements and features (e.g., design aesthetics in the user interface) as a means to alter (or nudge[9]) retail investor behavior or otherwise to encourage or discourage certain behaviors or activities? If so, what types of design elements are used and how are they used? Please explain any such specific design elements, how they intend to encourage specific retail investor behaviors, and whether and to what extent they are achieving their intended purposes.

1.2 To what extent do firms that utilize DEPs provide retail investors the ability to opt in or out of interacting with those DEPs when using the firm's digital platform? To what extent, and how, are firms tailoring or personalizing DEPs to a particular retail investor?

1.3 What types of firms use DEPs on their digital platforms, and on what types of platforms? Are these practices more prevalent among certain types of firms, or on certain types of platforms? How prevalent is the use of DEPs by broker-dealers? How prevalent is the use of DEPs by investment advisers? Which types of DEPs are most prevalent? For firms that have chosen not to use DEPs or certain DEPs, what are their reasons? Are firms that are not currently using DEPs considering adopting such features in the future?

1.4 What market forces are driving the adoption of DEPs on digital platforms and how? For example, to what extent and how is the use of DEPs influenced or driven by

9 Richard Thaler and Cass Sunstein define "nudge" as "any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives." See Richard H. Thaler and Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness 6 (Penguin Books 2009).

market practices related to compensation and revenue (e.g., "zero commission" and PFOF)? What types of compensation and revenue arrangements influence or drive market practices related to the use of DEPs? Do such arrangements vary across product types and asset classes (e.g., options, other complex products)? How does the competition for new customers or clients or the retention of existing customers or clients drive firm adoption or use of DEPs?

1.5 Are DEPs used to promote or otherwise direct retail investors to specific securities or certain types of securities, investment strategies, or services? If so, what types of securities, investment strategies, and services, what types of DEPs are used, and how are the DEPs used for these purposes? Do firms use DEPs to promote or otherwise direct retail investors to securities, investment strategies, or services that are more lucrative for the firm or that may be riskier to the retail investor than others – such as: margin services, options trading, proprietary products, products for which the firm receives revenue sharing or other third-party payments, or other higher fee products? Do firms use DEPs that are or can be tailored to the retail investor's investment profile and risk tolerance? If so, how? If not, why not?

1.6 To what extent and how do firms monitor the use and proper functioning of DEPs? For example, to what extent and how do firms monitor notifications that retail investors receive or see from or on the firm's digital platforms?

1.7 To what extent and how do firms use DEPs or alter their use of DEPs in response to changes in the market price volatility and trading volumes in securities, both for specific assets and the market as a whole? For example, to what extent and how do firms use DEPs to notify retail investors of market events? To what extent and how do firms use DEPs to notify retail investors of firm policies and procedures or other actions that may be taken by the firm, such as in response to market events (e.g., imposition of trading restrictions)? What type of DEPs are used, what information is communicated through DEPs in such circumstances, and what is the timing of such communications?

1.8 Are firms seeking to use DEPs specifically to increase investor education? If so, how? What type of investor educational content is provided, how is that content chosen, and what types of DEPs are used? For example, are firms using DEPs to educate investors about the risks of certain activities, such as trading on margin or options trading? Are firms using DEPs to help investors understand how to make investment choices that are consistent with their investment objectives? If so, what types of DEPs are they using for these purposes, and how are they used? Have firms tested or otherwise observed the effectiveness of any such educational efforts at increasing retail investor knowledge and understanding of investing concepts including risks? Please explain and include any relevant data or information.

1.9 Do firms use DEPs to encourage longer-term investment activities, including, but not limited to, increased contributions to or establishment of retirement accounts? If so, how?

1.10 Do firms that utilize DEPs offer live, phone-based customer support or customer support through live, human-directed online support (i.e., online conversations that are not through an automated chatbot)? Does the availability of this type of support depend on the type of account or investments held (e.g., investors holding riskier products) or on account balances or asset thresholds? If firms offer live, phone-based customer support or human-directed online support, what training do firms offer their customer support personnel, and what monitoring and quality assurance programs are used? How do firms interact with investors when the platform is unavailable--for example, when the firm has lost internet service or when the platform is undergoing maintenance? What alternative means of communication are available to investors during those times?

1.11 To what extent and how do firms target certain specific groups of retail investors (including prospective customers or clients) through DEPs? What types of DEPs are used, and how are they targeted to specific retail investors or groups of retail investors? What factors do firms look to when deciding which groups of retail investors to target for each type of DEP?

1.12 What feedback, positive or negative, or complaints do firms receive from retail investors relating to the use of DEPs?

Investor characteristics and practices:

1.13 What types of retail investors are customers or clients of firms that utilize DEPs? How does this customer or client base differ, if at all, from those firms that do not use such features—including as to age, prior investment experience, education, net worth, risk tolerance, liquidity needs, investment time horizon, and investment objectives? What types of retail investors engage most frequently with DEPs on platforms that use them? Do firms utilize DEPs for only certain types of customers or clients? If so, which ones and why? To what extent and how have DEPs enabled firms to reach, educate, and provide experience to first-time retail investors? To what extent and how have DEPs enabled retail investors to access specific investments or investment strategies more quickly and/or with less investing experience than under traditional methods? Please provide or identify any relevant data and other information.

1.14 What trading or investment activities are retail investors engaging in through digital platforms that use DEPs? For retail investors who were investing prior to using digital platforms that use DEPs, how have their activities with respect to trading and investing changed since they started using such platforms and/or were first exposed to DEPs? For example, how often do retail investors engage in trading or investing through such platforms, how often did they engage in trading or investing prior to using such platforms, and how has such frequency changed as a result of using such platforms and/or being exposed to DEPs? How often do retail investors engage in other ways with such platforms (e.g., education, social features, and games)? How do retail investors learn of these platforms (e.g., news coverage, social media, internet search, paid advertisements)? Do firms collect data on how retail investors learn about or use the platforms, such as by asking as part of account opening? Please provide or identify any relevant data and other information.

1.15 What customer and client trends have been observed in connection with or as a result of the adoption and implementation of DEPs? Specifically, is data available regarding changes in customer or client behavior, including in accounts opened, amount invested, frequency of deposits, order frequency, order size (including fractional shares), types of securities traded, the risk profiles of securities that are traded, use of margin, volume of customer complaints, and the adoption and use of new features on the firms' digital platforms? Is there data showing how, for customers with a similar investment profile, these changes compare with any changes in the behavior of customers or clients of firms that do not utilize DEPs? Is there data regarding numbers or percentages of new accounts opened by retail investors that received targeted communications from the firm as compared to new accounts opened by retail investors that had received no prior communications from the firm? Please provide or identify any relevant data and other information. What experience did retail investors have in the market prior to interacting with DEPs? What percentage of retail investors invested for the first time after interacting with a DEP? What role did DEPs play in their decision to begin investing?

Public perspectives and data:

1.16 What are the benefits associated with the use of DEPs from the perspective of firms, retail investors, and other interested parties? How do these benefits differ depending upon the type of feature used? Are there specific types of DEPs or specific uses of DEPs that have the potential to be particularly beneficial to retail investors? Are there significant investor protection benefits that arise from the use of DEPs generally or particular DEPs? Which particular DEPs and why? Are there ways in which DEPs are particularly successful at conveying information to retail investors in a way that they can process and implement effectively? Please provide or identify any relevant data and other information.

1.17 What are the risks and costs associated with the use of DEPs from the perspective of firms, retail investors, and other interested parties? How do these risks or costs differ depending upon the type of feature used? Are there significant investor protection concerns that arise from the use of DEPs generally or particular DEPs? Are there particular DEPs that may pose unique risks or elevated investor protection concerns? Are there characteristics of particular DEPs that may encourage retail investors to engage in more frequent trading or invest in higher risk products or strategies? Please provide or identify any relevant data and other information.

1.18 What experience do retail investors have with DEPs? Do retail investors believe that DEPs have caused a change in their investing behavior or type of investments? If so, how? Do retail investors feel like DEPs help or hurt their overall investment performance? Do retail investors believe DEPs have helped increase their understanding of securities markets and investing? If so, how? Do retail investors believe DEPs have made trading, investing, and monitoring their investments more or less accessible to them? Do retail investors believe DEPs have increased or decreased the benefits or risks of trading or investing in securities products? Do retail investors believe that they would have invested in the markets if only more traditional methods were available? Do retail investors believe that they would trade less frequently, invest in different products, or use different investment strategies if only more traditional methods were available?

1.19 Do retail investors believe they are receiving investment advice or recommendations from DEPs or certain types of DEPs? If so, please explain. What types of DEPs do retail investors believe are most beneficial, and what types of features are most harmful, in meeting their own trading or investment objectives?

1.20 For retail investors who have previously invested with the assistance of a financial professional, how do they believe their investing experience has changed as a result of interacting with a digital platform as opposed to a financial professional?

1.21 How do commenters view the educational services currently provided by digital platforms? How could firms adopt or modify DEPs to facilitate and increase opportunities for investor education and encourage longer-term investment activities, including, but not limited to, through increased contributions to or establishment of retirement accounts?

1.22 What similarities and differences exist between the functionality, and overall user experience, including with respect to DEPs, on a digital trading or investment platform versus similar practices on digital platforms in other contexts (e.g., shopping, fitness, entertainment)? Does a retail investor's experience with these types of features in other contexts affect the retail investor's trading or investment activity, and their engagement with the broker-dealer or investment adviser's digital platform where DEPs are employed? Do commenters believe that certain types of DEPs are more, less, or as appropriate in the investing context than in other contexts? What types of features and why?

1.23 Have researchers (including in the fields of behavioral finance, economics, psychology, marketing, and other related fields) studied the use of DEPs by broker-dealers and investment advisers? In particular, how have these practices been studied or observed to influence or reinforce the behavior of retail investors? To the extent retail investors have shifted from investing through human interaction (with a financial professional) to digital interaction (on a digital platform), how has that shift affected the behavior of retail investors? Please identify any relevant literature or data, including research related to the use of similar practices in other fields that could assist the Commission in its consideration of these issues.

1.24 Is there research in the fields of experimental psychology and marketing that contains evidence regarding the ability of DEPs to influence retail investors? Are there findings in those fields that suggest retail investors may not be fully aware that they have been influenced by a particular DEP?

1.25 Do studies of gambling or addiction offer evidence regarding whether and to what extent the immediate positive feedback provided by certain DEPs may influence retail investor decision-making?

1.26 How do commenters view the disclosures that firms are providing in connection with or specifically addressing the use of DEPs and the timing of such disclosures? In particular, how effective are disclosures at informing retail investors of any associated conflicts of interest presented by the use of DEPs and how DEPs could influence them and their trading and investing behavior? How accessible are these disclosures to retail investors engaging with DEPs? Please identify any relevant data or other information.

B. DEP-RELATED TOOLS AND METHODS

In order to develop, test, and implement these practices, and thereafter to assess their effectiveness, firms may use numerous analytical and technological tools and methods.[10] From a technological perspective, these tools and methods can employ predictive data analytics and AI/ML models—including deep learning, supervised learning, unsupervised learning, and reinforcement learning processes.[11] These tools and methods can be designed to build and adapt

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[10] In some cases, firms may rely on in-house and proprietary tools and methods to develop, test and implement DEPs, and in others, firms may use third-party service providers to assist in the DEP development process.

[11] See, e.g., Department of the Treasury et al., Request for Information and Comment on Financial Institutions' Use of Artificial Intelligence, Including Machine Learning (Feb. 2021) [86 FR 16837, 16839-40 (Mar. 31, 2021)] ("Treasury RFI"); FINRA, Artificial Intelligence (AI) in the Securities Industry 5 (June 2020) ("FINRA AI Report"), https://www.finra.org/sites/default/files/2020-06/ai-report-061020.pdf; Financial Stability

DEPs based on observable investor activities. Such adaptations may be based on the AI/ML models' understanding of the neurological rewards systems of retail investors (obtained in the interactions between each retail investor and the firm's investment platform), and may be utilized to develop investor-specific changes to each retail investor's user experience.

