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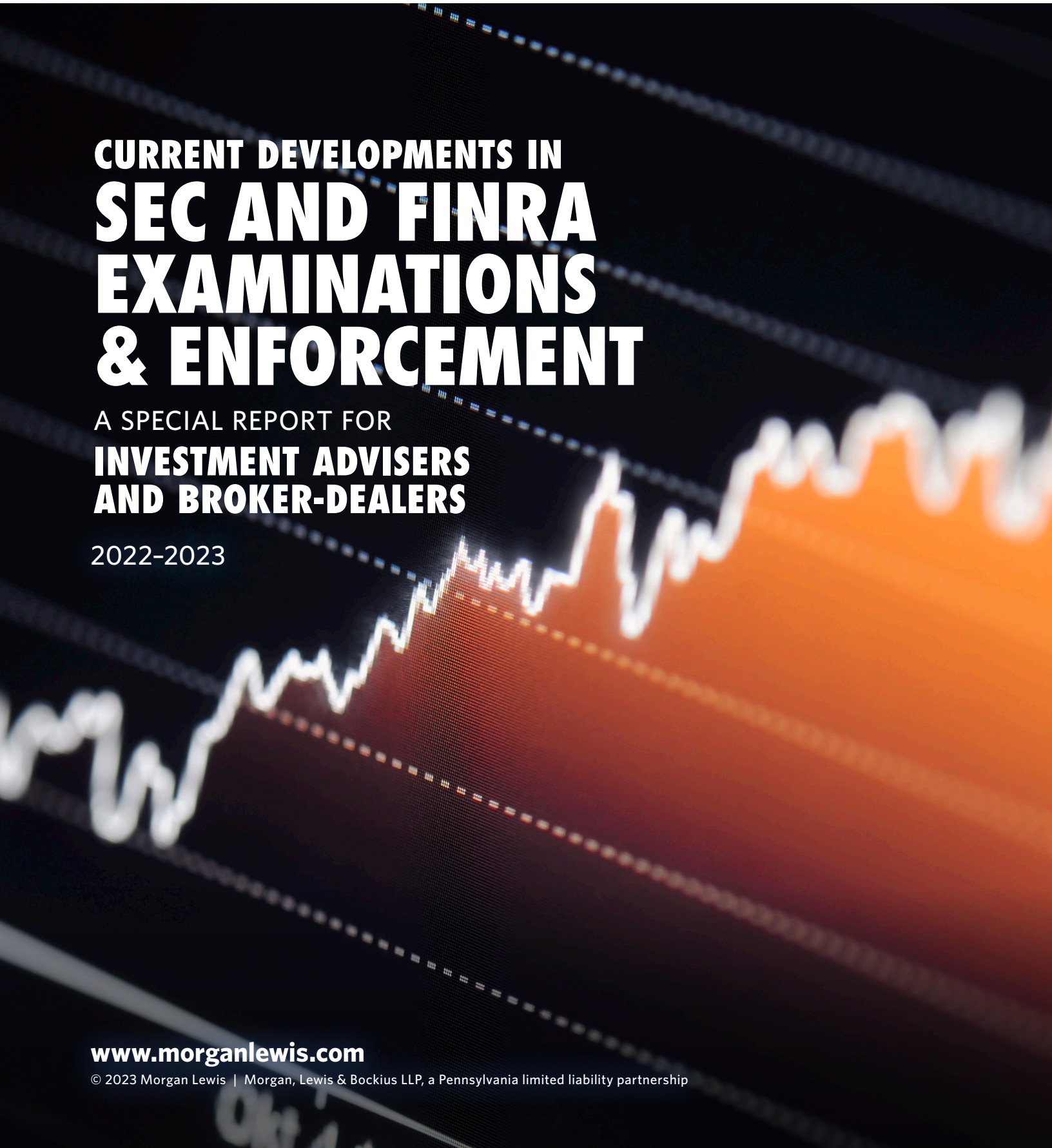
REPORT



CURRENT DEVELOPMENTS IN SEC AND FINRA EXAMINATIONS & ENFORCEMENT

A SPECIAL REPORT FOR

INVESTMENT ADVISERS AND BROKER-DEALERS

2022–2023

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CURRENT DEVELOPMENTS IN SEC AND FINRA EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR INVESTMENT ADVISERS AND BROKER-DEALERS

2022–2023

Registered entities continued to be a significant focus of the US Securities and Exchange Commission's (SEC's or Commission's) enforcement and rulemaking programs in 2022, and we expect similar attention this year. The SEC's Division of Examinations recently issued its 2023 Examination Priorities Report, highlighting a number of areas that will draw increased scrutiny from the Examinations staff and are likely precursors to future enforcement sweeps and referrals.[1] Similarly, the Financial Industry Regulatory Authority's (FINRA's) January 10, 2023 Report on Examination and Risk Monitoring Program identified many areas of focus for broker-dealers that will garner continued attention, including Regulation Best Interest, Consolidated Audit Trail, mobile apps, and cybersecurity.[2]

Last year will be remembered for aggressive rulemaking and enforcement, with the SEC securing record-breaking penalties. FINRA's new Sanction Guidelines, which in part eliminated upper limit fine ranges for mid-size/large firms and catalogued several additional nonmonetary sanctions, suggest that FINRA too will be escalating sanctions.[3]

Ambitious regulatory agendas combined with an already heavy enforcement and examination focus on investment advisers and broker-dealers means that this year is likely to see registered entities continue to attract a disproportionate amount of regulators' attention. Outlined below are some key items that investment advisers and broker-dealers should expect to encounter this year, divided by section:

For readers concerned with how the SEC's examination and enforcement outlook will affect private funds advisers, please see our companion piece directed to private funds.

GENERAL SEC ENFORCEMENT OUTLOOK FOR REGISTRANTS

Penalties, Sweeps, New Hires, and Newton's Third Law

Two years ago, we devoted substantial space to reviewing SEC Chairman Gary Gensler's time at the Commodity Futures Trading Commission (CFTC) and forecasting a significant rise in SEC enforcement activity.[4] Last year we focused on Director Grewal's discussion of "speeding tickets" as an indication of an SEC willing to pursue and penalize routine violations.[5] The statistics recently released by the SEC's Division of Enforcement reflect aggressive enforcement and outsized civil penalties untethered, in many instances, to past precedent.[6]

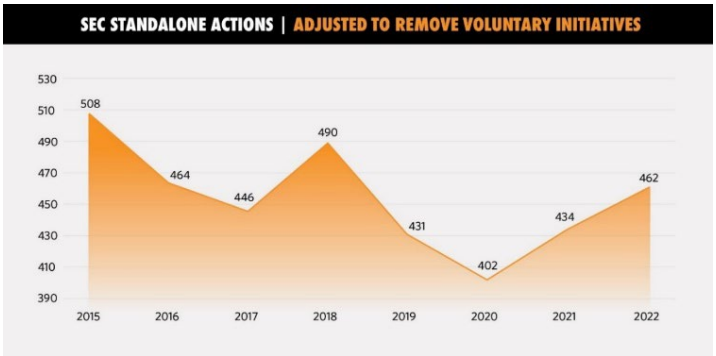
It would be simple to just say, "expect more of the same" because we do expect those trends to continue. However, even the least scientifically inclined among us might recall from high school physics Newton's Third Law: for every action (force) in nature there is an equal and opposite reaction. Over the last decade we have witnessed aggressive SEC enforcement approaches result in a number of unintended consequences that significantly affected the regulatory space.

