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FINRA's 2024 Annual Regulatory Oversight Report: What Broker-Dealers Need to Know

January 17, 2024

On January 9, 2024, the Financial Industry Regulatory Authority (FINRA) published its *2024 FINRA Annual Regulatory Oversight Report* (Report).[1] Previously titled *Report on FINRA's Examination and Risk Monitoring Program*, the Report is released each year and provides insight into findings from FINRA's oversight activities in key focus areas. For each area selected by FINRA, the Report outlines effective practices and common regulatory deficiencies FINRA has observed and identifies questions firms should consider in assessing their compliance programs. In this alert, we highlight some notable changes to this year's Report, including new topics and emerging risks as well as new findings and suggested considerations added by FINRA to existing sections. We have organized our key takeaways around three main topics: (i) sales practices, (ii) trading and (iii) other recent trends and emerging risks, including the use of artificial intelligence tools.

Key Takeaways Related to Retail Sales Practices

Regulation Best Interest (Reg BI): Focus on Care Obligation and Conflicts of Interest

Care Obligation

Reg BI establishes a "best interest" standard of conduct for broker-dealers and their associated persons when they recommend to retail customers any securities transaction or investment strategy involving securities, including account recommendations.[2] The Report incorporates recent Securities and Exchange Commission (SEC) staff guidance on Reg BI's Care Obligation and

[1] FINRA, 2024 FINRA Annual Regulatory Oversight Report (Jan. 9, 2024), https://www.finra.org/rules-guidance/guidance/reports/2024-finra-annual-regulatory-oversight-report (Report).

[2] 17 C.F.R. § 240.15l–1.

identifies considerations for assessing and documenting "reasonably available alternatives" when making recommendations.[3] Specifically, the Report identifies the following new considerations:

- Does your firm and do its associated persons understand **how they should consider reasonably available alternatives** and, to the extent required by your firm's policies and procedures, **when to document these considerations**?
    - Do your firm and its associated persons consider the **potential risks, rewards and costs** associated with reasonably available alternatives?
    - Has your firm developed a process to identify the scope of reasonably available alternatives that its associated persons should evaluate?
        - Do your firm and its associated persons begin by considering a broader array of investments or investment strategies generally consistent with the retail customer's profile, before narrowing the scope of a smaller universe of potential investments or investment strategies, as the analysis becomes more focused on meeting the best interest of a particular retail customer?
    - Do your firm and its associated persons **consider reasonably available alternatives to high-risk and complex products** when making recommendations to retail customers? If so, how? When recommending a higher-cost or higher-risk product, do your firm and its associated **persons consider whether any reasonably available alternatives are less costly or lower risk**, and consistent with the retail customer's investment profile?[4]

While the Report lists a number of considerations that firms should assess as part of their Reg BI programs, it does not provide much detail on how firms should implement these considerations.[5] Rather, it appears to provide firms with discretion to decide, for example, how to identify and consider "reasonably available alternatives" for different categories of investments and when and how to document those considerations. That said, firms should expect scrutiny of their processes to evaluate, document and supervise considerations of reasonably available alternatives, particularly when a lower-cost, less complex or lower-risk product may be available.

Relatedly, in the Report, FINRA includes a new finding that firms fail to comply with the Care Obligation by recommending complex or illiquid products that are inconsistent with a retail customer's investment profile when, for example, they exceed concentration limits specified in the firm's policies or comprise a sizable portion of a retail customer's liquid net worth or securities

[3] Report, at 44–45 (incorporating elements of SEC Staff, Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations, SEC (Apr. 20, 2023), https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers).

[4] Id. (emphasis added).

[5] Id. at 43–51.

holdings.[6] The Care Obligation, as it relates to complex or illiquid products, such as private placements, has also been a focus for the SEC's Division of Examinations, which included similar considerations in its discussion of Reg BI in its *2024 Examination Priorities*.[7]

Conflicts of Interest Obligation

The Report also highlights several new considerations for identifying conflicts of interest, such as:

- evaluating whether conflicts of interest arise in different aspects of the relationship with the retail customer (e.g., account recommendations, product menus, allocation of investment opportunities among retail customers, and cash management services);
- establishing a process for identifying new conflicts that arise, for example, in connection with changes to the firm's business or structure, changes in compensation structures, or the introduction of new products or services; and
- having a process to assess whether compensation practices may raise conflicts, including whether practices incentivize associated persons to offer recommendations that are not in retail customers' best interests, whether the basis for determining associated persons' compensation effectively passes along firm-level conflicts by incentivizing them to recommend certain products, account types or services to retail customers that are most profitable for the firm, and whether there are other types of compensation or benefits that may create conflicts of interest that would need to be addressed under Reg BI.[8]

Communications with the Public: Mobile Apps, Nudges and Content Deficiencies

FINRA Rule 2210 governs communications between a broker-dealer and the public and establishes content standards, review requirements and filing requirements. FINRA Rule 2220 governs firms' communications with the public relating to options.

