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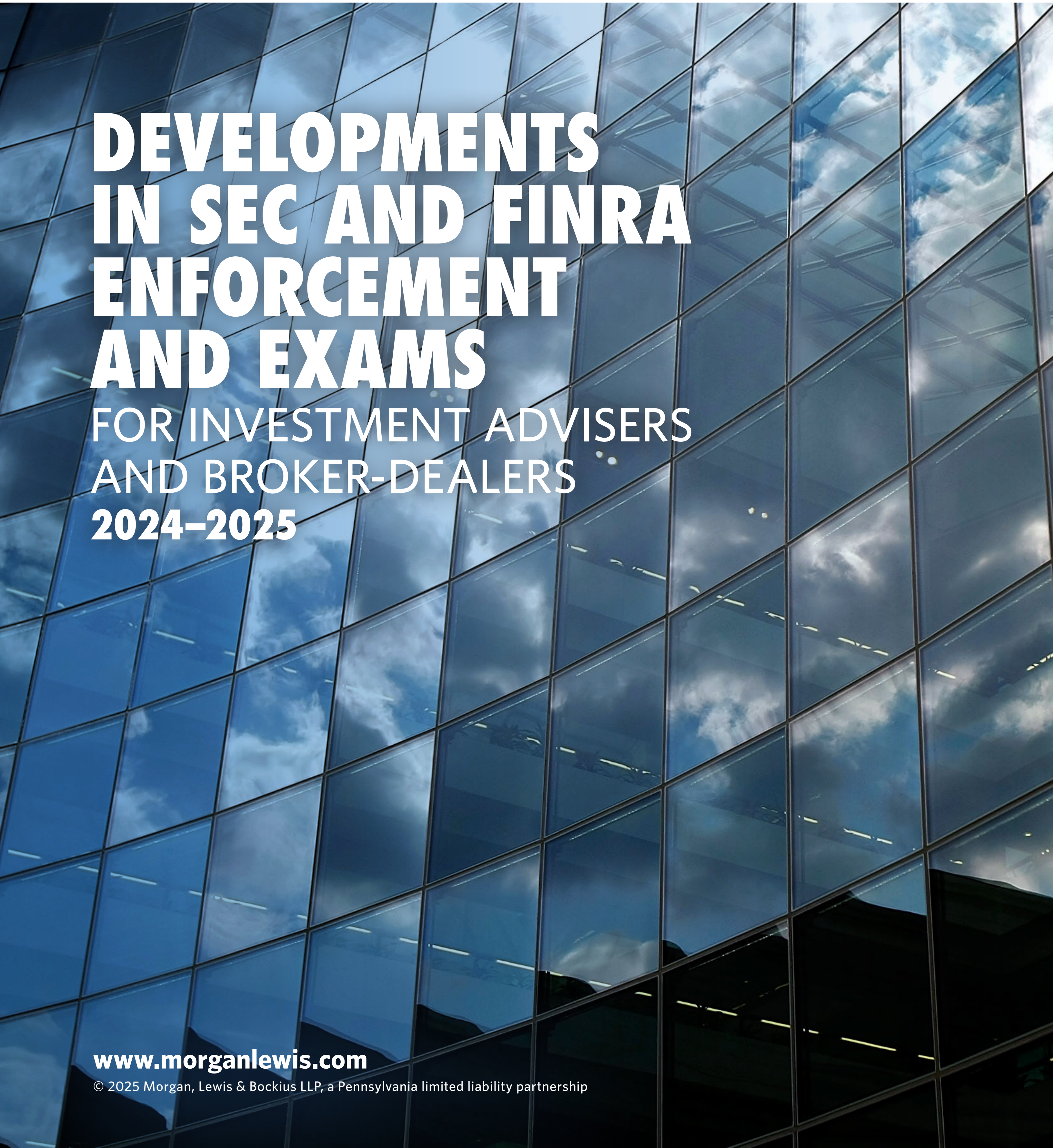

DEVELOPMENTS IN SEC AND FINRA ENFORCEMENT AND EXAMS

FOR INVESTMENT ADVISERS AND BROKER-DEALERS

2024–2025

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DEVELOPMENTS IN SEC AND FINRA ENFORCEMENT AND EXAMS FOR INVESTMENT ADVISERS AND BROKER-DEALERS: 2024–2025

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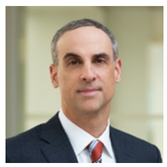

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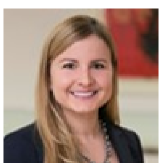

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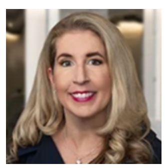

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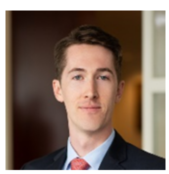

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DEVELOPMENTS IN SEC AND FINRA ENFORCEMENT AND EXAMS FOR INVESTMENT ADVISERS AND BROKER-DEALERS: 2024–2025

The US Securities and Exchange Commission (SEC) brought a number of significant enforcement proceedings against investment advisers and broker-dealers in FY 2024 and during the first quarter of FY 2025. If history serves as a guide, we do not expect the new administration to pay less attention to these firms in the coming year. We do, however, anticipate that the SEC, under new leadership, will recommit its focus on fraudulent conduct and trading abuses, especially as it relates to retail investors. This emphasis will have specific implications for investment advisers and broker-dealers. For example, we expect the SEC to expand the use of its data analytics program, which has already resulted in numerous insider trading, cherry-picking, and trade allocation cases involving financial advisors and registered representatives, as discussed below.

We likewise would not be surprised to see the SEC launch "mini-initiatives" aimed at probing how investment advisers and broker-dealers are handling investments, disclosures, and fees for specific populations, such as elderly clients or other affinity groups. We also expect to see a continued focus on the disclosures to, and interactions between, regulated entities and investors, with particular emphasis on conflicts of interest for investment advisers and Regulation Best Interest (Reg BI) for broker-dealers. We expect the Financial Industry Regulatory Authority (FINRA) to similarly remain active, particularly with respect to the focus on fraudulent conduct, retail investors, and Reg BI. FINRA has also indicated that it is taking steps to increase efficiency, so we may see enforcement matters move with more alacrity.