As defendants eschewed settlement and litigated in federal court, the SEC lost the right to assert principles of equitable tolling,[7] disgorgement was deemed a penalty and time limited,[8] and disgorgement was limited to personal gain.[9] The SEC also suffered a successful challenge to the procedure for administrative law judge (ALJ) appointments,[10] and insider trading cases became significantly more difficult for the SEC and Department of Justice to pursue.[11] Indeed, the SEC appears to have forsworn its administrative forum altogether for any litigated matters.

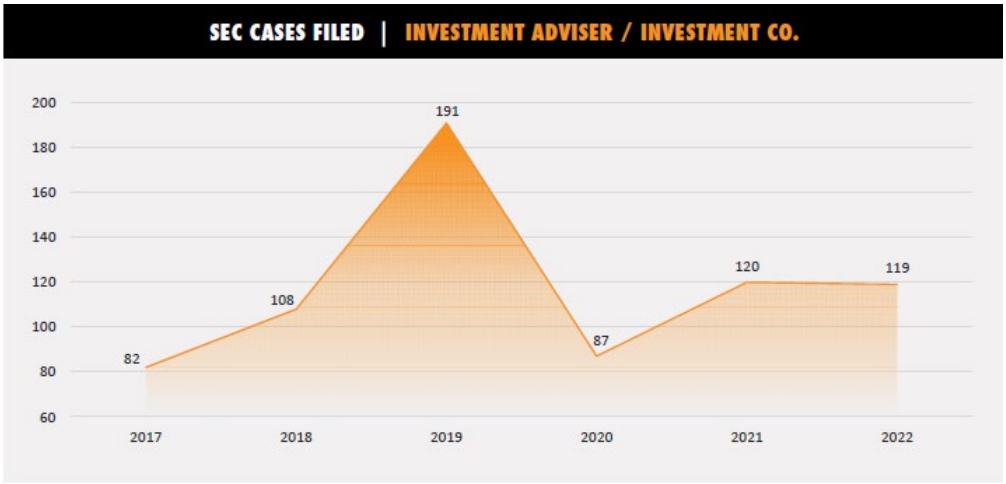
The equal and opposite reaction to oversized penalties and "speeding tickets" will again be litigation. We are not alone in this view: the SEC supported its request to Congress for increased enforcement headcount by noting that "it is expected that the number of litigated cases will continue to rise as [the Division of Enforcement] increasingly holds wrongdoers accountable for their misconduct with more meaningful and, in some instances, escalating sanctions. [The Division of Enforcement] requires additional resources to ensure that it has an adequate number of attorneys to staff the increasing number of litigated cases."[12]

With increased litigation, we expect to learn whether "speeding ticket" cases have sufficient jury appeal. Further, because the determination of a civil penalty is governed by statutory "tiers" and decided by the judge, not the jury, in federal court,[13] the SEC's justification for outsized civil penalties will be subject to significant scrutiny in litigation. All of these factors could, once again, significantly alter the enforcement landscape.

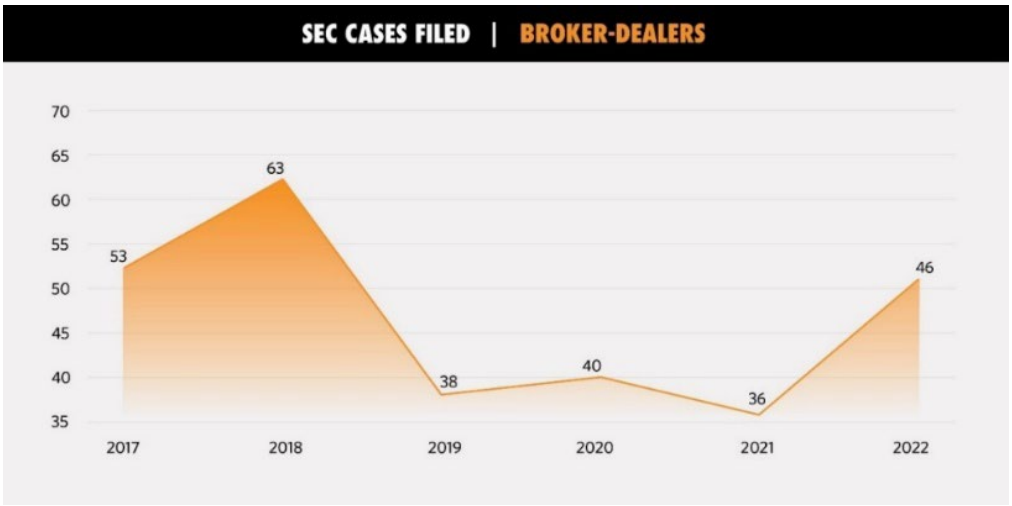
Consistent Enforcement Focus on Investment Advisers and Broker-Dealers[14]



Although the overall results for enforcement reflect a significant increase in the number of SEC standalone actions, cases filed against investment advisers and investment companies did not proportionally increase. Instead, the increase was the result of more insider trading, broker-dealer, and issuer reporting and accounting cases. That said, enforcement actions are a trailing indicator of enforcement attention, as most investigations take a number of years to complete.



Broker-dealers saw a significant jump in cases, largely driven by the off-channel communication cases discussed more fully below. Overall actions against investment advisers and broker-dealers accounted for 35.7% of the SEC's standalone enforcement actions in FY 2022.



Civil Penalties and Disgorgement

The SEC's position on civil penalties was recently articulated by Director Grewal:

> With respect to penalties and remedies, simply put, they must be adequate to both punish and deter wrongdoing. If market participants think that getting fined by the SEC is just another expense to be priced into the cost of doing business, then penalties are neither effective punishment, nor deterrence. Market participants must realize that complying with securities laws is cheaper than violating those laws.[15]

Through its September 2022 fiscal year end, the SEC issued orders imposing nearly $4.2 billion in civil penalties, which is the highest in any year by a significant margin.

Total Money Ordered (in millions)						
	FY 2022	FY 2021	FY 2020	FY 2019	FY 2018	FY 2017
Penalties	**$4,194**	$1,456	$1,091	$1,101	$1,439	$832
Disgorgement	**$2,245**	$2,395	$3,588	$3,248	$2,506	$2,957
	$6,439	$3,852	$4,680	$4,349	$3,945	$3,789

Disgorgement totals for 2020 and 2021 have been adjusted to exclude amounts ordered but waived. The currently-reported 2020 figure of $3,588 (in millions) was previously reported as $3,589 (in millions). The currently reported 2021 figure of $2,395 (in millions) was previously reported as $2,396 (in millions). No other years were adjusted.