Relatedly, firms that utilize AI/ML models may utilize model risk management to provide a governance framework for these models throughout their life cycle in order to account for AI/ML-specific risks. Technological tools and methods also include the use of natural language processing ("NLP") and natural language generation ("NLG"). These specific uses of AI/ML may be employed to transform user interfaces and the interactions that retail investors have on digital platforms by developing an understanding of the investor's preferences and adapting the interface and related prompts to appeal to those preferences.[12]

Beyond technological tools, firms may engage in various forms of research in order to help shape the DEPs developed and implemented on their platforms. This may include consultations with behavioral science professionals, and cross-industry research intended to identify those customer engagement practices used in other industries that have proven most effective.

Industry practices:

2.1 To what extent, and how, do firms use (or in the future expect to use) tools based on AI/ML (including deep learning, supervised learning, unsupervised learning, and

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Board, Artificial Intelligence and Machine Learning in Financial Services: Market Developments and Financial Stability Implications (Nov. 1, 2017) ("FSB AI Report"), https://www.fsb.org/wp-content/uploads/P011117.pdf.

12 See, e.g., FSB AI Report, supra note 11, at 14-15 (finding that chatbots are being introduced by a range of financial services firms, often in mobile apps or social media, and that chatbots are "increasingly moving toward giving advice and prompting customers to act").

reinforcement learning) and NLP and NLG, to develop and evolve DEPs? What are the objective functions of AI/ML models (e.g. revenue generation)? What are the inputs relied on by those AI/ML models (e.g. visual cues or feedback)? Does the ability to collect individual-specific data impact the effectiveness of the ML model in maximizing its objective functions?

2.2 To what extent, and how, do firms use (or in the future expect to use) behavioral psychology to develop and evolve platforms or DEPs? To what extent, and how, do firms use (or in the future expect to use) predictive data analytics to develop and evolve DEPs? To what extent, and how, do firms use "dark patterns"[13] in connection with DEPs? To what extent do firms utilize these types of tools, analytics, and methods to modify DEPs over time, tailored to a specific retail investor's history on the platform? Which types of tools and methods are used for these and other purposes?

2.3 What types of research, information, data, and metrics are firms collecting, acquiring, and using in connection with the tools and methods identified above, or otherwise to design, implement, and modify DEPs and to assess their effectiveness? What are the sources for such information and data (e.g., proprietary research, user data, third-party behavioral research, consultants, other service providers)? Does this research, information, data, and metrics, indicate whether DEPs affect trading frequency, volume, and results? If so, how?

2.4 How are firms using cross-industry research and sources to design, implement, and modify DEPs? Specifically, how are firms using techniques employed, and lessons

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13 See supra note 8.

learned, within industries like retail shopping, video gaming, and video or music streaming services? What features originally adopted in other industries have been utilized and implemented by firms to increase user engagement? How has the use of such features impacted investor activity on digital platforms?

2.5 To what extent, and how, do firms test or otherwise assess how their DEPs affect investor behavior and investing outcomes? What metrics are used for these assessments? What data and other results have such tests and assessments yielded? Have firms found that DEPs can be developed, evolved and implemented in order to affect retail investors' trading or investment behavior, either individually or as a group? Have firms found that those behaviors can be affected in a statistically significant way? If so, how? What controls do firms have in place to monitor the impact of DEPs on investor outcomes? How do firms incorporate any testing and monitoring into their policies and procedures?

2.6 How do firms develop, test, deploy, monitor, and oversee the tools and methods they use, including any AI/ML models (including deep learning, supervised learning, unsupervised learning, and reinforcement learning), NLP, NLG, or other types of artificial intelligence? To what extent are these tools and methods proprietary to firms or offered by third parties? Do relationships with vendors result in conflicts of interest, and if so, what types of conflicts of interest? For example, are broker-dealers or investment advisers affiliated with these providers, or does compensation of the provider vary based upon investor activity? What formal governance mechanisms do firms have in place for oversight of the vendors they use for these purposes? What model risk management steps do firms undertake? How do firms incorporate these practices and mechanisms into their policies and procedures?

2.7 What type of data concerning retail investors is used to develop, evolve, implement, test and run DEPs? How is this data used? For example, are firms using data on how retail investors—individually and/or when grouped together—have engaged with their digital platform (including trading or investment activity) following exposure to DEPs? If so, how? Are firms tailoring or personalizing DEPs to individual retail investors or groups (or sub-groups) of retail investors? If so, how? Are firms collecting information about specific identifiers attributable to particular retail investors or groups (or sub-groups) of retail investors? If so, what types of specific identifiers are collected? Do firms use such identifiers (or others) in connection with determining the location of retail investors? If so, how do firms use location information? Do firms seek to cause any particular types of engagement with DEPs? If so, how? Are there other ways firms are using data concerning retail investors to develop, evolve, implement, test, and run DEPs?

2.8 To what extent do firms purchase data from third-party vendors, including data concerning retail investors, to develop, evolve, implement, test, and run DEPs? How are firms utilizing data acquired from third-party vendors to develop, evolve, implement, test, and run DEPs? Are firms using data obtained from third-party vendors to tailor or personalize DEPs to individual retail investors? If so, how? To what extent do firms sell or otherwise share data about their own customers' or clients' behavior on their digital platforms, and who are the primary purchasers or recipients of that data?

2.9 To the extent that firms use AI/ML to develop, evolve, implement, test, and run DEPs, are they ensuring that the AI/ML is explainable and reproducible?[14] If so, how?

2.10 Are there any particular challenges or risks that firms face in using AI/ML (including deep learning, supervised learning, unsupervised learning, and reinforcement learning), including AI developed or provided by third parties? If so, what are they and how do firms address such challenges or impediments and any risks associated with them? Have firms found that using AI/ML or retail investor data gathered in connection with DEPs raises unique issues related to financial privacy, information security, or identity theft prevention?

2.11 To what extent and how do firms employ controls to identify and mitigate any biases or disparities that may be perpetuated by the use of AI/ML models[15] in connection

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14 See, e.g., Treasury RFI, at 16839-40 (describing explainability as "how an AI approach uses inputs to produce outputs" and describing challenges associated with lack of explainability); see also FSB AI Report, at 2 (stating that the "lack of interpretability or 'auditability' of AI and machine learning models could become a macro-level risk"); Gregory Barber, Artificial Intelligence Confronts a 'Reproducibility' Crisis, Wired (Sept. 16, 2019), https://www.wired.com/story/artificial-intelligence-confronts-reproducibility-crisis/.

15 See e.g., Joy Buolamwini and Timnit Gebru, Gender Shades: Intersectional Accuracy Disparities in Commercial Gender Classification, 81 Proceedings of Machine Learning Research 77 (2018), https://dam-prod.media.mit.edu/x/2018/02/06/Gender%20Shades%20Intersectional%20Accuracy%20Disparities.pdf; Ziad Obermeyer et al., Dissecting Racial Bias in an Algorithm Used to Manage the Health of Populations, 366 Science 6464, 447-453 (Oct. 25, 2019), https://science.sciencemag.org/content/366/6464/447; Executive Office of the President of the United States, Big Data: A Report on Algorithmic Systems, Opportunity, and Civil Rights pp. 6-10 (May 2016), https://obamawhitehouse.archives.gov/sites/default/files/microsites/ostp/2016_0504_data_discrimination.pdf.

with the use of DEPs? For example, do firms evaluate the outputs of their AI/ML models to identify and mitigate biases that would raise investor protection concerns? Do firms utilize human oversight to identify biases that would raise investor protection concerns, in both the initial coding of AI/ML models and the resulting outputs of those models?

Public perspectives and data:

2.12 What are the benefits associated with the use of the tools and methods identified above (e.g., AI/ML, predictive data analytics, cross-industry research, behavioral science) in connection with the design, implementation, and modification of DEPs from the perspective of firms, retail investors, and other interested parties? How do these benefits differ depending upon the type of tools or methods? Do the tools and methods mitigate, or have the potential to mitigate, biases in the market that may have prevented participation by some retail investors (e.g., by lowering barriers to entry)? Please provide or identify any relevant data and other information.

2.13 What are the risks and costs associated with the use of the tools and methods identified above (e.g., AI/ML, predictive data analytics, cross-industry research, behavioral science) in connection with the design, implementation, and modification of DEPs from the perspective of firms, retail investors, and other interested parties? How do these risks differ depending upon the type of tools or methods used? What are the most significant investor protection concerns arising from or associated with the use of such tools and methods by broker-dealers and investment advisers in the context of DEPs? Please provide or identify any relevant data and other information.

2.14 What are the similarities and differences between the use of the types of tools and methods identified above in the context of DEPs versus other contexts? Do commenters believe that certain types of tools or methods are more, less, or as appropriate in the investing context than in other contexts? Please provide or identify any relevant data and other information.

2.15 Are there any particular challenges or risks associated with the use of AI/ML (including deep learning, supervised learning, unsupervised learning, and reinforcement learning), including AI developed or provided by third parties? If so, what are they and how should firms address such challenges or impediments and any risks associated with them? What model risk management steps should firms undertake? Does the use of AI/ML or retail investor data gathered in connection with DEPs raise unique issues related to financial privacy, information security, or identity theft prevention?

2.16 Have researchers (including in the fields of behavioral finance, economics, psychology, marketing, and other related fields) studied the use of such tools and methods in the context of the use of DEPs by firms, or in related contexts of individual decision-making? Please identify any relevant literature or data, including research related to the use of similar practices in other fields, that could assist the Commission in its consideration of these issues.

2.17 To what extent can the use of the tools and methods identified above (e.g., AI/ML models) in connection with the use of DEPs perpetuate social biases and disparities? How, if at all, have commenters seen this in practice with regard to the development and use of DEPs on digital platforms (e.g., through marketing, asset allocation, fees)? Are there AI/ML models that are more or less likely to perpetuate such biases and disparities?

C. REGULATORY ISSUES ASSOCIATED WITH DEPS AND THE RELATED TOOLS AND METHODS AND POTENTIAL APPROACHES

Broker-dealers and investment advisers are currently subject to extensive obligations under federal securities laws and regulations, and in the case of broker-dealers, rules of SROs (in particular, the Financial Industry Regulatory Authority, Inc. ("FINRA")[16]) that are designed to promote conduct that, among other things, protects investors from abusive practices. Following is an overview of some of the existing statutory provisions, regulations, and rules that are particularly relevant to the use of DEPs and related tools and methods by broker-dealers and investment advisers.[17]

In addition to these specific obligations, federal securities laws and regulations broadly prohibit fraud by broker-dealers and investment advisers as well as fraud by any person in the offer, purchase, or sale of securities, or in connection with the purchase or sale of securities. Generally, these anti-fraud provisions cover manipulative or deceptive conduct, including an

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16 Any person operating as a "broker" or "dealer" in the U.S. securities markets must register with the Commission, absent an exception or exemption. See Exchange Act section 15(a), 15 U.S.C. 78o(a); see also Exchange Act sections 3(a)(4) and 3(a)(5), 15 U.S.C. 78c(a)(4) and 78c(a)(5) (providing the definitions of "broker" and "dealer," respectively). Generally, all registered broker-dealers that deal with the public must become members of FINRA, a registered national securities association, and may choose to become exchange members. See Exchange Act section 15(b)(8), 15 U.S.C. 78o(b)(8); 17 CFR 240.15b9-1. FINRA is the sole national securities association registered with the SEC under Section 15A of the Exchange Act. Because this Request is focused on broker-dealers that deal with the public and are FINRA member firms, we refer to FINRA rules as broadly applying to "broker-dealers," rather than to "FINRA member firms."

17 Broker-dealers and investment advisers are subject to a host of other obligations that are not summarized in this overview, and that may also be relevant to the use of DEPs and related tools and methods. For example, additional regulatory obligations on broker-dealers include those relating to: registration; certain prohibited or restricted conflicts of interest; fair prices, commissions and charges; and best execution. As another example, additional regulatory obligations on investment advisers include those relating to registration; certain prohibited transactions; and written codes of ethics.

affirmative misstatement or the omission of a material fact that a reasonable investor would view as significantly altering the total mix of information made available.[18]

1. Existing Broker-Dealer Obligations:[19]

Under the anti-fraud provisions of the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers and observe high standards of commercial honor and just and equitable principles of trade.[20] A number of more specific obligations are summarized below:

- Account Opening and Other Approval Obligations. Broker-dealers must obtain certain information about their customers at account opening, under anti-money laundering

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18 See Securities Act section 17(a), 15 U.S.C. 77q(a); Exchange Act section 10(b), 15 U.S.C. 78j(b); Exchange Act section 15(c), 15 U.S.C. 78o(c); Investment Advisers Act of 1940 ("Advisers Act") section 206, 15 U.S.C. 80b-6; see also Exchange Act section 9(a), 15 U.S.C. 78i(a); see also Basic v. Levinson, 485 U.S. 224, 239 n.17 (1988).

