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PREPARING FOR REGULATORY EXAMINATIONS EVALUATING THE DIGITIZATION OF TRADING AND INVESTMENT ADVICE

The growth of digital engagement practices ("DEP") has raised regulatory compliance issues for broker-dealers and investment advisers. The authors discuss a variety of such issues, including account opening due diligence and best execution. They suggest that, to prepare for examinations, firms should review current practices and address issues and concerns raised by the SEC and FINRA in recent statements, guidance, and regulatory responses.

By Amy J. Greer and Gavin M. Meyers *

Over the past few years, both the U. S. Securities and Exchange Commission and FINRA have shown a growing interest in and expressed concerns about the rapidly changing online trading and digital advice landscape. With fewer places to go during the pandemic, and perhaps out of boredom, retail investors sparked a social-media-fomented trading movement and, at the same time, online broker-dealers benefitted from a rapid increase in new retail investors. In January 2021, a handful of stocks experienced unusual market volatility largely driven by a concerted effort of like-minded retail investors who found each other through social media, including, most prominently, on Reddit through the r/WallStreetBets subreddit. These retail investors targeted certain heavily shorted and previously low volume stocks, such as GameStop and AMC, turning them into "meme stocks," which resulted in short squeezes and extreme price swings. This meme stock "movement" perhaps was an inevitable next step in the evolution of online brokerage over the past few years, led largely by zero-commission platforms and interfaces that offer a social-media-like customer experience. Of course, zero-commission trading is now the standard for online self-directed brokerage, and firms continuously look for innovative ways to entice new customers. However, balancing innovation while maintaining compliance with securities regulations can be complex — for the brokers and their regulators.

Not surprisingly, after the market volatility in January 2021, the SEC and FINRA appear to have embarked on a campaign to somehow address the rapidly changing marketplace. For broker-dealers, one issue that seems less clear is to what extent regulatory exams and expectations may be changing or adapting to these changes in the marketplace. While this article focuses on the recent statements, guidance, and regulatory response that may shed some light on these issues, firms

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INSIDE THIS ISSUE

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also should question how this recent regulatory focus may have broader implications to the digitization of a firm's processes more generally.

GAMIFICATION AND DIGITAL ENGAGEMENT PRACTICES

In February 2021, FINRA highlighted that the use of interactive and "game-like" features by online broker-dealers to engage with customers may result in increased risk for customers if not designed with appropriate compliance considerations in mind.[1] More recently, in August 2021, the SEC published a request for comment regarding broker-dealer and investment adviser digital engagement practices ("DEP") more generally.[2] Not to be outdone, in September 2021, FINRA announced that it was conducting a targeted exam, sending inquiry letters to broker-dealers to review practices related to the use of social media (e.g., Twitter, TikTok, and Instagram) in the context of customer prospecting and referral programs.[3]

While it is presently unclear whether the SEC or FINRA will make regulatory changes to adapt to or limit DEPs, the constant drumbeat regarding these practices suggests that efforts to-date may be only the first phase of broader initiatives to gather data and information that ultimately are used for rulemaking. In any event, firms should use the opportunity to take a serious look at their DEPs to evaluate compliance with existing regulations, focusing on the areas highlighted by the SEC and FINRA, including whether the firm's DEPs:

- rise to level of a recommendation under Regulation Best Interest,[4] or the Suitability Rule,[5] or investment advice under the Advisers Act;[6]
- contain appropriate disclosures to address potential risks and potential conflicts of interest; and
- comply with the firm's recording-keeping, account opening, advertising, and Regulation S-P[7] obligations.

We can anticipate that many of these types of issues, within the context of digital engagement, will arise in the examination context for firms that routinely interface with clients through online platforms or otherwise engage through electronic media. Moreover, as the January 2021 market volatility and firm reactions shows, firms should be reviewing their procedures regarding customer order-handling, margin and liquidity management, for the ability to address extreme market volatility. We will address some of these areas in a bit more detail below.