Notably, disgorgement did not similarly increase, dipping to its lowest level in the last six years. Speaking about disgorgement, Director Grewal focused on the importance of civil penalties and cited headwinds due to recent adverse court decisions affecting the ability to secure disgorgement as reasons for the decline.[16] But there may be a more compelling reason: There is no demonstrable benefit to the registrant from the violations pursued.

Admissions

The off-channel communications cases that resulted in more than $1.2 billion in civil penalty settlements also included admissions, as predicted by Chair Gensler and Director Grewal at the beginning of their tenure.[17] Director Grewal has cautioned that we should expect more admissions cases in the future: "Admissions are an incredibly powerful accountability measure and you should expect us to continue seeking admissions in similar cases. And as I've said before, when we put them on the table it's not to gain an advantage in negotiations. We'll litigate those matters."[18]

Direct From Enforcement Sweep Investigations

Over the last several years, we witnessed the advent of sweep investigations of registrant practices originating directly from the Division of Enforcement. Issue-focused sweeps were once a tool almost exclusively used by the Division of Examinations to police registrants, with the potential of resolving issues before an enforcement referral. Now these issues are being escalated by enforcement through investigations.

Director Grewal offered two reasons for the use of sweep investigations. First, recurring issues: "Another way that we work to address the declining trust in the financial markets is by conducting proactive enforcement sweeps and initiatives that specifically target recurring issues."[19] Second, deterrence: "Filing multiple, coordinated actions simultaneously not only demonstrates accountability, but also has a more pronounced deterrent effect than if the Commission filed separate standalone cases at different times."[20]

There is one more reason for this approach, and why we expect to see more sweeps in the future: efficiency. Because of repetition, a sweep investigation does not demand the same investment of enforcement resources as a series of standalone and unique investigations. One Enforcement staff attorney can handle a number of investigations in a single sweep.

Increase in Enforcement Staff

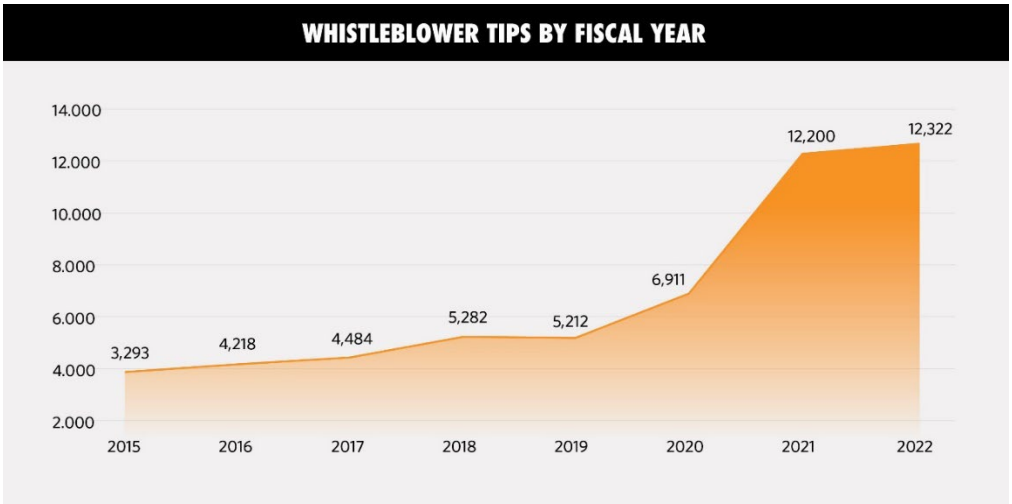
The Fiscal Year 2023 Omnibus Appropriations Bill passed by Congress in December 2022[21] gave the SEC all it was looking for in its 2023 budget, including an increased enforcement headcount,[22] which is expected to climb from 1,366 to 1,499. The rationale for this nearly 10% increase is to "strengthen [the Division of Enforcement's] capabilities to investigate new and emerging issues, including crypto-asset

markets, cyber-related risks, and the environmental, social, and governance space."[23] More investigative staff will mean more investigations.

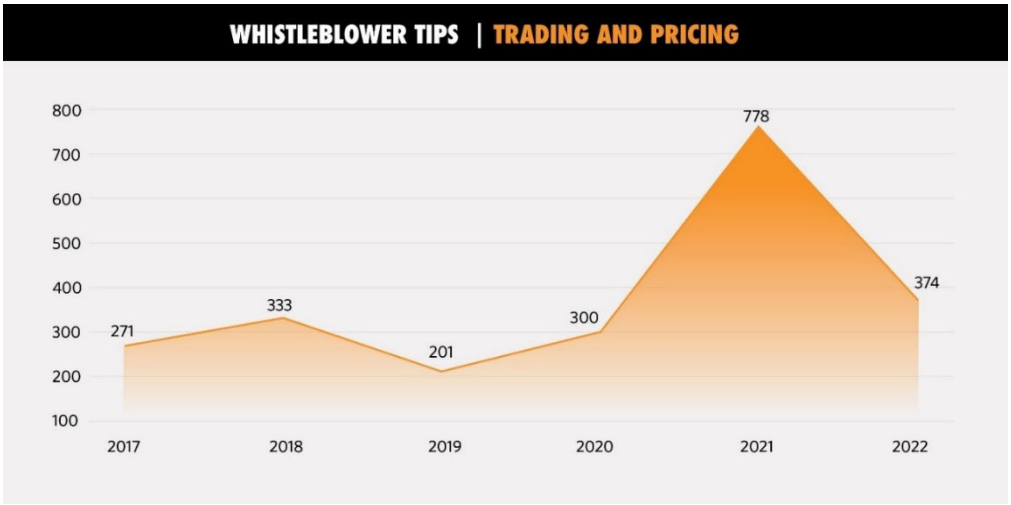
Whistleblowers[24]

Fiscal year 2022 saw the overall number of tips received through the SEC's whistleblower program plateau at slightly more than 12,000 tips. The Commission awarded approximately $229 million to 103 whistleblowers during the fiscal year. These figures are down from the previous year's records, but still represent the second largest dollar amount and number of individuals awarded in a single fiscal year.[25]

Although these numbers are still high, we are seeing a change in the distribution by subject matter. Tips regarding trading and pricing declined by approximately 50%, whereas tips concerning manipulation, offering fraud, and initial coin offerings (ICOs)/cryptocurrencies increased. Not surprisingly, ICO/cryptocurrency tips more than doubled from 762 to 1,718.



Nonetheless, given that whistleblower awards are paid to eligible individuals who voluntarily provide original information that leads to successful enforcement actions that result in monetary sanctions of more than $1 million, the effect of hundreds of eligible whistleblowers has been, and will continue to be, substantial.