19 These obligations cannot be waived or contracted away by customers. See Exchange Act section 29(a), 15 U.S.C. 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or any rule or regulation thereunder, or any rule of a [SRO], shall be void.").

20 See, e.g., Duker & Duker, Exchange Act Release No. 2350, 6 S.E.C. 386, 388 (Dec. 19, 1939) (Commission opinion) ("Inherent in the relationship between a dealer and his customer is the vital representation that the customer be dealt with fairly, and in accordance with the standards of the profession."); see also U.S. Securities and Exchange Commission, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, at 238 (1st Sess. 1963) ("An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws, rests upon the theory that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public."); FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); NASD Interpretive Material 2310-2 (Fair Dealing with Customers) ("Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of [FINRA's] Rules, with particular emphasis on the requirement to deal fairly with the public.").

("AML") and know your customer requirements,[21] and are required to maintain customer account information, including whether a customer is of legal age.[22]

Additional obligations apply for investors to transact in certain types of securities (e.g., options) or obtain certain services (e.g., margin).[23] For example, broker-dealers

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21 Financial institutions, including broker-dealers, are required to establish written customer identification programs (CIP), which must include, at a minimum, procedures for: obtaining customer identifying information from each customer prior to account opening; verifying the identity of each customer, to the extent reasonable and practicable, within a reasonable time before or after account opening; making and maintaining a record of information obtained relating to identity verification; determining within a reasonable time after account opening or earlier whether a customer appears on any list of known or suspected terrorist organizations designated by Treasury; and providing each customer with adequate notice, prior to opening an account, that information is being requested to verify the customer's identity. See 31 CFR 1023.220 (Customer Identification Program for Broker-Dealers). As part of broker-dealers' AML compliance programs, they must include risk-based procedures for conducting ongoing customer due diligence, to comply with the Customer Due Diligence Requirements for Financial Institutions ("CDD Rule") of the Financial Crimes Enforcement Network (FinCEN). See FINRA Rule 3310 (Anti-Money Laundering Compliance Program); 81 FR 29398 (May 11, 2016) (CDD Rule Release); 82 FR 45182 (Sept. 28, 2017) (correction to CDD Rule amendments). Additionally, pursuant to FINRA Rule 2090 (Know Your Customer), all member broker-dealers must use reasonable diligence, at both the opening of a customer account, and for the duration of the customer relationship to know and retain the "essential facts" concerning each customer. Such "essential facts" include those that are necessary "to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules." See FINRA Regulatory Notice 11-02 (SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations); see also 17 CFR 240.17a-3(a)(17).

22 See FINRA Rule 4512 (Customer Account Information). As a general matter, whether any particular individual is able to enter into a contract (such as that associated with opening a brokerage account) is a matter of state law, and not explicitly governed by the federal securities laws. See also 17 CFR 240.17a-3(a)(17).

23 Approval obligations also apply for investors to engage in day-trading. See FINRA Rule 2130 (Approval Procedures for Day-Trading Accounts).

must pre-approve a customer's account to trade options on securities.[24] Prior to approving a customer's account for options trading, the broker-dealer must seek to obtain "essential facts relative to the customer, [their] financial situation and investment objectives."[25] Broker-dealers must then verify the background and financial information they obtain regarding each customer, and obtain an executed written agreement from the customer agreeing, among other things, to be bound by all applicable FINRA rules applicable to the trading of option contracts.[26]

With respect to margin, broker-dealers are required to obtain the signature of the account owner with respect to a margin account[27] and to obtain a customer's written

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24 See FINRA Rule 2360(b)(16) (Options). FINRA has also extended the options account approval requirements of Rule 2360(b)(16), by reference, to customers seeking to place orders to buy or sell warrants. See FINRA Rule 2352 (Account Approval). Numerous exchanges that facilitate options trading apply similar standards for customer pre-approval before accepting orders for options contracts on the exchange.

25 See FINRA Rule 2360(b)(16)(B).

26 See FINRA Rule 2360(b)(16)(C) and (D). FINRA has also indicated that in the case of options, broker-dealers should consider whether they should provide limited account approval to a customer, based on this information. For example, customers may be approved to make purchases of puts and calls only, be restricted to covered call writing, or be approved to engage in uncovered put and call writing. See FINRA Regulatory Notice 21-15 (FINRA Reminds Members About Options Account Approval, Supervision and Margin Requirements).

27 See 17 CFR 240.17a-3(a)(9).

consent.[28] These written consents and signatures are generally obtained by broker-dealers when a customer executes a margin agreement.[29]

- Standard of Conduct. Regulation Best Interest ("Reg BI") requires broker-dealers that make recommendations of securities transactions or investment strategies involving securities (including account recommendations) to retail customers to act in their best interest, and not place the broker-dealer's interests ahead of the retail customer's interest.[30] The use of a DEP by a broker-dealer may, depending on the relevant facts and circumstances, constitute a recommendation for purposes of Reg BI. Whether a "recommendation" has been made is interpreted consistent with precedent under the federal securities laws and how the term has been applied under FINRA rules.[31] Broker-

28 The written consent is a condition necessary for the broker-dealer to be able to hypothecate (i.e., pledge) securities under circumstances that would permit the commingling of customers' securities. Broker-dealers are also required to give written notice to a pledgee that, among other things, a security pledged is carried for the account of a customer. See 17 CFR 240.8c-1 and 240.15c2-1.

29 See 17 CFR 240.8c-1, 240.15c2-1, and 240.17a-3(a)(9). Margin agreements also typically state that a customer must abide by the margin requirements established by the Federal Reserve Board, SROs such as FINRA, any applicable securities exchange, and the firm where the margin account is established. See also FINRA Rule 4210(f)(8)(B) (Margin Requirements) regarding special margin requirements for day trading, including special requirements for "pattern day traders" (any customer who executes four or more day trades within five business days, provided that the number of day trades represents more than six percent of the customer's total trades in the margin account for that same five business day period).

30 17 CFR 240.15l-1; Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031 [84 FR 33318 (July 12, 2019)] ("Reg BI Adopting Release"). Following the adoption of Reg BI, which, among other things, incorporated and enhanced the principles found in FINRA's suitability rule (Rule 2111), FINRA amended Rule 2111 to, among other things, state that the rule does not apply to recommendations subject to Reg BI. See Exchange Act Release No. 89091 (June 18, 2020) [85 FR 37970 (June 24, 2020)].

31 Reg BI Adopting Release, supra note 30, at 33337. The determination of whether a recommendation has been made turns on the facts and circumstances of a particular

dealers satisfy their obligations under Reg BI by complying with four specified component obligations: a disclosure obligation;[32] a care obligation;[33] a conflict of interest obligation;[34] and a compliance obligation.[35] Additional suitability obligations are imposed on broker-dealers when recommending transactions in certain types of securities, such as options, to any customer.[36]

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situation. Id. at 33335 ("Factors considered in determining whether a recommendation has taken place include whether a communication 'reasonably could be viewed as a "call to action"' and 'reasonably would influence an investor to trade a particular security or group of securities.' The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'") (citation omitted); see also NASD Notice to Members 01-23 (Apr. 2001) (Online Suitability—Suitability Rules and Online Communications) (providing examples of electronic communications that are considered to be either within or outside the definition of "recommendation"). To the extent that a broker-dealer makes a recommendation, as that term is interpreted by the Commission under Reg BI, to a retail customer through or in connection with a DEP, Reg BI would apply to the recommendation.

32 The disclosure obligation requires the broker-dealer to provide certain required disclosure before or at the time of the recommendation, about the recommendation and the relationship between the broker-dealer and the retail customer. 17 CFR 240.15l-1(a)(2)(i).

33 The care obligation requires the broker-dealer to exercise reasonable diligence, care, and skill in making the recommendation. 17 CFR 240.15l-1(1)(a)(2)(ii).

34 The conflict of interest obligation requires the broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers. Among other specific requirements, broker-dealers must identify and disclose any material limitations, such as a limited product menu or offering only proprietary products, placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the broker-dealer or the associated person to place the interest of the broker-dealer or the associated person ahead of the retail customer's interest. 17 CFR 240.15l-1(a)(2)(iii).

35 The compliance obligation requires the broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. 17 CFR 240.15l-1(a)(2)(iv).

36 See, e.g., FINRA Rule 2360(b)(19).

- Disclosure Obligations. Broker-dealers are subject to a number of customer disclosure obligations, including disclosures at the inception of the customer relationship,[37] disclosures that must be made in conjunction with recommendations of securities transactions or investment strategies involving securities,[38] and certain product- or activity-specific disclosures pertaining to among others, options, margin, and day trading.[39] Additionally, broker-dealers are liable under the anti-fraud provisions for failing to disclose material information to their customers when they have a duty to make such disclosure.[40] Broker-dealers are also required to make disclosures to customers of their order execution and routing practices.[41]

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37 Disclosure obligations include Form CRS relationship summary (describing the broker-dealer's services, fees, costs, conflicts of interest and disciplinary history). See 17 CFR 240.17a-14.

38 See 17 CFR 240.15l-1 (Reg BI).

39 See, e.g., FINRA Rule 2360(b)(16)(A) (requiring broker-dealers to provide certain risk disclosures when approving customers for options transactions); FINRA Rule 2264 (Margin Disclosure Statement) (specifying disclosures in advance of opening a margin account for a non-institutional customer); 17 CFR 240.10b-16 (requiring disclosures of all credit terms in connection with any margin transactions at account opening); FINRA Rule 2270 (Day-Trading Risk Disclosure Statement) (requiring that a disclosure statement be provided to any non-institutional customer that opens an account at a broker-dealer that promotes a day-trading strategy).

40 See Basic v. Levinson, supra note 18. Generally, under the anti-fraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which depends on the relevant facts and circumstances. See, e.g., Conway v. Icahn & Co., Inc., 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.").

41 See generally 17 CFR 242.605 and 242.606 (Regulation NMS Rules 605 and 606). For example, under NMS Rule 606, broker-dealers must provide public reports concerning the venues to which they route customer orders for execution and discuss material aspects of their arrangements with these execution venues, including PFOF that broker-dealers receive from the venues. Pursuant to amendments implemented in 2020, these reports require enhanced specificity concerning PFOF and other types of practices that may

- Reporting and Other Financial Responsibility Requirements. Broker-dealers are subject to comprehensive financial responsibility rules, including reporting requirements under Exchange Act Rule 17a-5, minimum net capital requirements under Exchange Act Rule 15c3-1, and customer protection requirements under Exchange Act Rule 15c3-3.[42] Broker-dealers are also subject to various rules relating to margin, including, for example, disclosure and other requirements when extending or arranging credit in certain transactions,[43] disclosure of credit terms in margin transactions,[44] a description of the margin requirements that determine the amount of collateral customers are expected to

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present broker-dealer conflicts of interest. See Exchange Act Release No. 78309 (Nov. 2, 2018) [83 FR 58338, 58373-6 (Nov. 19, 2018)].

42 Rule 17a-5 has two main elements: (1) a requirement that broker-dealers file periodic unaudited reports about their financial and operational condition using the FOCUS Report form; and (2) a requirement that broker-dealers annually file financial statements and certain reports, as well as reports covering those statements and reports prepared by an independent public accountant registered with the Public Company Accounting Oversight Board ("PCAOB") in accordance with PCAOB standards. 17 CFR 240.17a-5. The objective of Rule 15c3-1 is to require a broker-dealer to maintain sufficient liquid assets to meet all liabilities, including obligations to customers, counterparties, and other creditors and to have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if the firm fails financially. See 17 CFR 240.15c3-1. Rule 15c3-3 requires a carrying broker-dealer to maintain physical possession or control over customers' fully paid and excess margin securities. The rule also requires a carrying broker-dealer to maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers. 17 CFR 240.15c3-3.