This report begins with investment adviser and broker-dealer enforcement numbers, then moves on to discuss penalties and remedies. It also outlines areas of focus for investment advisers and broker-dealers. With respect to investment advisers, this report discusses takeaways from the SEC Division of Examination's (Exam's) report of examination priorities for 2025 (the Priorities Report), then touches on several areas of interest for the SEC in 2024 with respect to enforcement activity, including the following:

- Sweep Investigations
- Conflicts of Interest
- Artificial Intelligence (AI) and "AI Washing"
- Trading Abuses and Related Violations
- Marketing Rule

With respect to broker-dealers, this report discusses takeaways from the Priorities Report and FINRA's 2025 Annual Regulatory Oversight Report, then discusses other FINRA and SEC developments, including:

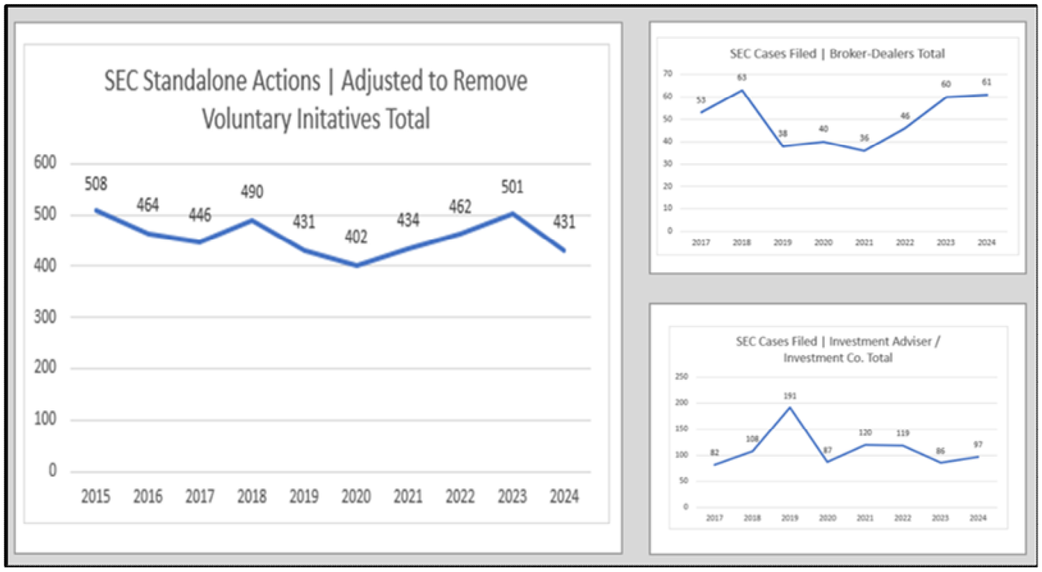
- Regulation Best Interest Enforcement
- Anti-Money Laundering (AML)
- Expectations for SEC Enforcement Related to Broker-Dealers in FY 2025
- FINRA Enforcement Process Updates
- FINRA Thematic Reviews

SEC Investment Adviser and Broker-Dealer Enforcement Numbers

During FY 2024, the SEC's Division of Enforcement filed a total of 431 standalone actions, which was a nearly 14% decrease compared to the 501 total standalone actions brought in FY 2023. Of these 431 enforcement actions, 97 were specifically brought against investment advisers. This was an overall decrease of 49% from the zenith of 191 investment adviser actions that occurred in 2019 (principally due to the Share Class

Selection Disclosure Initiative). On the contrary, FY 2024 enforcement actions against broker-dealers (61) remained relatively stable compared to FY 2023 (60).

Notably, there were nearly 11% more cases filed against investment advisers under the Trump-Pence administration (468 total) compared to the Biden administration (422 total). This suggests that overall numbers for FY 2025 may remain relatively consistent.



SEC Investment Adviser and Broker-Dealer Penalties and Remedies

The SEC used numerous remedies in matters involving investment advisers and broker-dealers in 2024, including:

- **Monetary Relief:** In FY 2024, the SEC imposed approximately $8.2 billion in total monetary relief, the highest amount in SEC history. However, 62% of that total was attributable to two judgments: A $4.5 billion award (or 56% of the total monetary relief obtained) following the SEC's jury trial win against Terraform Labs and Do Kwon.[2] Additionally, more than $600 million stemmed from settlements in the SEC's ongoing off-channel communications sweep. Without these outliers, the SEC would have imposed in FY 2024 the lowest amount of monetary relief since FY 2013.[3] Going forward, we expect penalties against investment advisers and broker-dealers to be driven not by an emphasis on ratcheting up dollar amounts and instead by factors such as actual harm to clients or customers and comparable past precedent. With respect to disgorgement, we note that during the Trump-Pence administration, a decreased focus on penalties was accompanied by increased attention on disgorgement to harmed investors, which jumped from $158 million in 2015 to $1.07 billion in 2017.[4] In the new administration, we likewise expect to see disgorgement rise with penalties falling.

- **Cooperation Credit:** In 2024, the SEC repeatedly emphasized the importance and benefits of "cooperating" with the SEC, including by self-policing, self-reporting, remediation, cooperation, and collaboration.[5] Cooperation was credited in multiple enforcement actions against investment advisers and broker-dealers in 2024, with a particular emphasis on self-reporting and cooperation during the investigation itself. Under the new SEC administration, we anticipate a greater opportunity for cooperation credit in all forms and for that credit to be applied in terms of whether a case is brought, the conduct a case covers, and the remedies imposed (both monetary and otherwise).