The Report highlights the need for brokerage mobile apps and, relatedly, "nudges" by broker-dealers to promote customer engagement on those apps, to comply with risk disclosure content standards.[9] The use of the term "nudge" hearkens to prior statements by SEC officials and SEC staff relating to the "gamification" of the stock market and concerns that retail investors are being "nudged" into trading more frequently and in products outside of their risk profile, such as options, crypto or products that involve the use of leverage.[10] Although FINRA does not explicitly identify

[6] Id. at 47.

[7] SEC Staff, Division of Examinations, 2024 Examination Priorities, SEC (Oct. 16, 2023), https://www.sec.gov/files/2024-exam-priorities.pdf.

[8] Report, at 45–46.

[9] Id. at 40.

[10] See, e.g., Chair Gary Gensler, "Investor Protection in a Digital Age," Remarks Before the 2022 North American Securities Administrators Association Spring Meeting & Public Policy Symposium, SEC (May 17, 2022), https://www.sec.gov/news/speech/gensler-remarks-nasaa-spring-meeting-051722; Request for

those same concerns in the Report, the connection is clear, as the Report stresses the importance of risk disclosures to retail customers generally and specifically highlights the need to fully and prominently disclose risks relating to the use of margin and trading in options and crypto assets.[11] Firms can expect that advertisements or other communications that could be perceived as marketing riskier, costlier or more complex products to customers will be subject to additional regulatory scrutiny under the FINRA content standards.

Key Takeaways Related to Trading

Best Execution and Interpositioning (Best Ex): Ascertaining the Best Market, Including for Listed Options

FINRA Rule 5310 requires that, in any transaction for or with a customer or a customer of another broker-dealer, a firm use "reasonable diligence to ascertain the best market for the subject security" and trade in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.[12] Firms must also monitor and supervise their compliance with this standard, including through periodic "regular and rigorous" reviews of the execution quality they are obtaining for customer orders if they do not conduct an order-by-order review.[13]

Under the Best Ex section of the Report, FINRA included the following new questions for firms to consider as part of their Best Ex assessments:

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

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, 86 Fed. Reg. 49067 (Sept. 1, 2021); Gary Gensler, Prepared Remarks at SEC Speaks, SEC (Oct. 12, 2021), https://www.sec.gov/news/speech/gensler-sec-speaks-2021-10-12; Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960, 54002 (Oct. 10, 2023) ("The use of these technologies can generate conflicts of interest if firms use these technologies to suggest or nudge users to trade more frequently on their platform, or to invest in products that are more profitable for the firm but expose investors to higher costs or risks, against investors' interests.").

[11] Report, at 40–42.

[12] FINRA Rule 5310(a)(1).

[13] FINRA Rule 5310.09.

- If applicable, does your firm **conduct an independent review of the execution quality obtained by another firm to which your firm routes all** of its customer orders?[14]

FINRA's decision to highlight retail liquidity programs and odd lots is notable and mirrors related discussions in the SEC's proposed Regulation Best Execution and the other SEC market structure proposals that focus on alternative liquidity sources.[15] FINRA's focus on "interpositioning" is also interesting and likely stems from a recent enforcement action that found a violation of Rule 5310(a)(2) as well as Rule 5310(a)(1).[16] Finally, as evidenced by the last question in the above list, firms that route all their orders (or all orders of a given type) to a single broker-dealer should anticipate that FINRA will scrutinize their independent assessment of the execution quality they receive from that broker-dealer.