43 See 17 CFR 240.15c2-5 (Disclosure and other requirements when extending or arranging credit in certain transactions).

44 See 17 CFR 240.10b-16 (Disclosure of credit terms in margin transactions).

maintain in their margin accounts,[45] and a requirement to issue a margin disclosure statement prior to opening a margin account.[46]

- Communications with the Public Rules. Broker-dealers are subject to a number of rules governing communications with the public, including advertising or marketing communications. These rules apply to broker-dealers' written (including electronic) communications with the public and are subject to obligations pertaining to content, supervision, filing, and recordkeeping.[47] All communications must be based on principles of fair dealing and good faith, be fair and balanced, and comply with a number

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45 See FINRA Rule 4210 (Margin Requirements). See also 12 CFR 220.1 et seq. (Federal Reserve Board's Regulation T regulating, among other things, extensions of credit by brokers and dealers);

46 See FINRA Rule 2264 (Margin Disclosure Statement). See also FINRA Regulatory Notice 21-15 (FINRA Reminds Members About Options Account Approval, Supervision and Margin Requirements).

47 See, e.g., FINRA Rule 2210 (Communications with the Public). FINRA has provided guidance regarding the applicability of the communications rules in the context of social media and digital communications. See FINRA Regulatory Notice 19-31 (Disclosure Innovations in Advertising and Other Communications with the Public); FINRA Regulatory Notice 17-18 (Social Media and Digital Communications); FINRA Regulatory Notice 11-39 (Social Media Websites and the Use of Personal Devices for Business Communications); FINRA Regulatory Notice 10-06 (Social Media Web Sites); see also 17 CFR 240.17a-4(b)(4). Paragraph (b)(4) of Rule 17a-4 requires a broker-dealer to preserve originals of all communications received and copies of all communications sent (and any approvals thereof) by the broker-dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to the rules of an SRO of which the broker-dealer is a member regarding communications with the public. The term "communications," as used in paragraph (b)(4) of Rule 17a-4, includes all electronic communications (e.g., emails and instant messages). See Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers, Exchange Act Release No. 87005 (Sept. 19, 2019) [84 FR 68550, 68563-64 (Dec. 16, 2019)].

of other content standards.[48] Through its filings review program, FINRA's Advertising Regulation Department reviews communications submitted either voluntarily or as required by FINRA rules.[49] In the case of communications relating to options, broker-dealers are subject to certain heightened obligations.[50]

- Supervision Obligations and Insider Trading Procedures. Broker-dealers must "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."[51] Among other things, broker-dealers must 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

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48 Among other requirements and prohibitions, firms may not "make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication;" firms "must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits;" and firms "must consider the nature of the audience to which the communication will be directed and must provide details and explanations appropriate to the audience." See FINRA Rule 2210 (Communications with the Public).

49 FINRA reviews communications for compliance with applicable regulations. Broker-dealers must submit certain retail communications to FINRA for its approval at least ten business days prior to first use or publication. In addition to reviewing filed communications, broker-dealer communications can also be subject to spot-check reviews by FINRA. See FINRA Rule 2210(c).

50 See FINRA Rule 2220 (Options Communications). For example, when making retail communications concerning the sale of options products, broker-dealers must submit certain of those communications to FINRA for its approval at least ten calendar days prior to use.

51 See FINRA Rule 3110 (Supervision). Under Exchange Act Sections 15(b)(4)(E) and 15(b)(6), the Commission institutes administrative proceedings against broker-dealers and supervisors for failing reasonably to supervise, with a view to preventing violations of the federal securities laws. 15 U.S.C. 78o(b)(4)(E) and 78o(b)(6).

regulations, and with applicable FINRA rules.[52] Broker-dealers must also establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the broker-dealer or its associated persons.[53]

- Recordkeeping Obligations. Section 17(a) of the Exchange Act provides the Commission with authority to issue rules requiring broker-dealers to make and keep for prescribed periods such records as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Rules 17a-3 and 17a-4 prescribe the primary recordkeeping requirements for broker-dealers.[54]
- Customer Complaints. Broker-dealers are required to have procedures to document and capture, acknowledge, and respond to all written (including electronic) customer complaints,[55] and report to FINRA certain specified events related to customer complaints, as well as statistical and summary information on customer complaints.[56]

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52 See FINRA Rule 3110(b)(1).

53 See Exchange Act section 15(g), 15 U.S.C. 78o(g).

54 Exchange Act Rule 17a-3 (delineating certain records that broker-dealers must make and keep current, including customer account records, copies of customer confirmations, records of customer complaints, and records related to every recommendation of any securities transaction or investment strategy involving securities made to a retail customer); Exchange Act Rule 17a-4 (specifying the time period and manner in which records made pursuant to Rule 17a-3 must be preserved, and identifying additional records that must be maintained for prescribed time periods.). See 17 CFR 240.17a-3 and 240.17a-4.

55 See FINRA Rule 3110(b)(5).

56 See FINRA Rule 4530; see also FINRA Rule 4311(g) (addressing certain requirements for carrying agreements relating to customer complaints).

Broker-dealers must also make and keep a record indicating that each customer has been provided with a notice with the address and telephone number to which complaints may be directed.[57]

- Privacy and Cybersecurity. Regulation S-P requires broker-dealers to disclose certain information about their privacy policies and practices, limits the instances in which broker-dealers may disclose nonpublic personal information about consumers to nonaffiliated third parties without first allowing the consumer to opt out, and requires broker-dealers to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.[58] Regulation S-P also limits the re-disclosure and re-use of nonpublic personal information, and it limits the sharing of account number information with nonaffiliated third parties for use in telemarketing, direct mail marketing, and email marketing.[59] Broker-dealers are also required, under Regulation S-ID, to develop and implement a written identity theft prevention program designed to detect, prevent, and

57 See 17 CFR 240.17a-3(a)(18) (requiring broker-dealers to make and maintain a record for each written customer complaint received regarding an associated person, including the disposition of the complaint).

58 See 17 CFR 248. Regulation S-P implements the consumer financial privacy provisions, as well as the customer records and information security provisions, of Title V of the Gramm Leach Bliley Act ("GLBA"). It also implements the consumer report information disposal provisions (Section 628) of the Fair Credit Reporting Act ("FCRA") as amended by the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act").

59 See 17 CFR 248.11 and 248.12.

mitigate identity theft in connection with certain existing accounts or the opening of new accounts.[60]

2. Existing Investment Adviser Obligations:

The Investment Advisers Act of 1940 ("Advisers Act") establishes a federal fiduciary duty for investment advisers, whether or not registered with the Commission, which is made enforceable by the anti-fraud provisions of the Advisers Act. The fiduciary duty is broad and applies to the entire adviser-client relationship, and must be viewed in the context of the agreed-upon scope of that relationship.[61] As a fiduciary, an investment adviser owes its clients a duty of care and a duty of loyalty.[62] Under its duty of loyalty, an adviser must make full and fair disclosure of all material facts relating to the advisory relationship and must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict. An adviser's duty of care includes, among other things: (i) a duty to provide investment advice that is in the best interest of the client, based on a

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60 See 17 CFR 248.201. Regulation S-ID implements the identity theft red flags rules and guidelines provisions (Section 615(e)) of the FCRA as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

61 For example, to the extent that an adviser provides investment advice to a client through or in connection with a DEP, then all such investment advice must be consistent with the adviser's fiduciary duty.

62 This fiduciary duty "requires an adviser to adopt the principal's goals, objectives, or ends." See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669, 33671 (July 12, 2019)] ("IA Fiduciary Duty Interpretation") (internal quotations omitted). This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. See id.

reasonable understanding of the client's objectives;[63] (ii) a duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts); and (iii) a duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship.[64] We discussed the fiduciary duty and these aspects of it in greater detail in a Commission interpretation.[65]

Rules adopted under the Advisers Act also impose various obligations on registered investment advisers (or investment advisers required to be registered with the Commission), including:

- Disclosure Requirements. Registered investment advisers are subject to a number of client disclosure obligations, including disclosures before or at the time of entering into an advisory contract, annually thereafter, and when certain changes occur. These disclosures include information about a number of topics, including an adviser's business practices, fees, conflicts of interest, and disciplinary information, and about advisory employees and their other business activities.[66]
- Reporting Requirements. Investment advisers register with the Commission by filing Form ADV and are required to file periodic updates.[67] Like all market participants,

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63 In order to provide such advice, an investment adviser must have a reasonable understanding of the client's objectives. See id. at 33672-3.

64 See id. at 33669-78.

65 See id.

66 See, e.g., 17 CFR 275.204-3 (requiring an adviser to deliver a Form ADV Part 2A brochure to advisory clients); 17 CFR 275.204-5 (requiring an adviser to deliver Form CRS to each retail investor).

67 See, e.g., 17 CFR 275.204-1.

investment advisers are subject to reporting obligations under the Exchange Act under specified circumstances,[68] as well as trading rules and restrictions under the Exchange Act.[69]

- Marketing Requirements. Rule 206(4)-1, as amended in December 2020, governs investment advisers' marketing practices.[70] This rule contains seven general prohibitions on the types of activity that could be false or misleading that apply to all advertisements. The rule also prohibits advertisements that contain testimonials, endorsements, third-party ratings, and performance information, unless certain conditions are met.
- Compliance Programs. Under rule 206(4)-7, an investment adviser must adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the firm and its supervised persons.[71] Among other things, an adviser's compliance policies and procedures should address portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions. This rule requires review of such

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68 These include, for example, Schedule 13D or Schedule 13G reporting of "beneficial ownership" of more than 5 percent of shares of a voting class of a security registered under Section 12 of the Exchange Act and Form 13F quarterly reports filed by institutional investment managers that manage more than $100 million of specified securities. See 17 CFR 240.13d-1(a)-(c) and 240.13f-1.

69 These include prohibitions and restrictions on market manipulation and insider trading. See, e.g., 17 CFR 240.10b5-1 and 240.10b5-2.

70 The compliance date for amended rule 206(4)-1 under the Advisers Act is November 4, 2022. Until then, advisers that do not comply with amended 206(4)-1 must comply with existing rule 206(4)-1, which governs adviser's advertisements, and rule 206(4)-3, which governs cash payments for client solicitations.

71 See 17 CFR 275.206(4)-7.

policies and procedures at least annually, and the designation of a chief compliance officer responsible for administering such policies and procedures.

- Supervision Obligations and Insider Trading Procedures. Investment advisers have a duty to reasonably supervise certain persons with respect to activities performed on the adviser's behalf.[72] In addition, section 204A of the Advisers Act requires investment advisers (registered with the Commission or not) to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the investment adviser or any of its associated persons.
- Recordkeeping Requirements. Under rule 204-2, investment advisers must make and keep particular books and records, including certain communications relating to advice given (or proposed to be given), the placing or execution of any order to purchase or sell any security, and copies of the advertisements they disseminate.[73]
- Privacy and Cybersecurity. Advisers registered or required to be registered with the Commission are also subject to Regulation S-P and Regulation S-ID, which are discussed above in the context of broker-dealers.

Questions: Current regulatory compliance approaches:

3.1 How are firms approaching compliance relating to their use of DEPs and the related tools and methods, in order to ensure compliance with their obligations under federal securities laws and regulations, including those identified above? For example, how do firms supervise communications or marketing to retail investors through or in connection with DEPs? Do firms approach compliance relating to the use of DEPs

72 See Advisers Act section 203(e)(6), 15 U.S.C. 80b-3(e)(6).

73 See 17 CFR 275.204-2.

and related tools and methods differently from how they approach compliance relating to other engagement with customers or clients? If so, how do the approaches differ? For example, do such approaches differ based on any unique risks associated with or innate characteristics of DEPs and the related tools and methods?

3.2 What types of policies and procedures and controls do firms establish and maintain to ensure the design, development, and use of DEPs and related tools and methods comply with existing obligations? How do firms supervise the design, development, and use of these features, tools, and methods after implementation and adoption for continued compliance? In what ways do firms' policies and procedures, controls, and supervision differ with respect to their use of DEPs and related tools and methods from other policies and procedures, controls, and supervision that the firms employ?

3.3 Do firms implement registration or certification requirements for personnel primarily responsible for the design, development, and supervision of DEPs? If so, what are the requirements? What type of training do firms offer to their personnel in connection with the design, development, and use of DEPs and related tools and methods? Do firms outsource the design or development of DEPs? Do firms outsource the design and development of DEPs outside the United States?