ACCOUNT OPENING DUE DILIGENCE

The surge of new retail investors opening self-directed online brokerage accounts requires that firms

[1] 2021 Report on FINRA's Examination and Risk Monitoring Program (Feb. 2021), *available at* https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf.

[2] Rel. No. 34-92766 (2021), *available at* https://www.sec.gov/rules/other/2021/34-92766.pdf (requesting information and comments on broker-dealer and investment adviser digital engagement practices).

[3] *Social Media Influencers, Customer Acquisition, and Related Information Protection* (Sept. 2021), *available at* https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/social-media-influencers-customer-acquisition-related-information-protection.

[4] Rule 15l-1 under the Securities Exchange Act of 1934.

[5] FINRA Rule 2111.

[6] *See, e.g.*, Division of Investment Management, "Robo-Advisers," IM Guidance Update No. 2017-02 (Feb. 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-02.pdf.

[7] Regulation S-P imposes obligations on broker-dealers designed to protect improper use and disclosure of nonpublic personal information about consumers. A firm's DEPs may collect and use personal information about its customers which implicates Regulation S-P, in addition to other data privacy laws. Cybersecurity and data protection have been a focus of regulators for years and the push to more digital platforms will keep cybersecurity at the forefront of regulatory concerns.

balance efficiency, customer demand for immediate access, and regulatory compliance. Aside from dealing with a large volume of new accounts, these new retail investors also often seek higher-risk features for trading options and using margin. In response to the influx of new customers, FINRA issued Regulatory Notice 21-15, "Options Account Approval, Supervision and Margin," to remind firms of their account-opening obligations, and, in particular, obligations related to approving accounts for options trading.[8] FINRA imposes on broker-dealers certain disclosure, approval, and due diligence obligations in order to permit a customer to trade options.[9] For example, a broker-dealer may not permit a customer to trade options unless options trading has been approved by a registered principal of the broker-dealer after the exercise of due diligence.

To the extent that firms have automated account opening processes and, in particular, options approval, firms likely can expect that regulatory exams may more heavily scrutinize these processes and supervision. Indeed, not long after issuing Notice 21-15, FINRA finalized a disciplinary action against Robinhood Financial related to these very issues.[10] As part of the options trading approval process, FINRA found that Robinhood utilized a computer algorithm to review and approve options accounts with only limited oversight by a registered options principal and the "system suffered from a number of flaws," including automatically approving options trading:

- based on inconsistent or illogical customer responses;
- for customers with low-risk tolerance in contradiction with the firm's written procedures; and/or
- for customers who were previously rejected — often minutes earlier — when the customers changed responses after being rejected.

FINRA found that Robinhood failed to exercise the appropriate due diligence necessary to approve customers for options trading and failed to have a supervisory system that addressed the red flag issues noted above.

Although the violations cited by FINRA are familiar, firms with similar automated processes for account opening and options trading due diligence should consider the underlying context and issues. For instance, how should firms handle the review of inconsistent information through automated systems, particularly those firms with systems designed to provide less human interaction with clients? When a customer is rejected for options trading, should rejections based on certain responses require a waiting period before the customer can resubmit, or should a rejection mandate human interaction for resubmission? Given the volume of new retail investors seeking to participate in the trading markets, and the movement toward less human interface, these types of issues present significant questions for firms seeking to meet rapidly growing demand from new and less experienced retail investors while also meeting regulatory obligations. Asking those questions *before* your regulatory examination and considering how the issues will be managed expressly in your policies and procedures, as well as in real time, will be efforts well expended, since there is no doubt that your exam team will make these same inquiries.