Cooperation

Since Director Grewal was appointed to the Division of Enforcement in June 2021, he has spoken on several occasions about the importance of meaningful cooperation and how the SEC views cooperation. For example, in May 2022, Director Grewal discussed what qualifies as true cooperation, reiterating that "cooperation is more than the absence of obstruction."[26]

In that regard, he cautioned against "dilatory or obstructive conduct" from defense counsel, including actions that may merely delay or lead to a protracted investigation. He provided examples of instances in which the SEC may be inclined to offer credit for cooperation, including when a firm makes witnesses available on an expedited basis, highlights "hot" documents for the staff, offers document translations, flags documents that are particularly relevant even if they are arguably outside the scope of a subpoena, or makes presentations that go beyond serving as advocacy pieces by expanding on or highlighting key information or ideas.[27]

More recently, in November 2022, Director Grewal connected cooperation to his comments on penalties, noting that given the record-high penalties the SEC has been seeking (and presumably will continue to seek), firms should see a heightened incentive to cooperate.[28]

SEC EXAMINATIONS AND ENFORCEMENT DEVELOPMENTS FOR INVESTMENT ADVISERS

A RECAP OF 2022 SEC ACTIVITY

Environment, Social, and Governance (ESG)

As we noted last year, the early ESG exam sweep, the April 2021 ESG risk alert by the Division of Examinations, and extensive public comments by several SEC commissioners foretold heightened ESG enforcement activity.[29] The first of what we anticipate is just the start of enforcement actions in this area included the following:

- A settled action against an investment adviser for alleged materially misleading statements and omissions about the consideration of ESG principles in making investment decisions for certain mutual funds. The adviser neither admitted nor denied the allegations and agreed to pay a $1.5 million civil penalty.[30]
- A settled action against a robo-adviser that marketed itself as providing advisory services compliant with Sharia law but allegedly failed to adopt and implement necessary policies and procedures to ensure this objective was met. The adviser neither admitted nor denied the allegations and agreed to pay a $300,000 penalty and retain an independent compliance consultant.[31]
- A settled action against an investment adviser for alleged failure to follow policies and procedures involving two mutual funds and one separately managed account strategy that were marketed as ESG investments. The adviser neither admitted nor denied the allegations and agreed to pay a $4 million penalty.[32]

ESG investment practices will be further complicated by a series of proposed rules intended to achieve more standardized and comparable disclosures and reporting of ESG information to both investors and the SEC.[33]

For 2023, the Division of Examinations again identified ESG as a "Significant Area of Focus."[34] While Examinations will continue to "assess whether ESG products are appropriately labeled," the division also noted that this year it will examine "whether recommendations of such products for retail investors are made in investors' best interest."[35]

Cybersecurity

In fiscal year 2022, the SEC brought enforcement actions against investment advisers alleging a failure to comply with obligations to safeguard customer information. For example, on July 27, 2022, the SEC filed settled cases against three firms "for deficiencies in their programs to prevent customer identity theft, in violation of the SEC's Identity Theft Red Flags Rule, or Regulation S-ID."[36] In its press release announcing the cases, an SEC official stated that investment advisers need to design and operate identity theft prevention programs and update those programs in response to increased threats.[37]

Investment advisers that are victims of cyber-intrusions or examined in 2023 should expect scrutiny of "policies and procedures, governance practices, and response to cyber-related incidents, including those related to ransomware attacks."[38]

Conflicts of Interest

Investment adviser conflicts of interest and related disclosure issues continue to be a focus of the Division of Enforcement, including conflicts regarding the following:

- **Interfund Loans:** A settled action against an investment adviser for allegedly making interfund loans without having the authorization to do so, without disclosing the conflict, and without determining whether the loans were in clients' best interests.[39] The adviser neither admitted nor denied the allegations and agreed to pay a $200,000 civil penalty.
- **SPACs:** A settled action against an investment adviser for failing to disclose alleged conflicts of interest regarding its personnel's ownership of sponsors of special purpose acquisition companies (SPACs) into which the adviser recommended its clients invest.[40] The adviser neither admitted nor denied the allegations and agreed to pay a $1.5 million civil penalty.
- **Revenue Sharing:** A settled action against an adviser that allegedly failed to adequately disclose revenue sharing agreements with other parties.[41] The adviser neither admitted nor denied the allegations and agreed to pay $579,523.76 in disgorgement and a $150,000 civil penalty.
- **Cherry Picking:** A settled action against an investment adviser and its former investment adviser representative for an alleged multiyear cherry-picking scheme.[42] Both parties neither admitted nor denied the allegations. The adviser agreed to pay a $400,000 civil penalty and the representative agreed to pay $593,437 in disgorgement and a $300,000 civil penalty. In another action, the SEC brought settled charges against a former employee, an advisory firm, and the employee's former supervisor related to a similar alleged scheme. There, without admitting or denying the allegations, the supervisor and the firm settled charges that they failed to implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (Advisers Act).[43] The firm agreed to pay a $400,000 civil penalty, the supervisor agreed to pay a $75,000 civil penalty, and the representative agreed to pay disgorgement of $812,876, prejudgment interest of $169,089.83, and a civil penalty of $200,000.

- **Business Relationships:** A settled action against an individual who acted as a portfolio manager of a closed-end management investment company for failing to disclose an alleged conflict of interest arising from his relationship with a film distribution company in which the fund he managed invested millions of dollars.[44] Without admitting or denying the allegations, the manager agreed to pay a $250,000 civil penalty.

Finally, although the share class disclosure initiative may finally be winding down after more than four years, we expect the SEC to continue to spend resources investigating alleged undisclosed fees and conflicts.

Recordkeeping: Off-Channel Communications

As discussed more fully below in the section regarding broker-dealers, on September 27, 2022, the SEC filed actions against 15 broker-dealers and one affiliated investment adviser for "widespread and longstanding failures by the firms and their employees to maintain and preserve electronic communications."[45] Each of the firms involved in the case admitted the facts in their respective orders and cumulatively agreed to pay more than $1.1 billion in civil penalties.

Investment advisers are not immune from this risk. Since September 2022, it has been widely reported that the SEC is conducting a sweep of registered investment advisers relating to off-channel communications.[46] Section 204 and Rule 204-2(a)(7) require an investment adviser to maintain certain books and records, and the SEC cited both of these in the one case involving a dually registered investment adviser and broker-dealer in its September 2022 action.[47]

Insider Trading

In 2021, the SEC pushed the envelope on insider trading enforcement with its so-called "shadow trading" case involving a defendant who bought call-option contracts in a competitor company after learning that the acquisition of his employer was imminent, which was likely to have a positive impact on the competitor's stock price.

In 2022, the SEC continued its aggressive approach to insider trading, most notably with an action in which a trader's alleged inside information included observing that his friend, who was on the board of directors of a company whose stock the trader acquired, had become "unusually busy" on company-related matters. The case drew a dissent from Commissioner Hester M. Peirce, who questioned whether this observation could constitute material nonpublic information (MNPI). The trader settled the case against him, depriving us of a judicial determination of whether this kind of "soft" information could support an insider trading case.