3.4 What policies, procedures, and controls do firms have in place with respect to the use of DEPs that are designed to promote or that could otherwise direct retail investors to higher-risk products and services, for example, margin services and options trading? What policies, procedures, and controls do firms have in place with respect to the use of DEPs that are designed to promote or that could otherwise direct retail investors to securities or services that are more lucrative for the firm such as: proprietary products, products for which the firm receives revenue sharing or other third-party payments, or other higher fee products? To what extent do these policies and procedures consider or address the characteristics of retail investors to whom such products and services may be promoted or directed? For example, do the policies and procedures place controls around how DEPs may be utilized to promote or otherwise direct certain products or services to certain types of retail investors?

3.5 What disclosures are firms providing in connection with or specifically addressing DEPs and the related tools and methods (including with respect to any data or information collected from the retail investor)? How are such disclosures presented to retail investors? Does such disclosure address how the use of DEPs or the related tools and methods may affect investors and specifically their trading and investing behavior? Does such disclosure differ from other disclosures that firms provide? How do firms currently disclose information such as risks, fees, costs, conflicts of interest, and standard of conduct to retail investors on their digital platforms? To what extent and how do firms use DEPs to make such disclosures?

3.6 Do broker-dealers consider the observable impacts of DEPs when determining if they are making "recommendations" for purposes of Reg BI? How does the fact that a DEP might impact the behavior of a statistically significant number of retail investors affect this determination? What statistical concepts, tools, and quantitative thresholds do broker-dealers use in making this determination?

3.7 Are there particular types of DEPs that broker-dealers avoid using because they would be recommendations? If so, which DEPs and why? What are broker-dealers doing to ensure that the DEPs they adopt comply with Reg BI and other sales practice rules, where applicable?

3.8 Do investment advisers consider the observable impacts of DEPs when determining if they are providing investment advice? How does the fact that a DEP might impact the behavior of a statistically significant number of investors affect this determination? What statistical concepts, tools, and quantitative thresholds do investment advisers use in making this determination?

3.9 Are there particular types of DEPs that investment advisers avoid using because they would constitute providing investment advice? If so, which DEPs and why? How do investment advisers satisfy their fiduciary duty when using DEPs and related tools and methods? How do investment advisers take into account their fiduciary duty when designing and developing DEPs?

3.10 When providing investment advice or recommendations to a retail investor, do firms adjust that investment advice or recommendation to take into account any data they have about how their DEPs affect investor behavior and investing outcomes? If so, how is such investment advice or recommendation adjusted?

3.11 How do firms using DEPs obtain sufficient retail investor information and provide sufficient oversight to satisfy their regulatory obligations, including, for example, applicable anti-fraud provisions and account opening or approval requirements?

3.12 How does the recordkeeping process used by firms in connection with DEPs and the related tools and methods compare to the recordkeeping process used in connection with firms' traditional business? Do firms generate and retain records with respect to the development, implementation, modification, and use of DEPs, including the testing of, or due diligence with respect to, the technology that they use for those purposes? Do firms generate and retain records with respect to retail investor interaction with such DEPs? If so, what types of records?

Questions: Suggestions for modifications to existing regulations or new regulatory approaches to address investor protection concerns, including:

3.13 What additions or modifications to existing regulations, including, but not limited to, those identified above, or new regulations or guidance might be warranted to address investor protection concerns identified in connection with the use by broker-dealers and investment advisers of DEPs, the related tools and methods, and the use of retail investor data gathered in connection with DEPs? What types of requirements, limitations, or prohibitions would be most appropriate to address any such identified investor protection concerns?

3.14 Are there regulations that currently prevent firms from using DEPs and related tools and methods in ways that might be beneficial to retail investors? If so, what additions or modifications to those regulations would make it easier for firms to use DEPs and related tools and methods to benefit investors? Are there regulatory approaches that would facilitate firms' ability to innovate or test the use of new technology consistent with investor protection?

3.15 To the extent commenters recommend any modifications to existing regulations or new regulations, how should DEPs and the scope of tools and methods be defined to capture practices and tools and methods in use today and remain flexible to adapt as technology changes? Should any such modifications or new regulations specifically and uniquely address DEPs or the related tools and methods (i.e., distinct from regulation of interactions with retail investors such as marketing, investment advice, and recommendations)? If so, how? Should any such modifications or additional regulations be targeted specifically to address certain types of DEPs or certain tools or methods? If so, how? For example, should specific DEPs be explicitly prohibited or only permitted subject to limitations or other regulatory requirements (e.g., filing or pre-approval)?

3.16 Should any such modifications or additional regulations be targeted specifically to address particular risks, such as those related to certain types of securities (e.g., options, leveraged and inverse funds, or other complex securities), services (e.g., margin), or conflicts (e.g., payment and revenue sources)? If so, how? Should any such modifications or additional regulations be targeted specifically to increase protection for certain categories of investors (e.g., seniors or inexperienced investors)? If so, how?

3.17 Are there laws, regulations, or other conduct standards that have been adopted in other contexts, fields, or jurisdictions that could serve as a useful model for any potential regulatory approaches?

3.18 To the extent commenters recommend any modifications to existing regulations or new regulations, what economic costs and benefits do commenters believe would result from their recommendations? Please provide or identify any relevant data and other information.

III. USE OF TECHNOLOGY BY INVESTMENT ADVISERS TO DEVELOP AND PROVIDE INVESTMENT ADVICE

The Commission is also issuing the Request to assist the Commission and its staff in better understanding the nature of analytical tools and other technology used by investment advisers to develop and provide investment advice to clients, including (1) oversight of this technology; (2) how investment advisers and clients have benefited from technology; (3) potential risks to investment advisers, clients, and the markets more generally related to this technology; and (4) whether regulatory action may be needed to protect investors while preserving the ability of investors to benefit from investment advisers' use of technology.[74]

A. ISSUES FOR CONSIDERATION

Financial technology enables investment advisers to develop and provide investment advice in new ways or complements existing methods or tools for developing and providing advice,[75] including by allowing digital platforms to connect clients, their investment advisers, and third-party service providers.[76] We describe below some recent changes in delivery and development of investment advice and the role of analytical tools and other technology in each. These changes are those that we understand may directly affect clients' receipt of investment advice, and some may overlap depending on an adviser's particular business model and services.

While the increased role of technology has presented investment advisers and clients with benefits, it may also present risks. We recognize that some of these risks may be presented, or be presented differently, for advisers providing traditional investment advice that does not rely

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74 While we recognize that broker-dealers similarly use analytical tools and other technology for purposes of developing and providing recommendations, those issues are not the focus of Section III of the Request. However, the Commission welcomes comments on these issues relating to broker-dealers as part of the General Request for Comment as set forth in Section IV below.

75 The International Organization of Securities Commissions ("IOSCO") has stated that the terms financial technologies or "Fintech" are "used to describe a variety of innovative business models and emerging technologies that have the potential to transform the financial services industry." IOSCO Research Report on Financial Technologies (Fintech) at 4 (Feb. 2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf.

76 Many investment advisers also increasingly use third-party service providers to generate investment models (e.g., model portfolios) or strategies, and may use software based on, or otherwise incorporating, AI/ML models.

on technology. We understand as well that investment advisers may weigh differently those potential benefits and risks, including those described below, in determining how to use technology in developing and providing investment advice. We therefore are seeking comment to understand better the tools used by investment advisers to develop and provide investment advice and investment advisers' understanding and oversight of these tools and the related benefits and risks. In addition, we seek comment on other ways in which technology has changed investment advisers' development and provision of investment advice to their clients.

1. Robo-Advisers.

Some investment advisers, which we refer to here as robo-advisers, provide asset management services to their clients through online algorithm-based platforms.[77] The number of robo-advisers (also referred to as digital investment advisers, digital advisers, or automated advisers) has increased over the past several years.[78] Robo-advisers operate under a variety of business models and have varying degrees of human interaction with clients as compared to traditional advisers, and some rely exclusively on algorithms to oversee and manage individual

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77 An algorithm can be defined as a routine process or sequence of instructions for analyzing data, solving problems, and performing tasks. See Dilip Krishna et al., Managing Algorithmic Risks: Safeguarding the Use of Complex Algorithms and Machine Learning at 3, Deloitte Development LLC (2017) ("Deloitte Report").

78 See, e.g., Investment Adviser Association, 2020 Evolution Revolution at 8 (2020), https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/resources/Evolution_Revolution_2020_v8.pdf (noting that by 2020, "two of the top five advisers as measured by number of non-high net worth individual clients served [were] digital advice platforms, representing 7.5 million clients, an increase of 2.7 million clients from [the prior year]."); Robo-Advisers, IM Guidance Update No. 2017-02 (Feb. 2017), https://www.sec.gov/investment/im-guidance-2017-02.pdf.

client accounts.[79] In some cases, human personnel may have limited ability to override an algorithm, even in stressed market conditions, and there is limited, if any, direct interaction between the client and the adviser's personnel. In other cases, robo-advisers offer hybrid advisory services, which pair algorithm-generated investment options with human personnel who can answer questions, discuss and refine an algorithm-generated investment plan (e.g., clarify information where client questionnaire responses seem conflicting or address risk tolerance levels based on client reaction to stressed market conditions), or provide additional resources to clients. Some robo-advisers offer clients a choice between hybrid and non-hybrid services, at different price points.

In addition to using analytical tools to engage with clients, robo-advisers may use technology (including AI/ML tools) for a variety of other functions. For example, an adviser may use these tools to match clients to individual portfolios based on client inputs or determine how or when to trade for individual client accounts. An adviser also may use these tools to determine asset allocations, determine how to fill allocations, generate trading signals, or make other strategic decisions.[80]

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79 A robo-adviser or a third party may develop, manage, or own the algorithm used to manage client accounts. In some business models, a robo-adviser may provide its algorithm or its digital platform to another investment adviser. That investment adviser may then (i) use the robo-adviser's existing investment options (e.g., asset allocation models), (ii) use the algorithm or digital platform as a tool to create its own investment options, or (iii) use a combination of these features.

80 In addition, FINRA has observed client-facing digital advisers that incorporate trade execution, portfolio rebalancing, and tax-loss harvesting. See FINRA, Report on Digital Investment Advice at 2 (Mar. 2016), https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf (describing digital investment tools as tools within two groups: financial professional-facing tools and client-facing tools).

All Commission-registered robo-advisers are subject to all of the requirements of the Advisers Act, including the requirement that they provide advice consistent with the fiduciary duty they owe to clients.[81] Because robo-advisers rely on algorithms, provide advisory services over the internet, and may offer limited, if any, direct human interaction to their clients, they may raise novel issues when seeking to comply with the Advisers Act. For example, advisers may need to consider whether and how automation affects the development of digital advice and the potential risks that such automation may present. An automated algorithm may produce investment advice for a particular client that is inconsistent with the client's investment strategy or relies on incomplete information about the client that depends on limited input data. Increased reliance on automated investment advice may result in too much importance being placed on clients' responses to account opening questionnaires and other forms of automated client evaluation, which may not permit nuanced answers or determine when additional clarification or information could be necessary. This reliance may also result in a failure to detect changes in clients' circumstances that may warrant a change in investment strategy.

Robo-advisers also must determine how to effectively understand and oversee use of their algorithms (including those developed by third parties) and the construction of client portfolios, including any potential conflicts of interest. For example, robo-advisers' algorithms may result in clients being invested in assets in which the adviser or its affiliate holds interests or advises separately (e.g., mutual funds and exchange-traded funds). In these circumstances, the adviser would have a conflict of interest that it must eliminate or fully and fairly disclose such that the client can provide informed consent. In addition, any override or material changes to the

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81 See IA Fiduciary Duty Interpretation, supra note 62, at n.27.

algorithm must result in investment advice that is consistent with the adviser's disclosures and fiduciary duty.