- **Independent Compliance Consultants:** In 2024, the SEC continued to require the retention of an independent compliance consultant (ICC) in a number of matters involving investment advisers and broker-dealers. ICCs are typically an expensive undertaking and involve the review of a firm's policies, procedures, and controls with requirements to implement the consultants' recommendations for improvements. We expect the SEC under the new administration to continue to use ICCs in some matters involving investment advisers and broker-dealers, but we anticipate a more receptive audience to the argument that an ICC is not necessary where firms have voluntarily undertaken their own review and remediation. In addition, even in cases where ICCs are required, there may be the ability to narrow the scope of the ICC's remit, such as where the firm has already made a number of changes.

AREAS OF FOCUS FOR INVESTMENT ADVISERS AND A LOOK AHEAD

SEC's 2025 Exam Priorities for Investment Advisers

The SEC Division of Examinations (Exams) released the Priorities Report on October 21, 2024,[6] which reflects several focus areas for investment advisers.

The Priorities Report focuses heavily on firms' implementation and use of automated investment tools, AI, and trading algorithms, including the fairness and accuracy of representations, operational consistency with public disclosures, the appropriateness of algorithm-produced advice, and the adequacy of controls.

Regarding the use of AI, Exams plans to review the accuracy of representations regarding AI capabilities, as well as policies and procedures for both monitoring and supervising its use and protecting client data.

As in years past, Exams will continue to review firms' informational security and operational resilience. This includes review of practices to prevent mission-critical service interruptions and protect investor information. The review will focus on policies and procedures, governance, data loss prevention, access controls, account management, and incident response (e.g., ransomware attacks). Exams will also consider cybersecurity risks associated with third-party products and review whether firms are appropriately monitoring and complying with the US Department of the Treasury's Office of Foreign Assets Control sanctions.

Exams will continue to prioritize examinations of advisers that have never been examined, newly registered advisers, and those that have not been examined recently. The Priorities Report also indicates that Exams will focus on investment advisers' adherence to fiduciary duties of care and loyalty, including ensuring appropriate disclosures concerning conflicts of interest and actively prioritizing the interests of clients.

In addition, the Priorities Report reflects a focus on high-cost products, unconventional instruments, illiquid and difficult-to-value assets, and assets that are sensitive to interest rate changes or shifting market conditions (e.g., commercial real estate). Dual registrants and advisers with affiliated broker-dealers will continue to be prioritized, with a focus on assessing the suitability of investment advice, disclosures regarding an adviser's capacity when making recommendations, account selection practices (including rollovers), and the disclosure and mitigation of conflicts of interest. Exams will also review the impact of financial conflicts of interest on the impartiality of advice and best execution, particularly with respect to conflicts arising from nonstandard fee arrangements.

Exams will continue to review advisers' compliance with Rule 206(4)-7 under the Investment Advisers Act of 1940 (the Compliance Rule), and examinations will be designed to evaluate core compliance areas including marketing, valuation, trading, portfolio management, disclosure, filings, and custody. Exams will also focus on fiduciary concerns in the outsourcing of investment selection and management, alternative revenue sources and benefits accruing to the adviser, and the accuracy of fee calculations and disclosures where fee-related conflicts may exist. With respect to outsourcing, registrants may want to consider reviewing the SEC's

October 2022 rule proposal, which—although never adopted—could indicate the processes and diligence standards that Exams may expect to be in place.

Please see Morgan Lewis's analysis of the SEC's FY 2025 complete list of examination priorities for more information on the Priorities Report, including a comparison of the FY 2025 priorities with those from FY 2024.

Sweep Investigations

The use of "sweeps" (i.e., industry-wide investigations relating to similar conduct) was a trend that continued in FY 2024. As we move into FY 2025, it is less likely that we see a continued focus on sweeps, particularly where they involve policies and procedures or rule violations that do not involve allegations of client harm or fraud.[1] Below, we discuss active sweeps related to off-channel communications and whistleblower protections.

Off-Channel Communications

In FY 2024, the SEC continued to aggressively pursue settlements for off-channel communications, resulting in over $600 million in settlements from 70 broker-dealers, investment advisers (for the first time, some stand-alone), municipal advisors , and credit rating agencies.[7] This sweep—which began in 2021—has garnered more than $2 billion in penalties against over 100 firms.[8] One of the largest settlements occurred in August 2024, where the SEC brought charges against 26 broker-dealers, investment advisers, and dually registered broker-dealers and investment advisers. All 26 firms admitted that their conduct violated the recordkeeping provisions of the federal securities laws, including Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder and/or Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder. As part of the settlements (and in one case, prior to settlement), the firms retained ICCs to conduct a "comprehensive compliance review" of firm policies and procedures related to electronic communications.

A week before the administration change, the SEC announced charges against nine investment advisers and three broker-dealers for off-channel communication failures.[9] In sum, the firms paid combined civil penalties of $63 million. The comparatively smaller civil penalties in these later actions suggests that the firms may have leveraged the change in administration to secure more favorable settlement terms.

We anticipate standalone off-channel communication cases to sunset in FY 2025 as these cases have come under criticism by the Republican-appointed SEC Commissioners. For example, on September 24, 2024, the two Republican Commissioners dissented from an off-channel communications enforcement action by stating that even though firms may take reasonable steps to address off-channel communications, such firms may still not find themselves in proper compliance.[10]

Whistleblower Protections

In FY 2024, the SEC received 24,000 whistleblower tips, awarding more than $255 million to 47 individuals.[2] With this many tips, it is no surprise that the SEC continued to use sweeps to hone in on protecting whistleblowers under Exchange Act Rule 21F-17, and charged advisers who allegedly impeded potential whistleblowers from reporting securities laws violations to the SEC. For example, the SEC charged an investment adviser for entering into agreements with employment candidates and a former employee who made it more difficult for them to report securities law violations to the SEC. Notably, these cases involved not only agreements with former and current employees, but also agreements with clients and brokerage

[1] For example, the Division of Enforcement is conducting a sweep of investment advisers related to cash sweep products. In recent settlements related to cash sweep, the two Republican SEC Commissioners voted not to approve. It's uncertain how this will impact current sweep efforts.