In April 2022, the SEC Division of Examinations issued a risk alert concerning compliance issues at investment advisers involving MNPI.[48] The division highlighted the deficiencies it had seen during examination of investment advisers relating to nontraditional sources of data—alternative data, "value-added investors," and expert networks. With respect to alternative data, the division noted several areas of weakness in investment advisers' written policies and procedures as well as a lack of implementation of the policies and procedures they had adopted.

Similarly, the division noted that advisers did not have or did not appear to implement adequate policies and procedures regarding the status of value added investors who are more likely to possess MNPI. The SEC's pursuit of aggressive insider trading theories, and the attention on alternative streams of information, demonstrate its willingness to think creatively about how to support its insider trading cases, and we expect the SEC to continue doing so in 2023.

Speeding Tickets

As previewed above, issues that may have ended with a deficiency letter during an examination under previous SEC administrations are now enforcement actions—essentially a return to a "broken windows" approach. This is already affecting investment advisers.

For example, on September 9, 2022, the SEC announced charges against a number of investment advisers for allegedly failing to timely provide their investors in private funds with audited financials and/or update their Form ADVs in a timely manner.[49] There were no allegations that the investment advisers had not properly retained auditors or that the auditors had not timely completed their work. The investment advisers allegedly simply failed to timely distribute the audits themselves. Without admitting or denying the allegations, the investment advisers collectively agreed to pay more than $1 million to resolve the matters.

The next firms to fail may not get such light treatment, with Director Grewal remarking that the relatively low penalty amounts were based on "a unique circumstance for promptly resolving our investigations with this group of advisers." He further cautioned that the industry should not "assume that the Division will recommend similar resolutions going forward."[50]

Chief Compliance Officer Liability

The SEC remains focused on individual accountability. Consistent with that messaging, the SEC settled a matter with the CCO and principal of a registered investment adviser for violations of Section 206(4) and 206(4)-7 of the Advisers Act.[51]

The order stated that the CCO knew or should have known that the firm's compliance program was inadequate. Specifically, because the CCO received notices informing him that an investment adviser representative had an outside business activity (OBA) but the CCO did not require that individual to complete an OBA form or otherwise verify that the OBA had been properly disclosed to clients, the order stated that the CCO knew that the program was inadequate as to required OBA disclosures. In that case, the CCO also received notice that transactions involving transfers to the representative's OBA had been flagged for review, but the CCO did not take further steps to determine whether the transactions were legitimate.

Further, the CCO was informed of additional red flags, including that the representative took steps to avoid the firm's compliance policies and had been using his office address for an OBA. Without admitting or denying the allegations, the CCO agreed to a $15,000 civil penalty and a five-year bar from acting in a supervisory or compliance capacity.

The day after the settlement was issued, Commissioner Peirce released a statement of support, but noted that the action against the CCO merited close consideration.[52] Commissioner Peirce reviewed the New York City Bar Association's proposed CCO liability framework (published in June 2021), concluding that in this case, "charg[ing] the CCO, who was also a principal of the firm, help[ed] fulfill the SEC's regulatory goals; he had identified weaknesses in the compliance program [and] was in a position to address them, yet he did not do so."

2023 EXPECTED SEC ENFORCEMENT AND EXAMINATION FOCUS

Based on the 2022 enforcement activity and the recently released 2023 Examination Priorities, we expect the SEC to again focus a significant amount of attention on investment advisers this year.

2023 Examination Priorities

Fiduciary Duty and Form CRS

Examinations will focus on whether advisers are meeting their fiduciary standard of conduct with particular attention to the following:

- Investment advice and recommendations with regard to products, investment strategies, and account types
- Disclosures made to investors and whether such disclosures include all material facts relating to the conflicts of interest associated with the advice and recommendations
- Processes for making best interest evaluations, including those for reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest
- Factors considered in light of the investor's investment profile, including investment goals and account characteristics
- Whether the conflicts of interest disclosures are sufficient such that a client can provide informed consent to the conflict, whether express or implied

Product Focus

Expect 2023 examinations to focus on the following types of products:

- Complex products, such as derivatives and leveraged exchange-traded funds, exchange-traded notes and other exchange-traded products
- High cost and illiquid products, such as variable annuities and nontraded REITs
- Proprietary products
- Unconventional strategies that purport to address rising interest rates
- Microcap securities
- Products directed at seniors and advice regarding retirement account rollovers and 529 plans

Digital Engagement Practices

Firms that operate digital platforms with behavioral prompts, differential marketing, or game-like features should expect these, as well as analytical and technological tools and methods, to garner examination focus.

Other Focus Areas

Examinations will review whether advisers' operations and compliance programs have adopted and considered market factors, and how such factors may affect disclosure and reporting as well as custody and safekeeping of client assets, valuation, portfolio management, and brokerage and execution.

In addition, fees will again be scrutinized, including (1) the calculation of fees; (2) alternative ways that advisers may try to maximize revenue, including revenue earned on clients' bank deposit sweep programs; and (3) excessive fees. And finally, "examinations will review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers."

2023 Enforcement Focus

New rulemaking and examination priorities are excellent predictors of enforcement activity, and the SEC's Enforcement staff will be looking for examples of misconduct to support the need for those rules. Overall, we anticipate the SEC's Enforcement Division to focus on the following types of conduct in 2023 that may not have received significant attention in the past.

Outsourcing

Currently, the SEC is pursuing both enforcement and rulemaking in this area, and the proposed rule concerning "Outsourcing by Investment Advisers" identifies several issues also ripe for enforcement interest.[53] The stated purpose of the proposed rule is to protect investors from imprudent outsourcing. We expect this to be an area of focus on in FY 2023.

An investment adviser seeking to outsource a "Covered Function" would be required to (1) conduct due diligence prior to engaging certain service providers to perform covered functions; (2) periodically monitor service providers' performance and reassess whether to hire or retain them; and (3) make and keep books and records related to their due diligence and monitoring. A "Covered Function" is one that (a) is necessary to provide advisory services in compliance with federal securities laws; and (b) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on an adviser's clients or on the adviser's ability to provide investment advisory services.[54]

The rule would further impose reporting requirements on Form ADV about covered functions the third parties provide, and require advisers to obtain reasonable assurances that the third-party provider will meet the standards set out in the rule.

The SEC emphasized the importance of overseeing third-party provider work in a September 2022 settled action alleging violations of the Safeguards Rule (Rule 30(a) of Regulation S-P) and the Disposal Rule (Rule 30(b) of Regulation S-P).[55] The Commission claimed that a dually registered investment adviser and broker-dealer hired a moving company, with no experience in data destruction, to decommission thousands of hard drives and servers containing the PII of millions of customers. The drives and servers were not properly wiped or destroyed, and many were sold by the mover to another third-party purchaser. Without admitting or denying the allegations, the firm agreed to pay a $35 million civil penalty to resolve the matter.