2. Internet Investment Advisers.

Some investment advisers may solely use an interactive website to provide investment advice. These investment advisers, otherwise known as "internet investment advisers," are eligible for SEC registration even if they do not meet the assets-under-management threshold if they satisfy certain criteria, including that they provide advice to all of their clients exclusively through their interactive website ("internet clients"), subject to a *de minimis* exception for other clients.[82] The Commission has stated that the internet investment adviser exemption was designed to balance the burdens of multiple state registration requirements for internet investment advisers with the Advisers Act's allocation of responsibility for regulating smaller advisers to state securities authorities.[83]

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82 See 17 CFR 275.203A-2(e) (permitting Commission registration by an investment adviser that (i) provides investment advice to all of its clients exclusively through an interactive website, except that the investment adviser may provide investment advice to fewer than 15 clients through other means during the preceding twelve months; (ii) maintains specified records; and (iii) does not control, is not controlled by, and is not under common control with, another adviser that registers with the Commission solely because of its relationship with the internet investment adviser). Internet investment advisers represented only 1.5 percent of registered advisers in 2021, but have more than tripled in number since 2010—from 57 in 2010 (approximately 0.5 percent of total registered investment advisers) to 203 in 2021 (approximately 1.5 percent of total registered investment advisers). Data from Form ADV, Part 1A, Item 2.A.(11) (based on Form ADV filings through July 2021).

83 See Exemption For Certain Investment Advisers Operating through the Internet, Advisers Act Release No. 2091 (Dec. 12, 2002) [67 FR 77620, 77621 (Dec. 18, 2002)] ("Internet Investment Adviser Adopting Release") ("Because an Internet Investment Adviser uses an interactive Web site to provide investment advice, the adviser's clients can come from any state, at any time. As a result, Internet Investment Advisers must as a practical matter register in every state. This ensures that the adviser's registrations will be in place when it later obtains the requisite number of clients from any particular state" that requires state registration.).

For purposes of the exemption, "interactive website" means a website in which computer software-based models or applications provide investment advice to clients based on personal information each client supplies through the website. These websites generally require clients to answer questions about personal finances and investment goals, which the adviser's application or algorithm analyzes to develop investment advice that the website transmits to the client. The Commission has stated that the exemption is not available to investment advisers that merely use websites as marketing tools or use internet tools such as e-mail, chat rooms, bulletin boards, and webcasts or other electronic media in communicating with clients.[84] In addition, the Commission distinguished the interactive website described in the exemption from "other types of Web sites that aggregate and provide financial information in response to user-provided requests that do not include personal information."

This exemption is limited in scope. In the Internet Investment Adviser Adopting Release, the Commission stated that internet investment advisers typically are not eligible to register with the Commission because they "do not manage the assets of their Internet clients" and thus do not meet the statutory threshold for registration with the Commission. Further, the Commission stated that, in order to be eligible for registration under this exemption, an investment adviser "may not use its advisory personnel to elaborate or expand upon the investment advice provided by its interactive website, or otherwise provide investment advice to its Internet clients." The exemption generally requires that the investment adviser "provides investment advice to all of its clients" through its website, which means that the adviser must operate an interactive website

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84 Id. at n.15 and accompanying text. Effective September 19, 2011, Rule 203A-2(f) was renumbered as Rule 203A-2(e). See Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3221 (June 22, 2011) [76 FR 42950, 42963 (July 19, 2011)].

through which advice is given. That is, the exemption is unavailable to investment advisers lacking such a website.

Despite the limited nature of the exemption, we understand that some investment advisers may seek to rely on it and to register with the Commission without meeting the exemption's terms or intended purpose.[85] Examinations of investment advisers relying on the exemption have revealed various reasons for non-compliance with the exemption's requirements, including: (i) failure to understand the eligibility requirements; (ii) websites that were not interactive; (iii) businesses that became dormant but did not withdraw their registration; and (iv) client access to advisory personnel who could expand upon the investment advice provided by the adviser's interactive website, or otherwise provide investment advice to clients, such as financial planning.

Some robo-advisers may provide a broader array of advisory services than those provided by internet investment advisers but not be eligible for Commission registration unless they can rely on another exemption or until they have met the statutory assets-under-management threshold.[86] Prohibiting these investment advisers from registering with the Commission in these circumstances could impose burdens that the internet investment adviser exemption was intended to alleviate. Finally, because the internet investment adviser exemption was established almost twenty years ago, we seek to understand better how investment advisers are relying on it

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[85] The Commission has cancelled the registrations of advisers where the Commission found that those advisers did not meet the terms of the exemption. See, e.g., Order Cancelling Registration Pursuant to Section 203(h) of the Investment Advisers Act of 1940, Advisers Act Release No. 5110 (Feb. 12, 2019).

[86] Some of these advisers also may be eligible for the "multi-state adviser exemption" under 17 CFR 275.203A-2(d). The multi-state adviser exemption permits an adviser who is required to register as an investment adviser with fifteen or more states to register with the Commission.

and whether we should consider amending the exemption or creating another exemption that reflects investment advisers' current use of technology in providing investment advice.

3. AI/ML in Developing and Providing Investment Advice.[87]

Investment advisers may use, or be considering the use of, software or models based on, or otherwise incorporating, AI/ML (including deep learning, supervised learning, unsupervised learning, and reinforcement learning) in developing and providing investment advice, including by supporting human personnel's decision-making.[88] Investment advisers may use such models or software to devise trading and investment strategies or develop investment advice, including to assess large amounts of data or to provide clients with more customized service.[89] In addition, investment advisers may use these tools to monitor client accounts or track the performance of specific securities or other investments.[90]

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87 Investment advisers' use of AI/ML and other technological tools must comply with existing rules and regulations. The Commission is not expressing a view as to the legality or conformity of such practices with the federal securities laws and the rules and regulations thereunder, nor with the rules of self-regulatory organizations.

88 Advisers may also use AI as part of their internal operations, including by reviewing and classifying information (e.g., in regulatory filings and fund prospectuses), by assisting with trade matching or custodian reconciliation, for risk measurement (in part through earlier and more accurate estimation of risks) and stress testing purposes, and by facilitating regulatory compliance.

89 See, e.g., Treasury RFI, supra note 11, at 16839 (describing potential benefits of financial institutions' use of AI); see also FINRA AI Report, supra note 11 (highlighting three broad areas where broker-dealers are evaluating or using AI: communications with customers, investment processes, and operational functions); FSB AI Report, supra note 11, at 27.

90 Advisers may obtain these AI/ML tools in connection with contracting for cloud services. They may use other types of Fintech, as well, such as financial aggregator platforms that allow advisers to access information about clients' financial accounts, which can inform investment advice. Clients may allow such platforms to access information about their investment accounts and performance to enable a more fulsome analysis of their financial resources and investment experience.

Because ML models learn and develop over time, advisory personnel may face challenges in monitoring and tracking them, including reviewing both a model's input to assess whether it is appropriate and its output to assess accuracy or relevance.[91] For example, advisory personnel may lack sufficient knowledge or experience, or rely heavily on limited personnel, to challenge models' results. In addition, there may be systemic risks associated with the use of these technologies, including potential interconnectedness across the financial system and an emerging dependency on certain concentrated infrastructure and widely used models, which could propagate risks across the financial system. Further, different market participants may use technologies of varying or inadequate quality that could prompt investment advisers to provide unsuitable advice to their clients.

4. Potential Benefits.

The use of technology in developing and providing investment advice has provided certain benefits to investment advisers and, in turn, their clients. For example, digital advisers and internet investment advisers may offer lower cost advisory services. They also may provide attractive, user-friendly design features that clients appreciate, and may offer advisory services and online access at all hours of the day.[92] Digital investment advice may be more accessible than human advisory personnel to a wider range of clients, including clients who have greater confidence in digital investment advice; may facilitate access to a wider range of investment

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[91] See, e.g., IOSCO, The Use of Artificial Intelligence and Machine Learning by Market Intermediaries and Asset Managers at 11 (June 2020) (consultation report), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD658.pdf ("Unlike traditional algorithms, ML algorithms continually learn and develop over time. It is important that they are monitored to ensure that they continue to perform as originally intended.").

[92] See, e.g., Coryanne Hicks, What Is a Robo Advisor and When to Use One, U.S. News & World Report (Feb. 18, 2021), https://money.usnews.com/financial-advisors/articles/what-is-a-robo-advisor-and-when-to-use-one.

advisers, including through increased competition and a potential for lower fees; and may permit clients to easily access information about their account and investments.[93] In addition, digital advisers may be less prone to "behavioral biases, mistakes, and illegal practices" than human personnel.[94] By using AI-based software and methods, advisers may provide clients more customized advice or advice that benefits from analysis of more information (or types of information) on a more cost-effective basis than could be provided using traditional tools. In addition, investment advisers may use AI/ML to enhance and expand their services, generate investment strategies, and expand access to investment advice.[95] Clients may benefit from

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93 See, e.g., European Securities and Markets Authority ("ESMA") et al., Joint Committee Discussion Paper on Automation in Financial Advice at 16-17 (Dec. 4, 2015) ("ESMA Discussion Paper"), https://esas-joint-committee.europa.eu/Publications/Discussion%20Paper/20151204_JC_2015_080_discussion_paper_on_Automation_in_Financial_Advice.pdf; see also ESMA et al., Report on Automation in Financial Advice at 8-9 (2016) ("ESMA Report"), https://esas-joint-committee.europa.eu/Publications/Reports/EBA%20BS%202016%20422%20(JC%20SC%20CPFI%20Final%20Report%20on%20automated%20advice%20tools).pdf (discussing views on the benefits and risks of automated advice from respondents to the ESMA Discussion Paper).

94 Söhnke M. Bartram, Jürgen Branke, and Mehrshad Motahari, Artificial Intelligence in Asset Management, CFA Institute Research Foundation Literature Review 25 (2020) ("CFA Literature Review"), https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2020/rflr-artificial-intelligence-in-asset-management.ashx; see also ESMA Discussion Paper, supra note 93, at 17 ("A well-developed algorithm may be more consistently accurate than the human brain at complex repeatable regular processes, and in making predictions. Automated advice tools therefore could reduce some elements of behavioural biases, human error, or poor judgement that may exist when advice is provided by a human. A well-developed algorithm could ensure equal and similar advice to all consumers with similar characteristics."). But see ESMA Report, supra note 93, at 9 (stating that several respondents "stated that whether or not automated advice is more consistent and accurate depends on both the underlying logic of the algorithm and the quality and completeness of the information inputted"); text accompanying infra note 97.

95 See, e.g., World Economic Forum, The New Physics of Financial Services: Understanding How Artificial Intelligence is Transforming the Financial Ecosystem 114-123 (Aug. 2018), http://www3.weforum.org/docs/WEF_New_Physics_of_Financial_Services.pdf.

investment advisers' ability to use this this technology to improve trade execution, as well. In addition, AI-based tools may substantially enhance efficiencies in information processing, reducing information asymmetries, and contributing to the efficiency and stability of markets.

5. Potential Risks.

At the same time, these developments may pose new or different risks to clients, including risks presented by investment advisers' reliance on technology and any third parties that provide or service such technology. For example, digital advisers may limit clients' access to human personnel, including when clients are considering major life changes such as retirement or when clients have questions that are highly fact-specific. Clients of internet investment advisers may have issues accessing the interactive websites, which can present unique challenges when the website is the sole means for advice delivery. The quality of the investment advice may depend on an algorithm that human personnel may monitor infrequently, incorrectly or face challenges overseeing.[96] The use of algorithms may be subject to their own risks, including risks related to the input data (such as a mismatch between data used for training the algorithm and the actual input data used during operations), algorithm design (such as flawed assumptions or judgments), and output decisions (such as disregard of underlying assumptions).[97] Digital advisers may encourage clients to trade more to the extent that the adviser integrates trade execution services, which may benefit the adviser at the expense of the client.[98] Depending on

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96 See, e.g., In the Matter of AXA Rosenberg Group LLC et al., Advisers Act Release No. 3149 (Feb. 3, 2011) (settled action); see also In the Matter of Barr M. Rosenberg, Advisers Act Release No. 3285 (Sept. 22, 2011) (settled action) (finding, in part, that an adviser breached his fiduciary duty by directing others to keep quiet about, and delay fixing, a material error in computer code underlying his company's automated model).