[2] More than 14,000 of the 24,000 tips came from two individual whistleblowers.

customers and consultants. The SEC did not allege, in any of the enforcement actions this year, that individuals were *actually* impeded from voluntarily communicating with the SEC—just that they *could have been* impeded.

In the new administration, we expect the SEC to shift its focus away from aggressively pursuing sweeps involving potential violations of the whistleblower protection rules (although tips are here to stay). Instead, we expect there to be a continued focus on enforcement in instances where employment agreements clearly impede reporting to the SEC. We do not expect the focus to be on agreements with more tenuous language or where the agreements involve individuals outside of the employment context, such as customers or consultants. We also expect the new administration to focus on matters that result in actual, measurable harm instead of more hypothetical scenarios where harm might have occurred.

Conflicts of Interest

Because an investment adviser must make full and fair disclosure to its clients of any material facts related to their adviser-client relationship in order for the adviser to meet its fiduciary duty of loyalty, it should come as no surprise that undisclosed conflicts of interests are a perennial focus for the SEC, particularly with respect to fees and compensation. We expect that trend to continue in FY 2025 under the new administration. Conflicts of interest cases may impact individual retail investors and result in disgorgement, both of which we expect to align with a focus by the administration on retail investor harm.

Two examples from FY 2024 highlight the emphasis the SEC is placing on adequately disclosing—and papering, in the form of policies and procedures—any conflicts of interest that may arise. In March 2024, the SEC charged an investment adviser with failing to disclose material conflicts of interest concerning agreements with an investment manager for certain exchange-traded funds (ETFs).[11] The SEC alleged that the adviser failed to disclose conflicts arising from agreements it had entered with the ETF manager that created an incentive for the adviser to use funds managed by the ETF manager, which included the failure to disclose an "onboarding fee."[12] According to the Order, the adviser also failed to implement policies and procedures related to conflicts of interest. The adviser agreed to a civil penalty and disgorgement.

Another significant matter involving conflicts of interest was announced in May 2024. The SEC alleged that the adviser and its founder breached their fiduciary duties by failing to disclose conflicts of interest and making misleading statements to their clients stemming from investments in films produced by a production company.[13] The adviser allegedly failed to disclose that it received money from the production company in exchange for client investments, and prioritized certain redemption requests over the others, thereby violating the fiduciary obligations to their other clients. The adviser and its founder agreed to civil penalties and disgorgement.

Artificial Intelligence and "AI Washing"

AI has been a recent focus of the SEC across all parts of the agency, from enforcement actions to examination priorities to proposed rulemaking, and we expect that focus to continue and grow in 2025.[3] The SEC has paid particular attention to "AI washing," or making false and misleading statements concerning a firm's use of AI, as reflected in its settlements.

In FY 2024, the SEC announced "first-of-their-kind" settlements with two investment advisers for AI washing and violations of the Marketing Rule because the firms were allegedly making false and misleading statements about their alleged use of AI, resulting in combined penalties of $400,000.[14] In the first settlement, the SEC found that the firm had made false and misleading statements in its SEC filings, press releases, and on its public-facing websites concerning its purported use of AI and machine learning to

[3] Although the prior administration proposed rules relating to the use of AI, we expect the new administration will take differing views on how it proposes to regulate this area.

incorporate client data in its investment process.[15] According to the SEC, despite representing to current and prospective clients that its use of client data as inputs into its investing algorithms was a key differentiating characteristic from other advisers, the firm had not, in fact, created an algorithm to use client data.[16]

In the second settlement, the SEC determined that the firm had made false and misleading claims on its website and social media posts regarding its use of AI.[17] The firm had supposedly touted its status as the "first regulated AI financial advisor," despite not being able to "substantiate performance claims upon demand by the Commission."[18] Furthermore, the firm had claimed on its public website that its proprietary technology used "'[e]xpert AI-driven forecasts,'" when this was allegedly not correct.[19]

With AI-related investments continuing to proliferate, we expect the SEC to continue its heightened focus on AI, principally focusing on ensuring that retail investors are protected from any claims by firms of using AI in a way that is untrue or misleading. In the fall of FY 2024, the co-chief of the SEC's Asset Management Unit echoed this concern when he said that "[a]s AI becomes more popular in the investing space, we will continue to be vigilant and pursue those who lie about their firms' technological capabilities and engage in 'AI washing.'"[20]

Trading Abuses and Related Violations

Cases involving trading abuses and related violations are bread-and-butter enforcement investigations for the SEC, which we expect to be an area of heightened focus in the next administration, given that these cases often involve potential or actual harm to investors, often highlight the SEC's use of sophisticated data analysis, and involve the potential for charges against individuals, who often serve in roles as trusted financial advisors or in gatekeeping functions.

Material Nonpublic Information

In FY 2024, the SEC continued its focus on insider trading and related compliance failures. For example, the SEC settled a number of actions concerning inadequate policies and procedures relating to the misuse of material nonpublic information (MNPI). Notably, in these cases, the SEC did not find that the investment advisers charged *engaged* in insider trading. Instead, the allegations were limited to policy failures. With the start of the new administration, we anticipate MNPI and other insider-trading related issues will continue to be an area of focus for enforcement because of the importance of protecting individual retail investors from fraud and potential trading abuses.

In FY 2024, the SEC charged four investment advisers for failure to establish, maintain, and enforce policies and procedures reasonably designed to prevent misuse of MNPI. Three of the matters settled. The charges included alleged (1) misuse of MNPI in connection with a firm's collateralized loan obligations, settled for $1.8 million;[21] (2) misuse of MNPI related to a firm's in participation on ad hoc creditors' committees, settled for $1.5 million; and (3) disclosure of MNPI to investors who were subject to nondisclosure or confidentiality agreements without considering whether the disclosure was also necessary for a legitimate business purpose. The SEC also found that the latter fund published misleading claims concerning fund performance, and the two actions settled for $4 million. In these three actions, the SEC acknowledged the firms' remedial actions, which included training and revising its MNPI policies and procedures.