In addition to highlighting new considerations for Best Ex assessments generally, the Report provides new considerations for listed options specifically.[17] The Report includes the following questions on listed options orders, where the market structure is significantly different and the publicly available execution quality data is far more limited than for cash equities:

- If applicable, how does your firm **monitor options exchange order exposure requirements, auction mechanism usage and venue routing**?
- How does your firm monitor such requirements **when routing orders to an affiliated entity or another broker-dealer that provides PFOF**?[18]

These questions introduce considerations for listed options similar to those discussed in proposed Regulation Best Execution. In that proposal, the SEC stated that "a retail broker-dealer's policies and procedures could evaluate wholesaler practices concerning the use of price improvement auctions and whether such wholesalers are appropriately considering a broader range of opportunities to expose customer orders and identifying exposure opportunities that are designed to enhance competition for customer orders."[19]

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[14] Report, at 62–63 (emphasis added).

[15] For a discussion of the SEC's four market structure proposals, please see the WilmerHale client alert available at https://www.wilmerhale.com/insights/client-alerts/20221216-sec-holiday-reading-list-four-rule-proposals-that-would-overhaul-market-structure-and-how-retail-orders-are-executed. For a more targeted discussion of proposed Regulation Best Execution, please see the WilmerHale client alert available at https://www.wilmerhale.com/insights/client-alerts/20230216-the-sec-proposes-regulation-best-execution.

[16] FINRA Letter of Acceptance, Waiver, and Consent No. 2014041809401 (Dec. 28, 2023), available at https://www.finra.org/sites/default/files/fda_documents/2014041809401%20Interactive%20Brokers%20LLC%20CRD%2036418%20AWC%20vr.pdf.

[17] Report, at 62.

[18] Id. (emphasis added).

[19] Regulation Best Execution, 88 Fed. Reg. 5330, 5470–71 (Jan. 27, 2023).

Regulation SHO (Reg SHO): Bona Fide Market Making and Close-Out

Reg SHO imposes four general requirements with respect to short sales of equity securities: a marking requirement, a short sale price test circuit breaker, a locate requirement and a close-out requirement.[20] Rule 203(b)(1) (the locate requirement) generally prohibits a broker-dealer from accepting a short sale order in an equity security from another person, or effecting a short sale in an equity security for the broker-dealer's own account, unless the broker-dealer has borrowed the security, has entered into a bona fide arrangement to borrow it, or has reasonable grounds to believe that the security can be borrowed and delivered on the delivery date.[21] Rule 203(b)(2) provides an exception to the locate requirement for short sales effected by a market maker in connection with "bona fide market making activities."[22] Under Rule 204 of Reg SHO (the close-out requirement), registered clearing agency participants must deliver equity securities for clearance and settlement by settlement date or must close out a fail to deliver by the times described in that rule.[23] Under Rule 204(a)(3), participants that have a fail-to-deliver position attributable to bona fide market-making activities are provided additional time to close out such positions.[24]

In the Report, FINRA continues to focus on firms' compliance with the bona fide market-making exception in Reg SHO, noting that firms must confirm and be able to demonstrate that they qualify for the exception in any transaction for which they rely on it. The Report stresses that "a bona fide market maker must regularly and continuously place quotations in a quotation medium on both the bid and ask side of the market."[25] With regard to Reg SHO's close-out requirement, the Report highlights (i) the importance of developing appropriate policies and procedures to comply with the requirement, and (ii) that firms cannot use American Depositary Receipt conversion activity to satisfy the close-out requirement (in contrast, they can use exchange-traded fund conversion activity to satisfy this requirement under certain circumstances).[26]

Disclosure of Order Routing Information: Equity Securities

Rule 606 of Regulation NMS requires broker-dealers to disclose information regarding the handling of covered customer orders in NMS stocks and listed options.[27] The Report highlights new FINRA rules governing the disclosure of order routing information, FINRA Rules 6151 (Disclosure of Order

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[20] 17 C.F.R. § 242.200 et seq.

[21] 17 C.F.R. § 242.203(b)(1).

[22] 17 C.F.R. § 242.203(b)(2).

[23] 17 C.F.R. § 242.204.

[24] 17 C.F.R. § 242.204(a)(3).

[25] Report, at 67.

[26] Report, at 67–68; SEC No-Action Letter, Murphy & McGonigle, P.C. (Apr. 26, 2017), available at https://www.sec.gov/divisions/marketreg/mr-noaction/2017/murphy-mcgonigle-042617-204-sho.pdf.

[27] 17 C.F.R. § 242.606.