97 See Deloitte Report, supra note 77, at 4.

98 See CFA Literature Review, supra note 94, at 25 ("At the same time, because robo-advisors have trade execution services integrated into them, they often encourage

the quality, recency, and thoroughness of a client's information incorporated into an algorithm, as well as how broadly client risk tolerances or investment goals are generalized by the algorithm, the use of algorithms may cause some clients to receive investment advice that is less individualized than they reasonably expect. Similarly, clients may face risks when AI/ML models use poor quality, inaccurate, or biased data that produces outputs that are or lead to poor or biased advice. In this respect, biased data may be incorporated unintentionally through use of data sets that include irrelevant or outdated information, including information that exists due to historical practices or outcomes, or through the selection by human personnel of the data or types of data to be incorporated into a particular algorithm.[99]

To the extent that a third party, rather than the investment adviser, develops the analytical tools, the adviser may face challenges in understanding or overseeing those third parties or the technology. For example, there may be challenges in cases where software or a model is based on an approach or technology that is proprietary to the third party or is hosted by a third party, or where the investment adviser's personnel do not have the knowledge or experience necessary to understand the technology or to challenge its results. These circumstances may exacerbate exposure of investment advisers and their clients to cybersecurity and data privacy risks.

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investors to trade more. This increased trading can be both a benefit, in terms of encouraging investors to rebalance positions more often, and a pitfall, because it can lead to excessive trading that benefits robo-advising systems through commissions at the expense of investors.").

99 See FINRA AI Report, supra note 11, at 14; see also Treasury RFI, supra note 11, at 16840 ("Because the AI algorithm is dependent upon the training data, an AI system generally reflects any limitations of that dataset. As a result, as with other systems, AI may perpetuate or even amplify bias or inaccuracies in the training data, or make incorrect predictions if that data set is incomplete or non-representative."); Jessica Fjeld et al., Principled Artificial Intelligence: Mapping Consensus in Ethical and Rights-based Approaches to Principles for AI 47-49 (Berkman Klein Center for Internet & Society at Harvard University, Research Publication, 2020).

Further, these risks may affect more clients than those posed by investment advisers using traditional methods because of the scale at which investment advisers are able to reach clients through digital platforms.

Clients' ability to understand these and other risks rests on the quality and sufficiency of their investment advisers' disclosures, which may be particularly important to the extent that these developments reflect the use of underlying technology that is complex or otherwise requires technical expertise. Disclosure can put clients in a position to understand the different roles played by technology and advisory personnel in developing the investment advice that clients receive. Investment advisers may face challenges in disclosing sufficiently these types of risks where any such disclosure might be necessarily technical.

There may also be systemic risks associated with widespread use of AI/ML, including deep learning, supervised learning, unsupervised learning, and reinforcement learning, which may affect the maintenance of fair, orderly, and efficient markets. For example, the Financial Stability Board has stated that "applications of AI and machine learning could result in new and unexpected forms of interconnectedness between financial markets, for instance based on the use by various institutions of previously unrelated data sources."[100] In addition, there could be systemic risk to the extent that digital advisers employ models (including models from third-party model providers) that rely on past performance and volatility, which could constitute input data that is inappropriate for the current market. These and other risks may continue to grow as the use of AI continues to increase among investment advisers.

We request comment on all aspects of investment advisers' use of technology, particularly with respect to developing and providing investment advice, and the potential effect

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[100] FSB AI Report, supra note 11, at 1.

on investor protection and regulatory compliance. We specifically request comment on the following:

4.1 How do investment advisers currently use technology in developing and providing investment advice? What types of technology do advisers use for these purposes? How do investment advisers use technology in any quantitative investment processes that they employ?

4.2 Are our descriptions of the potential benefits and risks of investment advisers' use of technology in developing and providing investment advice accurate and comprehensive? If not, what additional benefits or risks to advisory clients are there from such use? What additional benefits or risks does using these types of technology provide to investment advisers? How do investment advisers weigh these benefits and risks in using technology to develop and provide investment advice? Does technology enable investment advisers to develop investment advice in a more cost-effective way and are clients able to receive less expensive advice as a result? Does technology increase access to investment advice for some clients who would otherwise not afford it or mitigate (or have the potential to mitigate) biases in the market that may have prevented access to some clients or prospective clients? Are there risks associated with the quality of services clients ultimately receive? If so, what are they and how do investment advisers address such risks? What factors do advisory clients consider in choosing to engage a robo-adviser rather than a traditional investment adviser? In what ways does investment advice developed or provided by a robo-adviser differ from investment advice developed or provided by a traditional investment adviser?

4.3 To the extent investment advisers use technology in developing and providing investment advice, do advisers assess whether the technology or its underlying models are explainable to advisory personnel or to clients? Is the technology or underlying model explainable? To what extent do investment advisers assess whether the results are reproducible? If so, are the results reproducible? To what extent do investment advisers rely on third parties to make these assessments?

4.4 How do investment advisers develop, test, deploy, monitor, and oversee the technology they use to develop and provide investment advice? Do investment advisers develop, test, and monitor AI/ML models differently from how they develop, test, and monitor traditional algorithms? How do investment advisers assess the effect on client accounts of any material change to advisers' technology, algorithm, or model prior to implementation? Do investment advisers communicate with clients about such material changes? If so, how?

4.5 What, if anything, do investment advisers do to understand how AI/ML models will operate during periods of unusual or volatile market activity or other periods where such models may have less, or less relevant, input data with which to operate? How does the use of these models by investment advisers affect the market more generally? What formal governance mechanisms do investment advisers have in place for oversight of the vendors that create or manage these models?

4.6 How do investment advisers disclose the use of algorithms or models to their clients, including the role of advisory personnel or third parties in creating and managing these algorithms or models? Do these disclosures address any effects that such use may have on client outcomes? When investment advice is developed and provided through an automated algorithm, how do advisers disclose the use of that automated algorithm? Do investment advisers assess how effective these disclosures are in informing clients about such use? If so, how effective are such disclosures? Please provide any available data to show how effective such disclosures are. What are clients' expectations for investment advice produced by an investment adviser's automated algorithm, and how are those expectations shaped by investment advisers' disclosures?

4.7 How do investment advisers account for the use of any poor quality, inaccurate, or biased data that are used by AI/ML models, and how do investment advisers determine the effect of this kind of data on the algorithms' output or seek to reduce the use of this kind of data? To what extent can the use of AI/ML models in developing investment advice perpetuate social biases and disparities? How have commenters seen this in practice with regard to the use of AI/ML models (e.g., through marketing, asset allocation, fees, etc.)? To what extent and how do investment advisers employ controls to identify and mitigate any such biases or disparities? For example, do investment advisers evaluate the output of their models to identify and mitigate biases that would raise investor protection concerns? Do investment advisers utilize human oversight to identify biases that would raise investor protection concerns, in both the initial coding of their models or in the resulting output of those models?

4.8 Are there any particular challenges or impediments that investment advisers face in using AI/ML to develop and provide investment advice? If so, what are they and how do investment advisers address such challenges or impediments and any risks associated with them?

4.9 When relying on AI/ML models to develop investment advice, how do advisers determine whether those models are behaving as expected? How do advisers verify the quality of the assumptions and methodologies incorporated into such models? How frequently do advisers test these models? For example, do advisers test a model each time it is updated? What model risk management steps should advisers undertake? What is advisers' understanding of their responsibility to monitor, test, and verify model outputs? How do advisers' approaches with respect to AI/ML models differ from other models that advisers may use in developing investment advice?

4.10 In the context of developing and providing investment advice, what is the objective function of AI/ML models (e.g., revenue generation)? What are the inputs relied on by AI/ML models used in developing and providing investment advice (e.g., visual cues or feedback)? Does the ability to collect individual-specific data impact the effectiveness of the AI/ML model in maximizing its objective functions?

4.11 What cybersecurity and data security risks result from investment advisers' use of technology in developing and providing investment advice? How do investment advisers address or otherwise manage those risks and how do investment advisers disclose these risks to clients? Do investment advisers believe that delivering investment advice through email, which may be encrypted, is more secure than delivery through online client portals? Conversely, do investment advisers believe that delivery through online client portals is more secure? How do investment advisers address these concerns when clients are using mobile apps?

4.12 How do investment advisers generate records to support the investment advice they develop from using these types of technology? What types of records do they produce and how do investment advisers retain them? Does an investment adviser's recordkeeping process differ based on the type of technology it uses? If so, how?

4.13 Do investment advisers generate and retain records with respect to the testing of, or due diligence with respect to, the technology that they use in developing and providing investment advice?

4.14 To what extent do investment advisers market the types of technology the adviser uses in developing and providing investment advice? To the extent investment advisers market their use of technology, do advisers demonstrate that use to clients? To what extent do prospective and existing clients seek to assess investment advisers' understanding of the technology, or seek to understand the technology for themselves, in determining whether to hire or retain an investment adviser? If prospective or existing clients make such an assessment, how do they do so?

4.15 How do investment advisers disclose the types of technology used in developing and providing investment advice? What types of potential risks and conflicts of interest are disclosed? How are fees disclosed? To what extent does investment advisers' use of technology produce conflicts of interest that are similar to those of investment advisers that do not use such technologies? To what extent does investment advisers' use of technology produce conflicts that result from such use?

4.16 In what ways do investment advisers assess whether using these types of technology to develop and provide investment advice enables them to satisfy their fiduciary duty to their clients? How do investment advisers assess their ability to satisfy their duty of care and duty of loyalty when using these types of technology? How does an investment adviser determine whether the advice produced by its automated algorithm is in the best interest of a particular client? To what extent and how often do advisory personnel review investment advisers' algorithms to be sure that such advice is in the client's best interest? In conducting such review, to what extent do advisory personnel understand the algorithm, how it was created, and how it operates in practice? How do advisers take into account their fiduciary duty when developing, testing, monitoring, and overseeing these types of technology? To what extent do investment advisers rely on technology vendors or other third parties to provide technical knowledge so that advisers can understand the algorithms and the information or analysis they generate? When relying on such vendors or third parties, how do investment advisers assess whether the investment advisers are able to satisfy their duty of care and duty of loyalty?

4.17 What types of policies and procedures do investment advisers maintain with respect to the technologies they use in developing and providing investment advice to clients? For example, do these investment advisers maintain policies and procedures under rule 206(4)-7 of the Advisers Act that are designed to address the technologies that they use or provide to clients? How do investment advisers' policies and procedures address their use of technology and the duties they owe their clients? Do they address how advisers determine how to incorporate information or analysis developed by these types of technologies into investment advice that satisfies their fiduciary duty? If so, how? How do investment advisers introduce new technology to their personnel?

4.18 What types of operational risks do investment advisers face using digital platforms to interact with clients? How do investment advisers interact with clients when the platform is unavailable—for example, when the adviser has lost internet service or when the platform is undergoing maintenance? What alternative means of communication are available to clients during those times? When issues arise, is the investment adviser responsible to the client for resolving those issues, or does the investment adviser rely on others to resolve the issues or to be responsible to the client? What terms of service do investment advisers put in place with cloud service providers in connection with the potential for loss of service or loss of data? We understand that investment advisers, like other financial services companies, may rely on a small number of cloud service providers.[101] What risks does this reliance present to the industry (and advisory clients)?

4.19 Under what circumstances do robo-advisers typically override their algorithm, and in what ways? What steps do robo-advisers take to ensure that any override of the algorithm is consistent with the adviser's disclosure and clients' best interest? Do robo-advisers document their determinations to override the algorithm and, if so,

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101 See, e.g., Sophia Furber, As 'Big Tech' Dominates Cloud Use for Banks, Regulators May Need to Get Tougher, S&P Global (Aug. 18, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/as-big-tech-dominates-cloud-use-for-banks-regulators-may-need-to-get-tougher-59669007.

what specifically is documented? What have robo-advisers found to be the outcomes from overriding an algorithm?

4.20 When evaluating digital platforms, how do investment advisers weigh the platform's cost and quality of service?

4.21 Should the Commission consider amending Form ADV to collect information about the types of technology that advisers use to develop and provide investment advice? If so, what type of technology and why? What information about technology should we consider collecting? Should the Commission require investment advisers to describe their efforts to monitor the outputs of technology upon which they rely? Should the Commission consider another method of collecting this information?

4.22 What costs or benefits do investment advisers experience in registering with the Commission under the exemption for internet investment advisers? What costs or benefits do clients of internet investment advisers experience as compared to clients of other investment advisers registered with the Commission? Do commenters believe that the exemption for internet investment advisers should be updated in any way, including to facilitate its use or to modernize it? Are its conditions appropriate? Should we consider changes to, for example, the *de minimis* exception for non-internet clients or the recordkeeping requirement? Should we consider changes to the exemption's definition of "interactive website"? Should the exemption specify what it means to provide investment advice "exclusively" through the interactive website? Would additional guidance on any of the exemption's conditions or definitions be useful?