The SEC filed a complaint against a firm charged with use of MNPI relating to the firm's participation on creditor's committees. This case remains in litigation and will be worth closely following to see whether the SEC's aggressive charging decision withstands judicial scrutiny.

Cherry-Picking

In September 2024 and December 2024, the SEC settled two matters that involved "cherry-picking" schemes.[22] "Cherry-picking" involves the fraudulent practice of preferentially allocating profitable trades or failing to allocate unprofitable trades to an advisor's personal accounts at the expense of advisory clients. In the first matter, the SEC found that the firm had failed to properly supervise two advisors who had disproportionately allocated profitable trades to their personal accounts and further failed to implement policies and procedures that would prevent such unfair trade allocations. The firm paid a civil penalty of $200,000.

In the second matter, the SEC charged an individual advisor of a firm with disproportionately allocating unprofitable trades to his clients while simultaneously directing profitable trades to his own accounts. The individual advisor further placed advisory clients in volatile and risky investments that did not align with the clients' investment profiles. Because of the individual advisor's actions, the firm paid a $375,000 civil penalty.

As these matters show, the SEC will not hesitate to use its in-house tools to perform sophisticated data analysis to identify potential fraud and target schemes like cherry-picking that directly harm retail investors who put their trust in their chosen investment advisers. In addition, the SEC will not hesitate to hold individuals accountable who participate in these schemes.

Trade Allocation

In September 2024, the SEC charged a representative of an investment adviser for unfairly allocating trades. The trades were aggregated through a master account and then allocated at the end of the trading day, when the representative would allegedly allocate the more profitable trades to his personal account and a few favored client account and allocating less profitable trades to his other clients. The SEC found the representative violated the Investment Advisers Act and imposed a cease-and-desist, a six-month suspension, disgorgement of the funds the representative personally benefited from the allocation, plus prejudgment interest, and a civil penalty of over $60,000.

Later the same month, the SEC charged an investment adviser and its majority owner for improperly allocating profitable trades with significant games to their own accounts rather than to advisory clients. As a result of the improper allocations, the firm and its majority owner achieved returns that were more than double participating advisory clients achieved. The SEC found this behavior breached their fiduciary duties and violated the firm's trade allocation policy. The firm agreed to pay over $120,000 in disgorgement, plus prejudgment interest, whereas the majority owner agreed to pay disgorgement of over $130,000, plus prejudgment interest and consented to a 12-month industry suspension.

As a sign of more of what we expect to see, the SEC's attention to trade allocation matters reflects the overall trend of focusing on direct harm to retail investors, particularly where, as here, they put trust in their advisers to appropriately manage their funds.

Rule 105

Rule 105 of Regulation M (Rule 105) under the Securities and Exchange Act aims to prevent manipulative practices related to short selling during the restricted period before a public offering of securities.

In FY 2024, the SEC settled charges against two international investment advisers for violating Rule 105. In the first, which settled in November 2024, the investment adviser allegedly participated in 14 public offerings after having short sold the same securities during the restricted period. The firm agreed to cease and desist from committing or causing violations of Rule 105, and to pay disgorgement of over $1.5 million plus prejudgment interest, and a civil money penalty of over $800,000.

In the second, which settled in December 2024, the firm allegedly participated in five covered offerings of securities after it had sold short the same securities during the restricted period. The firm agreed to cease and desist from committing or causing violations of Rule 105, and to pay disgorgement of over $1.8 million plus prejudgment interest, and a civil money penalty of over $500,000.

Because such violations may negatively influence a security's price at the time of its offering, we expect the SEC to continue to police for Rule 105 violations as part of the new administration's focus on protecting retail investors from risky trading behavior.

Marketing Rule

Perhaps no other rule under the Advisers Act has such widespread application as Rule 206(4)-1 (the Marketing Rule), which aims to protect investors by requiring investment advisers to present accurate, balanced, and clear marketing materials. The rule establishes guidelines on performance advertising, testimonials, endorsements, and third-party ratings, designed to prevent advisers from making misleading claims or omissions in their promotional efforts.

In April 2024, the SEC announced settlements with several investment advisers for Marketing Rule violations. The SEC alleged that the firms advertised on their public-facing websites hypothetical performance without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance was relevant to the intended audience and their financial situations and objectives. Firms that undertook corrective steps prior to being contacted by the SEC staff agreed to reduced penalties ranging from $20,000–$30,000. Corey Schuster, co-chief of the SEC Enforcement Division's Asset Management Unit, stated that the April settlements "serve as a reminder of the benefits to firms that take corrective steps before being contacted by Commission staff."

In September 2024, the SEC announced settlements with several investment advisers as part of an industry-wide sweep concerning Marketing Rule violations. Specifically, the SEC found that advisers made various (1) untrue statements about third-party ratings, false claims about membership in organizations that did not exist, and testimonials that did not come from current customers, (2) claims that could not be substantiated regarding conflict-free advisory services, awards provided to firm principals, (3) failures to disclose that testimonials were paid for, and (4) failures to disclose that advertised ratings were received for prior years. The firms paid civil penalties ranging from $60,000—$325,000 based on the severity and number of violations.

Although firms have had to comply with the Marketing Rule since late 2022, we expect the SEC staff to continue investigating potential Marketing Rule violations in 2025. Marketing and advertising are perennially a focus area on routine examinations, which we expect to continue in 2025.

AREAS OF FOCUS FOR BROKER-DEALERS AND A LOOK AHEAD

SEC's 2025 Exam Priorities for Broker-Dealers

The Priorities Report also reflects several key areas of focus concerning broker-dealers.