BEST EXECUTION

Both the SEC's and FINRA's actions highlight their on-going focus on the duty of best execution, particularly in the zero-commission environment. Generally, broker-dealers are subject to a duty of best execution which generally requires broker-dealers to seek the most favorable terms reasonably available under the circumstances when executing a customer transaction.[11] A broker-dealer's best execution obligations are implicated by payment for order flow because the broker-dealer is incentivized to direct orders to exchanges through which it receives compensation rather than objectively routing orders to the exchange with the best price for the customer.

Payment for Order Flow

The combination of recent market events plus zero-commission brokerage has caused the SEC and FINRA

[8] FINRA Regulatory Notice 21-15 (April 9, 2021), *available at* https://www.finra.org/sites/default/files/2021-04/Regulatory-Notice-21-15.pdf.

[9] FINRA Rule 2360.

[10] *Robinhood Financial LLC*, FINRA AWC No. 2020066971201 (June 30, 2021), *available at* https://www.finra.org/sites/default/files/2021-06/robinhood-financial-awc-063021.pdf.

[11] FINRA Rule 5130 provides that broker-dealers must "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."

to raise best execution concerns, particularly in the context of the practice of payment for order flow, which is a primary reason that firms are able to offer zero-commission brokerage. Nearly 25 years ago, the SEC considered banning the payment for order flow practice, but ultimately determined that disclosure was the appropriate response.[12] At the time, the SEC concluded that not all payment for order flow arrangements conflicted with the customer's best interests, and, therefore, a blanket ban would not be appropriate.[13] However, in light of the January 2021 market volatility, recent statements by current SEC Chair Gary Gensler indicate that banning payment for order flow is once again "on the table," along with a number of other potential options for protecting retail customers.[14]

Although any ban on payment for order flow would require rulemaking, the issue presents an area ripe for an SEC sweep to gather information about the current prevalence in the industry and the supposed conflicts. It may be prudent for firms to get ahead of this potential regulatory scrutiny by reviewing current practices to ensure risks are mitigated, that potential conflicts are properly disclosed, that supervisory systems are effective at protecting the firm from any compromise in meeting its best execution obligations, and that all of these efforts are fully documented.

On this last recommendation, we note that best execution efforts often are so ingrained in trading flow that the documentation step can be missed. How a broker-dealer or investment adviser has evaluated its executions may require more than retaining or reviewing trading records. Given the focus on best execution, considering how the firm documents these efforts, and its policies and procedures around these tasks, is a worthwhile undertaking in advance of an examination.

Customer Order-Handling Generally, and Liquidity Management

At the height of the January 2021 volatility, several of the online brokerage firms popular with the WallStreetBets crowd, implemented temporary trading restrictions on the affected meme stocks.[15] The action immediately enraged those retail investors, resulting in theories that the brokerage firms were trying to protect the larger-volume trading firms, and prompting class action lawsuits.[16] However, the more plausible reasoning publicly provided by the brokerage firms was that the extraordinary volatility significantly impacted those firms' net capital obligations and/or their clearinghouse deposits. In March 2021, FINRA issued Regulatory Notice 21-12, "Customer Order Handling, Margin and Liquidity," reminding firms of their obligations with respect to customer order handling and ensuring that the firm's procedures take into account the potential for extreme market volatility, as well as liquidity management.[17]

In this regard, in advance of an examination, firms may need to focus on the following areas:

- providing meaningful disclosures to customers about order handling during extreme market conditions, including about:
  - — potential delays in execution due to unusual high volume;
  - — the impact that market volatility may have on certain types of orders (e.g., stop orders);
  - — the potential for losses in the event market volatility causes trading system disruptions;

[12] Rel. No. 34-34902 (1995), *available at* https://www.sec.gov/rules/final/orderfin.txt.

[13] For instance, the SEC noted it was unclear what harm, if any, resulted from payment for order flow if it provides for price improvement of otherwise low volume or unpriced orders, and that customers may receive other benefits as a result of the payments received by their broker-dealers. *Id*.