The 2023 Examination Priorities also note that there will be additional focus on the cybersecurity issues associated with the use of third-party vendors, including "visibility into the security and integrity of third-party products and services" and "whether there has been an unauthorized use of third-party providers, particularly for transition assistance when departing RIA personnel attempt to migrate client information to another firm."[56]

Complex Short-Term Products

In a December 8, 2022 speech, Chair Gensler specifically mentioned single-stock exchange-traded funds as a concern, noting that these products "are not necessarily right for every investor" and "often are designed to be held for a short period of time, such as a single day."[57] We anticipate that these are not the only type of complex products that will get extensive scrutiny in the coming year, and the 2023 Examination Priorities promise particular attention to derivatives and leveraged exchange-traded funds, exchange-traded notes, and other exchange-traded products.[58]

Marketing Materials and the New Marketing Rule

On November 4, 2022 amendments to Rule 206(4)-1 of the Advisers Act became effective for registered investment advisers of all types.[59] The Marketing Rule now broadly defines "advertisement" to generally include communications with investors and potential investors on securities advisory services.

On September 19, 2022 the SEC's Division of Examinations announced that it will actively examine compliance with this new rule with a focus on whether advisers have done the following:

- Implemented appropriate written policies and procedures
- Have a reasonable basis for believing they will be able to substantiate material statements of fact in advertisements
- Complied with the rule's performance advertising prohibitions
- Maintained the appropriate books and records[60]

Failure to implement appropriate compliance procedures will likely draw immediate enforcement attention.

Crypto and Crypto-Related Assets

The SEC continues to aggressively pursue fraud and registration failures in the crypto, or digital asset, industry.[61] Indeed, the SEC highlighted cryptoassets as a key priority in its 2023 budget request to Congress.[62]

Given the high-profile collapse of FTX and other crypto exchanges, we expect the SEC to broaden its investigations to include asset managers that invest in the digital asset industry. For example, media reports indicate that the SEC is investigating financial firms that invested in FTX regarding "what diligence policies and procedures they have in place, if any, and whether they followed them when choosing to invest in FTX."[63] Further, the 2023 Examination Priorities warn that "given the disruptions caused by recent financial distress among cryptoasset market participants, the Division will continue to monitor and, when appropriate, conduct examinations of potentially impacted or affected registrants."[64]

In addition, it was recently reported that the SEC has initiated a sweep investigating whether registered investment advisers are meeting rules around custody of client cryptoassets.[65] As the SEC continues to increase its staff investigating the crypto space, look for it to continue to search for any perceived violations of the law in this heavily publicized area—especially since a sweep is one way the SEC can efficiently bring multiple cases.

Undisclosed Fees and Cash Sweep Accounts

We expect the SEC to continue aggressively investigating investment advisers for undisclosed fees this year—particularly related to cash sweep programs. For example, on January 19, 2023, the SEC brought a settled case against an investment adviser for allegedly failing to disclose that it received certain revenue sharing payments and financial incentives from two of its unaffiliated clearing brokers.[66] One of the revenue sharing payments was "transaction fee discounts and incentive credits that were contingent upon meeting certain dollar amount thresholds" in FDIC "insured bank deposit cash sweep" programs."[67]

Without admitting or denying the allegations, the investment adviser agreed to resolve the case by paying a $375,000 penalty and disgorgement of $1,436,182 plus prejudgment interest.[68] In this rising interest rate environment, cash sweep accounts are ripe for continued SEC enforcement activity.

FINRA AND SEC EXAMINATIONS AND ENFORCEMENT DEVELOPMENTS FOR BROKER-DEALERS

RECAP OF 2022 FINRA AND SEC ACTIVITY

Off-Channel Communications

On the heels of a December 2021 SEC settlement in which a broker-dealer agreed to pay a $125 million penalty, the SEC launched its largest industry sweep of 2022, focused on broker-dealers' employees' use of off-channel electronic communications for business purposes.[69] The sweep resulted in charges announced in September 2022 against 15 broker-dealers and an investment adviser that was affiliated with one of the broker-dealers for failure to maintain and preserve off-channel communications. Thirteen firms agreed to penalties of $125 million each, two agreed to $50 million penalties, and one agreed to a $10 million penalty.

According to recent news reports, the SEC has since commenced a similar sweep of investment advisers and funds, seeking information relating to books and records practices with respect to off-channel electronic communications.[70] We expect broker-dealers will likely continue to be scrutinized for this conduct, including by FINRA, which recently fined a firm $200,000 for failing to retain business-related iMessages.[71]

Best Execution

In October 2022, FINRA announced that it fined a broker-dealer $2 million for failing to comply with its best execution obligations in connection with its customers' electronic equity orders.[72] In the press release addressing that matter, Jessica Hopper, former head of FINRA's Department of Enforcement, stated that "FINRA continues to prioritize broker-dealer's compliance with best execution requirements when handling their customers' orders," and "Firms must continuously monitor their review of execution quality and make changes accordingly."[73]

FINRA had fined another broker-dealer $2 million six months earlier in March 2022.[74] These findings are not surprising as FINRA has included best execution as a topic in its priorities announcements for the last five years.[75]

The SEC also signaled that best execution is a priority with its December 2022 Regulation Best Execution proposal, which would establish a best execution regulatory framework and create the first SEC-established best execution rule.[76] The proposed rule would set forth a best execution standard: In any transaction for or with a customer, a firm would be required to use reasonable diligence to ascertain the best market for the security, and buy or sell so that the price to the customer is as favorable as possible.

It would also require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to comply with the standard, including requiring firms to address how they will determine the best market and make routing or execution decisions for customer orders. The proposed rule would also mandate that broker-dealers review their best execution policies and procedures annually and prepare written reports detailing the reviews.

Although the proposed rule is not yet in effect, it borrows heavily from existing self-regulatory organization rules, including FINRA Rule 5310 and MSRB Rule G-18. If the rule is adopted, we expect FINRA will react to avoid having overlapping rules in effect, perhaps by modifying its own rule. For example, FINRA may take the approach it took with the SEC's Regulation Best Interest and FINRA's suitability rule and state that FINRA's rule does not apply to situations covered by the SEC's rule.[77]

Restitution to Investors

Consistent with many settlements over the last several years, in June 2022, FINRA ordered a broker-dealer to pay $13.4 million (plus interest) in restitution to customers who purchased Class C mutual fund shares when Class A shares were available at a lower cost.[78] FINRA did not fine the firm, crediting its extraordinary cooperation, including establishing a plan to provide restitution to affected customers.

The SEC likewise seeks to restore money to investors where appropriate. In fiscal year 2022, the SEC ordered a total of $937 million to be paid in restitution to investors, an approximately 40% increase in restitution over each of the prior two years.[79] Director Grewal stated in November 2022 that the SEC was working to restore public trust in part by helping harmed investors recover their losses.[80] "Where appropriate," Director Grewal said, "we will aggressively seek disgorgement of all ill-gotten gains, regardless of whether the violations are scienter-based."

We expect both the SEC and FINRA to continue, as they have in years past, to focus on restitution to investors. FINRA has been clear that its number one enforcement priority is to obtain restitution for harmed customers.[81]

Cooperation

Both the SEC and FINRA have stated that meaningful cooperation can also lead to no penalties at all in certain matters, particularly where a firm has gone above and beyond in the information and assistance provided to the staff.