Exams will continue to prioritize examinations of broker-dealer practices with respect to Reg BI.[23] Exams will review: (1) recommendations and whether brokers have a reasonable basis for believing their recommendations are in the best interest of the customer and do not place the broker's interests ahead of the customer's interests; (2) conflict of interest disclosures; (3) practices for identifying and eliminating conflicts of interest; (4) processes for reviewing available alternatives; and (5) the factors representatives consider when aligning recommendations with individual investor profiles. As it examines these areas, Exams will pay particular attention to products that are complex, illiquid or high risk, such as highly leveraged or inverse products, crypto assets, structured products, alternative investments, unregistered products, and products with complex fee structures or based on exotic benchmarks.

Broker-dealer exams may also assess recommendations that are generated using automated tools, related to opening different account types, and/or made to specific investor types (e.g., older investors and those saving for retirement or college).

Exams may also examine dual registrants regarding conflicts identification and mitigation, account allocation and selection practices (including rollovers and advice to open wrap fee accounts), and supervision of sales practices at branch offices.

Form CRS practices remain a focus for Exams. Exams will review the content of broker-dealer relationship summaries, including descriptions of relationships and services offered to retail customers, fees and costs, conflicts of interest, and full disclosure of disciplinary history. Examinations will also evaluate compliance with SEC filing and retail customer delivery obligations.

Exams will continue to focus on compliance with net capital and customer protection rules such as broker-dealer accounting practices, the timeliness of financial notifications, and operational resiliency programs, including supervision of third-party vendors. Exams will also assess risk management controls related to credit, market, and liquidity stress testing.

Exams will carry on its focus on both equity and fixed-income trading practices, including an assessment of the structure, marketing fees and potential conflicts associated with retail offerings such as bank sweep programs and fully paid lending programs. We expect Exams to review the adequacy of broker-dealers' written policies and procedures and disclosures, as such items were the focus of two settlements with investment advisers issued by the SEC in January 2025.

Exams will also evaluate firms' compliance with the amendments to Exchange Act Rule 15c6-1 (reducing the standard settlement cycle for most securities to the day after trading (T+1)) and new Exchange Act Rule 15c6-2 (requiring broker-dealers engaging in the allocation, confirmation, or affirmation process to have written agreements or written procedures reasonably designed to complete the process as soon as practicable and no later than the end of day on trade date (T+0)).

Please see Morgan Lewis's analysis of the SEC's FY 2025 complete list of examination priorities for more information on the Priorities Report, including a comparison of the FY 2025 priorities with those from FY 2024.

FINRA's Annual Regulatory Oversight Report

In late January 2025, FINRA published its 2025 Annual Regulatory Oversight Report (the 2025 Report), which is intended to provide broker-dealers with insight into findings from FINRA's regulatory operations programs.[24] Although the 2025 Report includes a number of topics from last year, it highlights several completely new topics, and in a handful of perennial areas, includes new content. For each topic, the 2025 Report describes the relevant regulatory obligations, highlights select effective practices, and cites to additional resources like FINRA regulatory notices, reports, tools, and online resources. For select topics, the 2025 Report also includes findings from recent reviews, examinations, market surveillance, or investigations, observations about weaknesses in firm compliance programs, and emerging and continuing trends and risks. Below is a summary of several key items highlighted by FINRA in the 2025 Report.

Third-Party Risk Landscape

The 2025 Report includes as a new area of focus the risks associated with firms' reliance on third parties for activities and functions. The 2025 Report cites the increase in cyberattacks and outages at third-party vendors as a key vulnerability. FINRA makes several observations about practices firms should consider when developing and managing third-party vendor risk management programs, including (1) establishing appropriate third-party vendor risk management policies; (2) conducting initial and ongoing due diligence of third-party vendors (particularly those related to key areas like IT, cybersecurity, or anti-money laundering); (3) validating data protection controls in third-party contracts; (4) including vendor systems in Incident Response Plan testing; (5) having a process to return or destroy firm data after terminating a third-party contract; and (6) addressing third-party vendors' use of vendors (i.e., fourth-party vendors).

The 2025 Report also highlights effective practices for firms using third-party vendors, including (1) maintaining a list of all third-party vendor-provided services, systems, and software components to leverage in the event of a cybersecurity incident or outage; (2) establishing supervisory controls for potential business impact (e.g., assessments and contingency plans); (3) considering the impact on regulatory obligations if a vendor fails to perform; (4) evaluating whether vendors can take steps to prevent sensitive information from being ingested into third-party AI tools; (5) assessing how vendors protect sensitive information and data; and (6) putting in place a process to revoke access to systems and data once a vendor relationship ends. The 2025 Report also cites to Regulatory Notice 21-29 and Notice to Members 05-48, which provide firms with additional guidance on using and relying on third parties.

We expect to see this continue to be an area of focus as more and more broker-dealers rely on the services of third-party vendors. Already, FINRA has brought many vendor-related cases, although less through a risk management lens and more through a compliance lens, including several in the past year. For example, FINRA settled a matter in which a third-party vendor was not reporting short interest on a firm's behalf (although the firm believed it was doing so).[25] In another matter, a firm failed to have a process in place to supervise its Rule 606 reports or to supervise the third-party vendor that it used to prepare those reports.

Registered Index-Linked Annuities

This year, the 2025 Report includes a new topic related to Reg BI: reminding firms of their Reg BI obligations related to registered index-linked annuities (RILAs). According to FINRA, the market for RILAs has grown significantly in recent years and the 2025 Report identifies these products as an "emerging trend." The 2025 Report explains that RILAs have certain characteristics that can impact their performance: (1) RILAs periodically realize gains and losses, forcing liquidation at a specified date, which may be when market conditions are unfavorable; (2) performance may be based on a "price return" index, typically resulting in a lower return; and (3) due to RILAs' bounded return structure, investor gains may be limited if the performance of the index goes up in value, and losses may be limited if it goes down in value. In FINRA's view, retail communications related to RILAs should adequately explain how the product functions and any specialized terms, prominently include disclosures about risks, fees, and charges, and avoid exaggerated or misleading statements, claims, or hypothetical illustrations.