[14] *Robinhood tanks after SEC chair tells Barron's that banning payment for order flow is a possibility* (Aug. 30, 2021), *available at* https://www.cnbc.com/2021/08/30/robinhood-tanks-after-sec-chair-tells-barrons-banning-payment-for-order-flow-is-a-possibility-.html.

[15] *Robinhood, Other Brokerages Restrict Trading on GameStop, AMC*, https://www.wsj.com/articles/online-brokerages-restrict-trading-on-gamestop-amc-amid-frenetic-trading-11611849934.

[16] *Robinhood, Citadel reject conspiracy claims that they halted 'meme' trades* (Feb. 17, 2021), *available at* https://www.latimes.com/business/technology/story/2021-02-17/robinhood-citadel-reject-conspiracy-claims-they-halted-meme-trades.

[17] FINRA Regulatory Notice 21-12 (Mar. 18, 2021), *available at* https://www.finra.org/sites/default/files/2021-03/Regulatory-Notice-21-12.pdf.

- requiring additional margin in conditions of extreme market volatility;[18] and
- liquidity risk management to:
    - — avoid or at least limit disruption to the firm's normal business operations; and
    - — maintain compliance with the Net Capital Rule[19] and Customer Protection Rule,[20] each of which play a significant role in a broker-dealer's financial responsibility obligations and in protecting customer assets.[21]

CONCLUSION

This article highlights a number of practices relating to digital engagement practices and online trading that have been highlighted recently by the SEC and FINRA; however, as alluded to above, firms should consider the underlying themes and issues raised by regulators that are applicable more broadly to their digital processes. The digitization of firm processes can provide opportunities for efficiency, innovation, and growth, but also present regulatory risks for the unwary. Firms may need to rethink whether their compliance and supervision functions have kept up with their changes to processes, particularly those that previously relied largely on human involvement but that now largely rely on automation, algorithms, or other digital enhancements. Regulators are probing further into how firms' digital processes comply with securities regulations and may not fully understand the often complex nature of a firm's automated process. As a result, firms should be prepared to educate regulators how a digital process or algorithm functions, as well as to demonstrate the supervisory procedures and controls that ensure compliance with the securities laws.

With constant pressure from Congress and significant media attention, firms should expect the SEC and FINRA, as well as state securities regulators, to maintain and likely expand their focus on the rapidly evolving online trading and digital advice space for the foreseeable future. This expanded focus is likely to go beyond areas raised in recent headlines. Taking the time now to review current practices and to address issues and concerns raised by the SEC and FINRA, firms have an opportunity to enhance their supervisory processes and tighten controls before the SEC or FINRA come knocking. Moreover, regulators may be more inclined to report on industry best practices rather than develop additional regulations if they find that firms' processes and controls in the digital space are robust. History has shown time and time again that innovation without meaningful consideration of regulatory implications along the way, and repeated failures to demonstrate how innovation can be accomplished without sacrificing investor protection, places the future direction of a novel idea in the hands of regulators. ■

[18] Note that FINRA Rule 2264 (Margin Disclosure Statement) requires broker-dealers to provide a margin disclosure statement to non-institutional customers that explains, among other risks, that "the firm can increase its 'house' maintenance margin requirements at any time and is not required to provide you advance written notice."

[19] Rule 15c3-1 under Section 15 of the Securities and Exchange Act of 1934. The Net Capital Rule imposes minimum net capital requirements on broker-dealers that vary depending on a number of factors, including generally whether the broker-dealer is an introducing or carrying firm and the amount of unsecured liabilities of the broker-dealer.

[20] Rule 15c3-3 under Section 15 of the Exchange Act. The Customer Protection Rule requires broker-dealers to safeguard customer funds and securities.

[21] Even without volatile markets, calculating a broker-dealer's minimum net capital requirements can be complex. When a market experiences extreme volatility and heavy use of margin by customers, a broker-dealer's minimum net capital requirement can fluctuate significantly and raise concerns that the broker-dealer may violate its net capital requirements.