Routing Information for NMS Securities) and 6470 (Disclosure of Order Routing Information for OTC Equity Securities). Among other things, the new rules will require members to:

- on a quarterly basis, publish new monthly order routing disclosures for orders in OTC Equity Securities; and
- submit both the new order routing reports for OTC Equity Securities and their order routing reports for NMS securities under Rule 606 to FINRA for centralized publication on the FINRA website.[28]

OTC Quotations in Fixed Income Securities

Rule 15c2-11 under the Exchange Act governs the publication or submission of quotations by broker-dealers in a quotation medium other than a national securities exchange.[29] For many years, the industry and the regulators focused on the application of Rule 15c2-11 to equity securities. However, the Report adds a new section focused on fixed income titled "OTC Quotations in Fixed Income Securities."[30] This addition echoes the SEC's renewed focus on the application of Rule 15c2-11 to fixed income securities.[31] In it, FINRA provides guidance on how firms should seek to comply with Rule 15c2-11 when trading OTC fixed income securities.

Somewhat surprisingly, this section does not mention the recent SEC order exempting from Rule 15c2-11 fixed income securities sold in compliance with the safe harbor in Rule 144A under the Securities Act, which comprises a significant portion of the OTC fixed income market.[32]

Notable Emerging Risks and Recent Trends Discussed in the Report

Artificial Intelligence (AI)

FINRA flags the use of AI technology as an "emerging risk" in the financial services industry—noting that while this rapidly evolving technology has the potential to create operational efficiencies resulting in better service to customers, its expansion is also marked by concerns about accuracy,

[28] Report, at 64.

[29] 17 C.F.R. § 240.15c2-11.

[30] Report, at 70–71.

[31] For a discussion of Rule 15c2-11, please see the WilmerHale client alert available at https://www.wilmerhale.com/insights/client-alerts/20201029-sec-amends-rule-15c2-11-to-enhance-publicly-available-information-for-securities-quoted-in-the-over-the-counter-markets.

[32] SEC, Order Granting Broker-Dealers Exemptive Relief, Pursuant to Section 36(a) and Rule 15c2-11(g) under the Securities Exchange Act of 1934, from Rule 15c2-11 for Fixed-Income Securities Sold in Compliance with the Safe Harbor of Rule 144A under the Securities Act of 1933, 88 Fed. Reg. 75343 (Nov. 2, 2023).

privacy, bias and intellectual property, among others.[33] Because "the use of AI tools could implicate virtually every aspect of a member firm's regulatory obligations," the Report notes that "firms should consider these broad implications before deploying such technologies," and remain mindful that the regulatory landscape may change as the area develops.[34] The Report suggests that, at this time, firms consider paying particular attention to the following areas when considering their use of AI: anti-money laundering (AML); books and records; business continuity; communications with the public; customer information protection; cybersecurity; model risk management (including testing, data integrity and governance, and explainability); research; Reg BI; supervision; and vendor management.[35]

The use of AI in the financial services industry has been on the SEC's radar as well. SEC officials have remarked on the transformational potential and the risks of using AI in the financial markets and in the provision of financial services.[36] The SEC recently proposed rules intended to address conflicts of interest related to the use of "predictive data analytics" (including the use of AI, machine learning, natural language processing, chatbots and other technologies) by broker-dealers and investment advisers.[37]

Crypto Assets

In another newly added section, FINRA provides guidance for firms seeking FINRA approval to engage in crypto asset-related activity and highlights obligations of firms that have associated persons engaged in crypto-related activity outside of the firm.[38] FINRA identifies specific regulatory and compliance challenges and risks that firms should evaluate before engaging in crypto-related activities. This would include, for example, a review of their compliance and supervisory programs around cybersecurity, AML compliance, communications with customers, manipulative trading, performing due diligence on crypto asset private placements, and supervising associated persons' involvement in crypto asset-related outside business activities (OBAs) and private securities transactions (PSTs).

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[33] Report, at 10.

[34] Id.

[35] Id.

[36] See, e.g., Stefania Palma and Patrick Jenkins, Gary Gensler urges regulators to tame AI risks to financial stability, Financial Times (Oct. 15, 2023), https://www.ft.com/content/8227636f-e819-443a-aeba-c8237f0ec1ac.

[37] For a discussion of the SEC's proposed rules regarding "predictive data analytics," please see the WilmerHale client alert available at https://www.wilmerhale.com/insights/client-alerts/20230817-broker-dealers-and-advisers-beware-the-secs-pda-proposal-could-upend-firms-interactions-with-customers-clients-and-investors. See also Gary Gensler, "Isaac Newton to AI" Remarks before the National Press Club, SEC (July 17, 2023), https://www.sec.gov/news/speech/gensler-isaac-newton-ai-remarks-07-17-2023.