4.23 The Commission has stated that an investment adviser relying on the internet investment adviser exemption "may not use its advisory personnel to elaborate or expand upon the investment advice provided by its interactive Web site, or otherwise provide investment advice to its internet clients."[102] Should the Commission consider eliminating or modifying this language? Should the Commission consider changes to the exemption that reflect or otherwise address this language? Should the Commission provide additional guidance about the internet investment adviser exemption?

4.24 As discussed above, the Commission acknowledged that the internet investment adviser exemption was designed to balance these advisers' multiple state registration requirements with the Advisers Act's allocation of responsibility for regulating smaller advisers to state securities authorities. Consistent with this design, are there changes to the exemption that might help to ensure that it encompasses those investment advisers that provide advice through the internet while ensuring that advisers that use the internet only as a marketing tool, for example, remain subject to state registration? Should the Commission consider creating a registration exemption that reflects investment advisers' current use of technology in providing investment advice in a better way than the internet investment adviser exemption?

4.25 To what extent do investment advisers use digital platforms and other analytical tools in connection with wrap fee programs?[103] For example, do these programs use model

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102 Internet Investment Adviser Adopting Release, supra note 83, at 77621.

103 In a wrap fee program, clients generally are charged one fee in exchange for investment advisory services, the execution of transactions, and custody (or safekeeping) as well as other services. An adviser acting as a sponsor to such a program may choose the service

portfolios or portfolio allocation models (whether developed by the investment adviser or by a third party that provides such models to the adviser for its use) to recommend investor allocations?[104] Do wrap fee programs with an online presence allow clients to engage directly with the portfolio manager managing the client's assets or provide access to a wider array of service providers than the client might otherwise have? Are there concerns with respect to these programs for clients with minimal or no trading activity as commissions for trade execution have moved toward zero?[105] Are such concerns different for wrap fee programs sponsored by robo-advisers as compared to those sponsored by traditional investment advisers?

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providers, including other investment advisers, and provide clients with access to those services through internet-based platforms that enable clients to engage directly with service providers.

104 A model portfolio generally consists of a diversified group of assets (often mutual funds or ETFs) designed to achieve a particular expected return with exposure to corresponding risks that are rebalanced over time. See Morningstar, 2020 Model Portfolio Landscape (2020) (noting that, while models can focus on a single asset class, most models combine multiple asset classes). Model portfolios are distinct from portfolio allocation models, which can be educational tools that investors use to obtain a general sense of which asset classes (as opposed to which specific securities) are appropriate for the investor to allocate its assets to (e.g., appropriate balance of equities, fixed income, and other assets given age and other facts and circumstances).

105 See generally Securities and Exchange Commission, Division of Examinations, Risk Alert: Observations from Examinations of Investment Advisers Managing Client Accounts That Participate in Wrap Fee Programs (July 21, 2021), at 4 ("Infrequent trading in wrap fee accounts was also identified at several examined advisers, raising concerns that clients whose wrap fee accounts are managed by portfolio managers with low trading activity are paying higher total fees and costs than they would in non-wrap fee accounts."), https://www.sec.gov/files/wrap-fee-programs-risk-alert_0.pdf. The Risk Alert represents the views of the staff of the Division of Examinations. It is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved its content. The Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

4.26 To what extent do robo-advisers (as well as other sponsors of investment advisory programs) rely on Rule 3a-4 to determine that they are not sponsoring or otherwise operating investment companies under the Investment Company Act of 1940 (the "Investment Company Act")?[106] If such sponsors do not rely on the rule, what policies and practices have sponsors adopted to prevent their investment advisory programs from being deemed to be investment companies?

4.27 To satisfy the conditions of Rule 3a-4, among other things, a sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management must be reasonably available to the client for consultation. The rule does not dictate the manner in which such consultation with clients should occur. How do sponsors and other advisers satisfy this condition? Should we consider amending Rule 3a-4 to address technological developments, such as chatbots and/or other responsive technologies providing novel ways of interacting with clients? Should the Commission address these developments in some other way? Should the Commission provide additional guidance about this condition? If yes, what specifically should this guidance address?

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106 See 17 CFR 270.3a-4. Certain discretionary investment advisory programs may meet the definition of "investment company" under the Investment Company Act, but the Commission has indicated that investment advisory programs that provide each client with individualized treatment and the ability to maintain indicia of ownership of the securities in their accounts are not investment companies. Whether such a program is an investment company is a factual determination and depends on whether the program is an issuer of securities under the Investment Company Act and the Securities Act. Rule 3a-4 under the Investment Company Act provides a non-exclusive safe harbor from the definition of "investment company" to investment advisory programs that are organized and operated in the manner provided in the rule. A note to the rule also states that there is no registration requirement under Section 5 of the Securities Act for programs that rely on the rule, and that the rule is not intended to create any presumption about a program that does not meet the rule's provisions.

4.28 To satisfy the conditions of Rule 3a-4, among other things, each client's account must be managed on the basis of the client's financial situation and investment objectives. Sponsors must obtain information from each client about their financial situation and investment objectives at account opening and must contact each client at least annually thereafter to determine whether there have been any changes in the client's financial situation or investment objectives. The Commission stated that the receipt of individualized advice is "one of the key differences between clients of investment advisers and investors in investment companies."[107] How do sponsors ensure that they have sufficient information about a client's financial situation and investment objectives to provide investment advice that is in the best interest of the client, including advice that is suitable for the client? Given the availability of new technology for developing and providing investment advice, does a sponsor's reliance on Rule 3a-4 heighten the risk of clients receiving unsuitable advice? If so, are there other requirements or conditions that might address this risk?

4.29 One of the conditions of Rule 3a-4 is that investment advisory programs relying on the rule be managed in accordance with any reasonable restrictions imposed by the client on the management of the client's account. In addition, the client must have the opportunity to impose reasonable restrictions at the time the account is opened

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[107] See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Rel. No. 21260 (July 27, 1995), 60 FR 39574 (Aug. 2, 1995). The Commission also stated that to fulfill its duty to provide only suitable investment advice, "an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives. The adviser's use of a model to manage client accounts would not alter this obligation in any way." See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Rel. No. 22579 (Mar. 24, 1997), 62 FR 15098 (Mar. 31, 1997).

and must be asked at least annually whether the client might wish to impose any reasonable restrictions or reasonably modify existing restrictions. The Commission explained that the ability of a client to impose reasonable restrictions on the management of a client account is a critical difference between a client receiving investment advisory services and an investor in an investment company. Since the rule was adopted, enhanced technological capabilities and industry practices may have made it practical for sponsors to provide clients with other means of receiving meaningful individualized treatment regarding the management of their accounts. Do sponsors of investment advisory programs currently provide their clients with ways of customizing or personalizing their accounts other than through the imposition of reasonable restrictions? If yes, please provide examples of such practices. To what extent do clients avail themselves of those options for individualized treatment and do they find them to be valuable or important? Should we consider amending Rule 3a-4 to address these developments or should we address them in some other way, such as by providing additional guidance about this condition?

4.30 In view of the variety and increasing availability of technologies used by investment advisers to develop and provide investment advice, are there other regulatory matters that the Commission should consider? If so, what are they, and why? To the extent commenters recommend any modifications to existing regulations or additional regulations, what economic costs and benefits do commenters believe would result from their recommendations? Please provide or identify any relevant data and other information.

IV. GENERAL REQUEST FOR COMMENT

This Request is not intended to limit the scope of comments, views, issues, or approaches to be considered. In addition to broker-dealers, investment advisers and investors, we welcome comment from other interested parties, researchers and particularly welcome statistical, empirical, and other data from commenters that may support their views or support or refute the views or issues raised by other commenters.

By the Commission.

Dated: August 27, 2021.

Vanessa A. Countryman,

Secretary.

Appendix A

Tell Us about Your Experiences with Online Trading and Investment Platforms

We're asking individual investors like you what you think about online trading or investment platforms such as websites and mobile applications ("apps"). It's important to us at the SEC to hear from investors who trade and invest this way so we can understand your experiences.

Please take a few minutes to answer any or all of these questions. Please provide your comments on or before October 1, 2021 - and thank you for your feedback!

1. Do you have one or more online trading or investment accounts?

- o Yes, I have one or more accounts that I access online using a computer.
- o Yes, I have one or more accounts that I access using a mobile app.
- o Yes, I have one or more accounts that I access both online using a computer and using a mobile app.
- o Yes, I have one or more accounts that I access online, either using a computer or a mobile app, but I also access the account(s) in other ways (e.g., by calling or visiting in person).
- o I have one or more accounts, but I do not access them online using a computer or using a mobile app.
- o No, I don't have a trading or investment account.

2. If your response to Question 1 is "Yes", do you think you would trade or invest if you could not do so online using a computer or using a mobile app?

- o Yes
- o No

3. On average, how often do you access your online account?

- o Daily/more than once a day
- o Once to a few times a week
- o Once to a few times per month
- o Less often than once a month
- o Never
- o Other

If Other, Explain:

4. On average, how often are trades made in your online account, whether by you or someone else?

- o Daily/more than once a day
- o Once to a few times a week
- o Once to a few times per month
- o Less often than once a month
- o Never
- o Other

If Other, Explain:

5. If you access your account online, did you have the account first, and only began to access it electronically later? Or did you open the account with the idea that you would access it electronically immediately?

- o I had a pre-existing account and downloaded an app or visited a website to access my account.
- o I downloaded an app or visited a website first, and then opened up an account with the company.

6. My goals for trading or investing in my online account are (check all that apply):

- ☐ Keep the amount of money I have, while keeping up with inflation
- ☐ Save and grow my money for short-term goals (in the next year or two)
- ☐ Save and grow my money for medium- to long-term goals
- ☐ Have fun
- ☐ Other

If Other, Explain:

7. What would you like us to know about your experience with the features of your online trading or investment platform? (Examples of features are: social networking tools; games, streaks, or contests with prizes; points, badges, and leaderboards; notifications; celebrations for trading; visual cues, like changing colors; ideas presented at order placement or other curated lists or features; subscription and membership tiers; or chatbots.)

8. If you were trading or investing prior to using an online account, how have your investing and trading behaviors changed since you started using your online account? (For example, the amount of money you have invested, your interest in learning about investing and saving for retirement, the amount of time you have spent trading, your knowledge of financial products, the number of trades you have made, the amount of money you have made in trading, your knowledge of the markets, the number of different types of financial products you have traded, or your use of margin.)

9. How much experience do you have trading or investing in the following products (None, Less than 12 months, 1-2 years, 2-5 years, 5+ years):

Investment Products	None	Less than 12 Months	1-2 Years	2-5 Years	5+ Years
Stocks	o	o	o	o	o
Bonds	o	o	o	o	o
Options	o	o	o	o	o
Mutual Funds	o	o	o	o	o
ETFs	o	o	o	o	o
Futures	o	o	o	o	o
Cryptocurrencies	o	o	o	o	o
Commodities	o	o	o	o	o
Closed-End Funds	o	o	o	o	o
Money Market Funds	o	o	o	o	o
Variable Insurance Products	o	o	o	o	o
Business Development Companies	o	o	o	o	o
Unit Investment Trusts	o	o	o	o	o

10. What is your understanding, if any, of the circumstances under which trading or investing in your account can be suspended or restricted?

11. What else would you like us to know – positive or negative - about your experience with online trading and investing?

Other Ways to Submit Your Feedback

You also can send us feedback in the following ways (include the file number S7-10-21 in your response):
Print Your Responses and Mail Secretary Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090
Print a PDF of Your Responses and Email Use the printer-friendly page and select a PDF printer to create a file you can email to: rule-comments@sec.gov
Print a Blank Copy of this Flyer, Fill it Out, and Mail Secretary Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090

Contact Info (Not required; to submit anonymously, leave blank)

First Name: ________________________ Last Name:____________________________

We will post your feedback on our website. Your submission will be posted without change; we do not redact or edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly.

If you are interested in more information on the proposal, or want to provide feedback on additional questions, click here. Comments should be received on or before October 1, 2021.

Thank you!