In recent years, FINRA has focused on what qualifies for "extraordinary cooperation" credit, as set forth in Regulatory Notice 19-23 (FINRA Supplements Prior Guidance on Credit for Extraordinary Cooperation).[82] FINRA has put its published guidelines into practice during the last several years, including with the introduction of a new acceptance, waiver, and consent (AWC) section titled "Credit for Extraordinary Cooperation" for matters in which FINRA determined that the respondent provided extraordinary cooperation.

One such example is the case discussed above, in which a firm was fined $200,000 for failing to retain business-related iMessages.[83] FINRA recognized that the firm (1) discovered the iMessage issue through its own compliance review; (2) engaged an outside vendor to assess the nature and extent of the problem, assist in collecting and reviewing the messages, investigate the cause of the issue, and develop new controls; (3) conducted a comprehensive internal review; and (4) provided substantial assistance to the staff, shortening the time needed to investigate this matter.

FINRA Sanction Guidelines

On September 29, 2022, FINRA published new Sanction Guidelines.[84] The accompanying news release highlighted three key changes to the guidelines:

- Separate guidelines for individuals and firms
- Separate fine ranges for small firms and midsize/large firms
- For certain guidelines, removal of the upper-limit fine range for midsize/large firms

The new Sanction Guidelines also decrease the upper-limit fine range for individuals in certain instances, which FINRA stated was intended to more accurately reflect its settlements with individuals.

In Regulatory Notice 22-20 (National Adjudicatory Council (NAC) Revises the Sanction Guidelines) (RN 22-20), FINRA explained that the need to remove the upper-limit fine range for certain matters stems from the fact that it frequently seeks higher fine amounts for serious violations related to sales of

unregistered securities, Rule 8210, best execution, marking the open or marking the close, churning, excessive trading or switching, fraud, pricing (excessive markups/markdowns or commissions), research analysts and reports, and supervision and systemic supervisory failures.[85] The ranges are not "absolute," however, and the Sanction Guidelines explicitly allow FINRA to impose sanctions above or outside the recommended range.

The Sanction Guidelines also introduce six new anti-money laundering (AML) guidelines: three for firms and three for individuals. RN 22-20 identifies AML as a priority for FINRA because it is an area of high regulatory risk, and the new guidelines have no upper limit on the fine range for midsize/large firms for AML violations related to a failure to reasonably monitor and report suspicious transactions.

RN 22-20 also highlights that the Sanction Guidelines now describe additional nonmonetary sanctions for firms that engage in repeated violations or serious misconduct, including, for example, (1) suspensions or bars, (2) limitations to a firm's business lines or products offered, (3) heightened supervision requirements, (4) impositions of independent consultants, and (5) certifications regarding new policies or procedures.

Chief Compliance Officer Liability

On March 17, 2022, FINRA issued Regulatory Notice 22-10 (FINRA Reminds Member Firms of the Scope of FINRA Rule 3110 as It Pertains to the Potential Liability of Chief Compliance Officers for Failure to Discharge Designated Supervisory Responsibilities) (RN 22-10) addressing the scope of FINRA Rule 3110 as it relates to potential chief compliance officer liability.[86]

RN 22-10 reiterates that CCOs serve an advisory—not supervisory—role, and that compliance and supervision are separate functions. Therefore, a CCO is not subject to liability under FINRA Rule 3110 by virtue of their position or title, unless they are designated as having supervisory responsibility. As set forth in RN 22-10, a CCO may be designated as having supervisory responsibility in the following scenarios:

- The firm's procedures assign the CCO responsibility to establish, maintain, and update written supervisory procedures (WSPs).
- The firm's WSPs make the CCO responsible for enforcing the policies and procedures or assign other oversight duties typically carried out by supervisors.
- A firm explicitly or implicitly assigns the CCO some other supervisory responsibilities.

However, even when the CCO has supervisory responsibilities, FINRA would only bring an action if the CCO failed to discharge those responsibilities in a reasonable way.

RN 22-10 sets forth the factors FINRA considers in analyzing whether the CCO failed to discharge designates supervisory responsibilities. Factors weighing in favor of an action include the following:

- The CCO was aware of multiple red flags or actual misconduct and failed to take steps to address them.
- The CCO failed to establish, maintain, or enforce a firm's written procedures as they related to the firm's line of business.
- The CCO's supervisory failure resulted in violative conduct.
- The violative conduct caused a high likelihood of customer harm.

Conversely, the following factors weigh against an action:

- The CCO was given insufficient support (i.e., budget, staffing, training).
- The CCO was unduly burdened.
- The supervisory responsibilities were poorly defined or were shared with others, making the definition of the CCO's responsibilities confusing or overlapping.
- The firm merged or adopted a new business line, or made new hires, such that the CCO should be allowed reasonable time to update the firm's systems and procedures.
- The CCO attempted to discharge their supervisory responsibilities by escalating issues that prevented them from doing so to firm leadership.

2023 EXPECTED FINRA AND SEC ENFORCEMENT AND EXAMINATION FOCUS

Jessica Hopper, Former Head of Department of Enforcement, Leaves FINRA

On January 24, 2023, FINRA announced that Jessica Hopper, the head of its Department of Enforcement, would leave FINRA on February 3.[87] Ms. Hopper was named Head of Enforcement in January 2020 after serving as the Acting Head of Enforcement since September 2019. She was with FINRA for 18 years, previously serving in several roles, including Deputy Head of Enforcement from 2016 to 2019. Christopher Kelly, the Deputy Head of Enforcement under Ms. Hopper's leadership, was named the Acting Head of Enforcement until FINRA selects a replacement.

FINRA Report on Examination and Risk Monitoring Program

On January 10, 2023, FINRA published the 2023 Report on FINRA's Examination and Risk Monitoring Program (the Report).[88] The Report highlights six areas in which FINRA will continue to focus its regulatory program, several of which are themes from years past.

Regulation Best Interest (Reg BI) and Form CRS

FINRA will continue to focus on firms' obligations pursuant to Reg BI and Form CRS, including whether they are making recommendations in accordance with Reg BI's Care Obligation, conflicts of interest, and required disclosures, and are establishing and enforcing adequate written supervisory procedures.

Consolidated Audit Trail (CAT)

FINRA states that firms' overall compliance with CAT reporting requirements remains a chief priority. The staff will review whether firms timely submit reportable events and corrections, report complete and accurate CAT records, and effectively supervise third-party vendors.

Order Handling, Best Execution, and Conflicts of Interest

As it stated in last year's report, FINRA has placed particular focus on order handling and best execution recently, including beginning a targeted exam in 2020 to evaluate how order-routing practices and decisions are impacted when firms do not charge commissions. Last year FINRA also began targeted reviews of wholesale market makers concerning order handling practices for orders from other broker-dealers.

The staff will continue to evaluate firms' compliance with best execution obligations under FINRA Rule 5310 and Rule 606 of Regulation NMS, including whether firms are fully and promptly executing

marketable customer orders, conducting adequate "regular and rigorous reviews," and providing appropriate disclosures.