[38] Report, at 21–25.

The Report describes the review of a member's crypto asset securities business lines by the FINRA Membership Application Program and describes the types of crypto asset securities business in which members have been approved to engage.[39] The Report also restates FINRA's prior guidance encouraging member firms to notify FINRA if they or their affiliates engage or plan to engage in crypto asset-related activities, including activities related to crypto assets that are not securities.[40]

The Report includes considerations for members determining whether to submit a New Membership Application or Continuing Membership Application to operate a crypto asset ATS or "special purpose broker-dealer" as well as considerations for firms with associated persons who may engage in crypto-related OBA and PST activity.[41] For example, the Report notes that firms should consider whether they have established written policies, procedures and controls to determine whether a crypto asset is a security when necessary (e.g., when assessing whether an OBA is a PST).[42] Thus, member firms that do not offer crypto-related products may still be required to have crypto-related polices, procedures and controls if they permit their associated persons to engage in crypto-related activities.

The Report also highlights surveillance themes based on potential violations by FINRA members involving crypto assets, and highlights effective practices such as due diligence on unregistered offerings, customer outreach and on-chain reviews (that is, the review of data on the blockchain to determine compliance with applicable regulatory requirements).[43]

Finally, the Report explains that crypto asset-related communications reviewed by FINRA's Advertising Regulation Department had a non-compliance rate that was significantly higher than that of other products.[44] As a result, FINRA conducted targeted examinations of firms that actively

[39] Report, at 21 ("FINRA's MAP has approved firms to engage in crypto asset securities business, including: serving as placement agent in the private placement of crypto asset securities; operating an Alternative Trading System (ATS) for crypto asset securities; and providing custodial services for crypto asset securities, under the SEC's December 23, 2020, statement regarding Custody of Digital Asset Securities by Special Purpose Broker-Dealers …").

[40] Id.; see also Regulatory Notice 20-23 (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets) and Regulatory Notice 21-25 (FINRA Continues to Encourage Firms to Notify FINRA if They Engage in Activities Related to Digital Assets).

[41] Report, at 21–22.

[42] Id. at 22.

[43] Id. at 23 (listing FINRA Rules 2210 (Communications with the Public), 3110 (Supervision), and 3310 (Anti-Money Laundering Compliance Program) as surveillance themes).

[44] Id.

communicate with retail customers concerning crypto assets and crypto asset-related services.[45] FINRA expects to publish a future update on its findings and effective practices.[46]

Off-Channel Communications

Given the recent spate of SEC (and Commodity Futures Trading Commission) enforcement actions and fines related to firms' failures to preserve and surveil business-related communications sent or received over unapproved communication channels, it is not surprising that the Report highlights this topic for attention. FINRA notes in the Report that it uses a risk-based approach to review how firms capture, maintain and surveil business-related communications, including off-channel communications, and that going forward, it will share helpful observations and effective practices that emerge from its reviews.[47] FINRA does not, however, provide any detail on what this "risk-based approach" means or how it is determined. The Report also includes new "guiding questions" that firms may consider in assessing their surveillance and compliance processes.[48] Specifically, firms should consider whether:

- their surveillance of communications via approved channels looks for indicia of communications occurring through off-channel text or encrypted messaging channels (e.g., email chains that copy a registered representative's email address from an off-channel domain, references in emails to electronic communications that occurred outside firm-approved channels or customer complaints mentioning such communications);
- their surveillance of communications looks for signs that approved channels of communications are underutilized (which could present a red flag that an associated person is utilizing an unapproved channel for business communications); and
- they have implemented corrective or disciplinary measures to deter associated persons from circumventing supervisory controls related to off-channel communications.

While these guidelines are not surprising and not new to many firms that are dealing with the challenges raised by off-channel communications, they are notable because they signify a renewed focus on this issue by FINRA. Accordingly, firms should be prepared to answer questions regarding their communications policies and procedures during FINRA exams.

Conclusion

As expected, the Report follows several recent trends, incorporating concepts from various market and regulatory developments from the past year, including some SEC rulemaking proposals that

[45] Id.

[46] Id.

[47] Id. at 30.

[48] Id.

have not yet been finalized. While not exhaustive, the Report gives ideas on what issues FINRA will likely be looking at when it enters its next examination cycle. Firms should review the Report and evaluate whether and how their compliance programs could be enhanced by incorporating FINRA's considerations, findings and effective practices.

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