Extended Hours Trading

Another new area highlighted in the 2025 Report is the recent increase in extended hours trading and a focus on FINRA Rule 2265, which requires firms to provide customers with a risk disclosure statement when engaging in such trading. The 2025 Report also reminds firms to be mindful to comply with all other FINRA and SEC rules, including but not limited to FINRA Rule 5310 (Best Execution) and FINRA Rule 3110 (Supervision) during extended hours trading.

The 2025 Report notes that FINRA has observed firms that failed to maintain reasonably designed supervisory systems and controls with respect to after-hours trading (e.g., failing to identify potentially manipulative activity), and that some firms have failed to report required information related to extended hours trading to FINRA's trade reporting facilities or the Consolidated Audit Trail. The 2025 Report summarizes effective practices firms should consider, including (1) best execution reviews; (2) customer disclosure reviews; (3) supervisory procedures to address unique characteristics of extended hours trading; and (4) operational readiness and customer support plans to deal with issues that may arise during overnight hours.

Artificial Intelligence

Similar to the SEC, AI continues to be a hot topic for FINRA. In recent years FINRA has highlighted the fact that although AI has many potential benefits, it also carries certain risks. The 2025 Report directs firms to Regulatory Notice 24-09 (the Notice), issued in June 2024, which reminds firms of their regulatory obligations when using AI. Both the 2025 Report and the Notice note that FINRA's rules are technologically neutral, meaning that they continue to apply when firms use AI in the course of their business. For example, the Notice states that the requirements of Rule 2210 surrounding communications with the public apply whether communications are generated by a human or an AI tool.

As with any other tool, firms need to appropriately evaluate AI tools prior to deploying them. The 2025 Report suggests that firms consider how they will supervise the use of AI, identify and mitigate associated risks, and address cybersecurity concerns such as leaks of customer personally identifiable information. The 2025 Report also notes that firms should consider whether they have a process in place to identify the use of AI by potential bad actors. Similarly, the Notice highlights that firms that use AI as part of their supervisory systems should have policies and procedures that address technology governance, model risk management, data privacy and integrity, reliability and the accuracy of the AI model. We expect to see continued focus on this space as firms increase their reliance on AI technology and new use cases develop.

Investment Fraud by Bad Actors Engaging Directly with Investors

According to the 2025 Report, FINRA has noticed an increase in investment fraud where individuals engage directly with investors to, for example, entice them to withdraw funds from their accounts to be sent to bad actors. The 2025 Report notes that this can take the form of, among other things, investment club scams, relationship investment scams, imposter websites, or tech support and support center scams.

To mitigate these types of threats, FINRA recommends: (1) monitoring for abrupt changes in customer behavior, including withdrawal requests that do not align with typical customer behavior; (2) educating firm personnel on red flags; (3) utilizing FINRA Rule 2165 to place a temporary hold on customer transactions if there is a reasonable belief that the customer is being exploited; (4) emphasizing the importance of trusted contact persons, providing educational material to customers; and (5) developing response plans for instances where a customer has been the victim of fraud (including notifying trusted contact persons or Adult Protective Services as applicable, filing suspicious activity reports (SARs), reporting the fraud to regulatory or law enforcement agencies, and attempting to recall fraudulent wire transactions).

Trade Reporting Enhancements for Fractional Share Transactions

The 2025 Report highlights planned enhancements to FINRA trade reporting facilities to support the reporting of fractional share quantities. Currently, firms may execute transactions in fractional share amounts, but the FINRA facilities do not support the entry of fractional share quantities. The new enhancements will add a "Fractional Share Quantity" field that must be populated for transactions with a fractional component.

Regulation Best Interest Enforcement

In 2024, the SEC settled several Reg BI cases with both firms and individuals. For example. In several matters, the SEC resolved allegations that the subject firm offered products to customers without taking reasonable steps to understand the potential risks and costs associated with their recommendations, such as failing to reasonably understand the significant disclosures associated with a product, or to assess a product's risks after its issuer underwent fundamental changes.[26] In some instances, the settlement also resolved allegations against a registered representative.[27]

The SEC also enforced Reg BI in matters alleging that the firms failed to maintain and enforce policies and procedures reasonably designed to determine whether a product met an investor's risk profile.[28] The SEC's recent cases have also addressed failures under Reg BI's disclosure obligation, including one matter in which a firm allegedly did not sufficiently disclose its conflicts of interest in transferring accounts to an affiliated institution.

FINRA has also been actively enforcing Reg BI. In a 2024 blog post, FINRA Executive Vice President and Head of Enforcement Bill St. Louis highlighted Reg BI as a key area of emphasis, noting the staff's increased activity in the area. FINRA settled several matters in 2024 relating to allegations that firms failed to establish reasonable supervisory systems to achieve compliance with Reg BI.[29] For example, FINRA resolved allegations that because a firm had insufficient procedures, it did not confirm that registered representatives had a reasonable basis to believe their recommendations were suitable or in the customer's best interest.[30] We expect to continue to see more Reg BI cases from the SEC and FINRA in 2025.

Anti-Money Laundering

AML is a perennial issue for both the SEC and FINRA. For the SEC, the Priorities Report cites AML as a key risk area impacting various market participants (including broker-dealers) that Exams intends to focus on during examinations in the upcoming fiscal year.[31] In particular, examinations will to focus on whether firms are (1) tailoring their AML program to their business model and related risks; (2) conducting adequate, independent testing; (3) implementing reasonable customer identification programs; and (4) meeting their suspicious activity report (SAR) filing obligations. The SEC will also review whether firms are complying with the Treasury's Office of Foreign Assets Control sanctions and taking appropriate steps to do so.