Mobile Apps

As the use of mobile apps continues to expand, FINRA will focus on whether firms are properly distinguishing between products/services offered by the broker-dealer as opposed to those offered by affiliates and third parties. It will also monitor disclosures for higher-risk products and services.

Cybersecurity

In August 2022, FINRA established the Cyber and Analytics Unit (CAU) to address cyber threats, particularly those associated with the cryptoasset market. The CAU will review firms' cybersecurity risk management, including by reviewing firms' controls and potential fraud incidents and investigating cryptoasset activity. Last year, FINRA also released Regulatory Notice 22-29 (FINRA Alerts Firms to Increased Ransomware Risks), which highlights ways that firms can evaluate the efficacy of their cybersecurity programs.[89]

Complex Products and Options

In March 2022, FINRA issued Regulatory Notice 22-08 (FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options),[90] which reiterated current obligations regarding complex products and options. FINRA will continue to review how firms communicate with customers about complex products, including how and what disclosures are made. FINRA will also review customer account activity to assess whether recommendations are in customers' best interest.

In December 2022, FINRA provided an update on its 2021 targeted exam of practices and controls related to the opening of options accounts and related areas.[91] Based on FINRA's observations, FINRA offered questions for firms to consider when assessing the adequacy of their supervisory systems for supervising the approval of options accounts and trading activity therein.

The Report also addresses the following four categories that were not in recent annual reports.

Financial Crimes and Manipulative Trading

The Report focuses on firms' surveillance systems to monitor for suspicious trading, encouraging firms to consider how they monitor for red flags for potential coordination among customers, determine thresholds for surveillance controls, and test their controls before placing them into production, among other items.

FINRA also highlights effective practices in this area, such as putting in place systems to review customer and proprietary data to detect manipulative schemes, implementing monitoring across multiple platforms, and designing systems to detect potential momentum ignition trading.

Fixed Income: Fair Pricing

FINRA focuses on firms' supervisory systems for complying with the fair pricing rules, how firms confirm that markups/markdowns are not based on expenses that are excessive, the methodology used to determine the prevailing market price for sales of bonds, and whether firms have supervisory procedures that address targeted fair pricing.

Fractional Shares: Reporting and Order Handling

The Report lists certain considerations that firms should focus on, including how firms confirm that their CAT, TRF, and ORF reports involving fractional shares are timely submitted, complete and accurate, and

aligned with reporting requirements; whether firms adequately disclose fractional-share order handling policies; and whether any Dividend Reinvestment Programs (DRIPs) are compliant with regulatory obligations.

Regulation SHO: Bona Fide Market-Making Exemptions and Reuse of Locates for Intraday Buy-to-Cover Trades

FINRA notes that it has observed instances in which firms failed to distinguish bona fide market-making from other proprietary trading activity that is not eligible to rely on Regulation SHO's bona fide market-making exceptions, and that firms have not properly reapplied locates for short sales executed after intraday buy-to-cover trades in reliance on Question 4.4 in the SEC's Reg SHO FAQs. FINRA encourages firms to evaluate their supervisory systems in these areas.

Crypto Communications: FINRA Targeted Exam Letter

FINRA announced in November 2022 that it is conducting a targeted exam of firm practices regarding retail communications concerning cryptoasset products and services.[92] FINRA defines cryptoassets to mean "any asset that is issued or transferred using distributed ledger or blockchain technology," although it may not meet the definition of a security.

The requests ask firms to provide retail communications relating to cryptoassets, including information related to those communications, such as whether the communication was filed with FINRA's Advertising Regulation Department, whether it was approved by a registered principal of the firm, and to which cryptoassets the communication related. FINRA also requests firms' written supervisory procedures regarding the dissemination of cryptoasset communications, related compliance policies, and any agreements or contracts concerning the creation or dissemination of cryptoasset communications on behalf of an affiliate, or affiliates' use of firm customer information to determine who will receive such communications.

SEC Risk Alert on Reg BI

On January 30, 2023 the SEC published a risk alert highlighting observations from examinations related to Reg BI, including deficiencies and examples of "weak practices" that could lead to deficiencies.[93] The risk alert groups the observations and examples into three categories.

The first section addresses firms' compliance obligations and notes that the staff observed that broker-dealers lacked adequate written policies and procedures, including multiple instances in which firms used generic written policies and procedures that were not tailored to the firm's business, or simply restated the rule's requirements.

The second section discusses firms' conflict of interest obligation and details the different deficiencies the staff observed relating to the requirement to have written policies and procedures reasonably designed to address conflicts of interest associated with recommendations to retail customers, including in some instances inappropriately relying on disclosures to mitigate certain conflicts.

Finally, the section on disclosure obligations covers the deficiencies the staff noted regarding missing website disclosures and disclosures where registered representatives are acting in multiple roles.

2023 SEC Examination Priorities for Broker-Dealers

On February 7, 2023, the SEC published the 2023 Examination Priorities and identified the following areas of focus for broker-dealers.

Compliance With Standards of Conduct

Examinations will monitor broker-dealers for compliance with their applicable standard of conduct with particular attention to the following:

- Investment advice and recommendations with regard to products, investment strategies, and account types
- Disclosures made to investors and whether such disclosures include all material facts relating to the conflicts of interest associated with the advice and recommendations
- Processes for making best interest evaluations, including those for reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest
- Factors considered in light of the investor's investment profile, including investment goals and account characteristics[94]

Digital Engagement Practices

Firms that operate digital platforms with behavioral prompts, differential marketing, or game-like features should expect these, as well as analytical and technological tools and methods, to garner examination focus.[95]

Informational Security and Operational Resiliency

Examinations will focus on the firms' policies and procedures, governance practices, and response to cyber-related incidents, including those related to ransomware attacks, and compliance with Regulations S-P and S-ID, where applicable. In addition, examinations will also inquire into "cybersecurity issues associated with the use of third-party vendors, including registrant visibility into the security and integrity of third-party products and services."[96]

Electronic Communications Related to Firm Business

Despite the substantial enforcement activity in this area last year, the Division of Examinations will continue to focus on supervisory and compliance programs for electronic communications this year.[97]

Trading Practices

Broker-dealers should expect attention to trading practices in both equities and fixed income securities, including (1) conflicts of interest in order routing and execution that may negatively affect retail investors, (2) compliance with Regulation SHO, including the rules regarding aggregation units and locate requirements, and (3) the operations of alternative trading systems for compliance with Regulation ATS, with a particular focus on consistency with disclosures provided in Form ATS-N.[98]

Municipal Securities

Examinations will focus on issues specific to municipal securities and other fixed income securities, including compliance with confirmation disclosure requirements and "municipal securities dealer and municipal underwriter compliance with obligations related to municipal issuer disclosure."[99]

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[55] *See* Press Release, Securities and Exchange Commission, $35 Million for Extensive Failures to Safeguard Personal Information of Millions of Customers (Sept. 20, 2022).
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