The Division of Enforcement has been active in this area. In August 2024, the SEC announced a settlement related to allegations that a broker-dealer failed to file numerous SARs for over three years, and did not have reasonably designed AML policies and procedures to identify possible red flags for suspicious activity related to transactions conducted through its alternative trading system.[32] In November 2024, the SEC announced settlements with three broker-dealers for allegedly filing deficient SARs, including, for example, that they did not identify the "who, what, when, where, and why" of the SARs being reported.[33] Recently, in January 2025, a broker-dealer and investment adviser agreed to an $18 million civil penalty and an undertaking to resolve allegations that it had longstanding failures in its customer identification program, including that it had failed to close certain accounts for which it had not verified the customer's identity and that were deemed high-risk. We expect additional Enforcement attention to AML going forward.

FINRA also resolved a number of AML cases in 2024. In February 2024, FINRA settled a matter involving allegations that a firm failed to establish and implement an AML program reasonably designed to cause the reporting of suspicious trading by its customers.[34] FINRA focused on the fact that the firm's AML program did not establish reasonable procedures for escalating potentially suspicious trading for review and alleged that the firm failed to escalate certain trading in order to assess whether a SAR should be filed. In a September 2024 settlement, FINRA alleged that a firm failed to develop and implement an AML program reasonably designed to achieve compliance with Customer Identification Program and Customer Due Diligence requirements for certain customers.

According to FINRA, as a result, the firm permitted those customers to open new accounts, even though there were multiple indicators that the firm did not know the true identity of the customers, without conducting ongoing customer due diligence.[35] In another settlement, FINRA alleged that a firm's AML compliance program did not have procedures that could be reasonably expected to detect and cause the reporting of suspicious transactions, and that the program did not develop and implement reasonable risk-based procedures for conducting ongoing due diligence.[36]

In that matter, FINRA alleged that multiple firm customers engaged in suspicious securities transactions and made suspicious wire transfer payments without the firm conducting reasonable reviews to detect and report the suspicious activity, despite the presence of red flags. Several of these matters arose from FINRA examinations. We expect FINRA Examinations and Enforcement will both continue to focus on AML compliance.

Expectations for SEC Enforcement Related to Broker-Dealers in FY 2025

As we continue to transition into the new US administration, we expect the SEC to retain its focus on certain perennial issues while moving away from some of the areas that garnered significant attention over the last several years. Specifically, we expect to see the SEC focus on longstanding issues like fraud, insider trading, spoofing, MNPI, and cybersecurity. We also anticipate the SEC will continue to seek to protect retail investors, particularly those in vulnerable populations, like seniors. On the other hand, we anticipate that the abundance of off-channel communications matters will dwindle, as well as cases based on novel legal theories. The next several months will be very telling as we see new leadership take over and the Division of Enforcement's priorities begin to take shape.

FINRA Enforcement Process Updates

Efficiency of Investigations

In an April 2024 blog post, FINRA Executive Vice President and Head of Enforcement St. Louis noted that FINRA Enforcement staff often receive feedback about the amount of time enforcement investigations remain open.[37] St. Louis explained that finding ways to efficiently close out cases is "top of mind" for FINRA Enforcement, and the staff is endeavoring to incorporate more frequent touchpoints for firms that are the subject of ongoing investigations. FINRA is also considering ways to better leverage subject matter experts to assist in efficiently handling certain matters. According to St. Louis, FINRA Enforcement is also taking steps to improve collaboration across all regulatory operations to strengthen the alignment of the exams, investigations, surveillance, and enforcement teams. St. Louis explained that by focusing on how these teams work together, FINRA has been able to enhance the quality and efficiency of its process and intends to continue to make similar strides.

Self-Reporting and Extraordinary Cooperation Credit

During the Securities Industry and Financial Markets Association's (SIFMA's) October 2024 Compliance and Legal Regional Seminar in New York, St. Louis discussed self-reporting and extraordinary cooperation credit. He reiterated that, to achieve extraordinary cooperation credit, self-reporting must go above and beyond just meeting the requirements of FINRA Rule 4530(b), and that firms that want such credit should come in early and share more information than required. St. Louis explained that the more a firm does, the earlier it does it, and the more transparent and thorough a firm is with the staff, the better position the firm is in to receive credit for extraordinary cooperation.

Nevertheless, setting aside cases involving instances in which a firm pays restitution to harmed customers, it appears that fewer and fewer Letters of Acceptance, Waiver, and Consent (AWCs) include a standalone section titled "Credit for Extraordinary Cooperation," commending the often-extensive remedial actions undertaken by a firm on its own initiative. Instead, the remedial and other cooperative efforts of a firm may be highlighted in a "Sanctions Considerations" section, which acknowledges the firm's positive actions, but does not formalize credit for extraordinary cooperation.

FINRA Thematic Reviews

Last year, FINRA's Member Supervision department introduced a new concept called "thematic reviews," to focus on a business area or product where FINRA has either seen heightened risk or believes member firms should pay additional attention.[38] Unlike targeted reviews or sweeps, which generally focus on areas where FINRA has already seen problematic behavior, thematic reviews are intended to help FINRA learn more about potential risk areas. Because of their focus on information gathering, thematic reviews will likely include a number of interviews with individuals in both business and control functions.

They will also focus on best practices that can be shared with the industry and getting ahead of potential problems before they become widespread or persist for a significant period of time. FINRA has explained that thematic reviews may ultimately result in a sweep if it determines through the review that there is a significant or widespread issue. FINRA has indicated that it conducted such exercises to gather information regarding social media communications, and how firms manage their financial statements in the context of net capital compliance.[39]

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CONCLUSION

As the new SEC administration settles in, we expect a continued focus on investment advisers and broker-dealers in FY 2025 and the years ahead. Investment advisers can expect continued scrutiny from SEC examiners, and we anticipate, under this new leadership, the SEC will recommit its focus on fraudulent conduct and trading abuses, especially as it relates to retail investors.

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