

## SEC's 2024 Examination Priorities for Broker-Dealers

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On Oct. 16, 2023, the U.S. Securities and Exchange Commission (SEC) Division of Examinations (the Division) released its annual **Examination Priorities** for fiscal year 2024 (the Report), marking the first time the SEC has aligned the Report's publication with the start of the fiscal year. Annually, the SEC directs the Division to gain insights on the developments of the financial industry and to ensure compliance with federal securities laws. In turn, the Division works closely with market participants through examinations and continuous outreach guided by the SEC's "four pillar" mission—to promote compliance, prevent fraud, monitor risk, and inform policy.

The Report, which is not materially different from the 2023 Examination Priorities, highlights the SEC's continued focus on Regulation Best Interest (Reg BI) and Regulations ATS and SHO as well as more emerging topics such as cybersecurity and crypto assets, blockchain technology, and other automated systems. The Division identified the following areas of focus for broker-dealers:

- Reg BI
- Form CRS
- Financial responsibility rules
- Trading practices
- Anti-money laundering (AML)
- Crypto assets

### Regulation Best Interest and Form CRS

Reg BI has been an area of focus for the Division in each of the Examination Priorities since its adoption. At a high level, Reg BI establishes a standard of conduct for broker-dealers who make recommendations to retail customers and requires that broker-dealers act in the customer's best interest. Part of the reason it continues to be an area of focus is its relative infancy compared with other regulations, its importance in terms of governing broker-dealer conduct, and its broad scope. For example, the specific language of Reg

BI relies heavily on the term "reasonably," leaving much of its applicability subject to interpretation and making the annual Report particularly helpful to broker-dealers in determining how the SEC will apply Reg BI to brokerage operations.

In the Report, the Division highlighted the following areas of interest:

1. Recommendations with regard to products, investment strategies, and account types
2. Disclosures made to investors regarding conflicts of interest
3. Conflict mitigation practices
4. Processes for reviewing reasonably available alternatives
5. Factors considered in light of the investor's investment profile, including investment goals and account characteristics

More specifically, the Report noted that examinations will focus on the following recommended products:

1. Derivatives and leveraged exchange-traded funds
2. Variable annuities
3. Nontraded real estate investment trusts and private placements
4. Proprietary product
5. Microcap securities

Most of the above were highlighted in some capacity in the Division's 2023 Examination Priorities, but their repeat inclusion only strengthens the Division's focus. Therefore, broker-dealers making recommendations to customers and thus subject to Reg BI must continue to ensure that they have policies and procedures designed to ensure compliance with Reg BI, with a particular focus on the firm's business and any costs or risks specific to the products the firm is recommending.

Under Reg BI, broker-dealers providing services to retail customers have an obligation to prepare and deliver their Customer Relationship Summary (Form CRS) to customers. The Division will continue to focus on Form CRS and, more specifically, on its content to ensure fees and costs, conflicts of interest, and any disciplinary history are appropriately disclosed.

### **Crypto Assets and Emerging Financial Technology**

Overall, the Report indicates that the Division will take a holistic view of emerging technologies and products. The Report highlights an intended focus on the evolving use of technological services and solutions, including mobile brokerage applications and automated and artificial intelligence (AI)-powered investment tools, as well as technological approaches to compliance and marketing considerations.

Unsurprisingly, the Division will continue to focus on crypto assets and their associated products and services. Specifically, regarding broker-dealers “involved with” crypto assets, the Division highlighted recommendations, compliance practices such as wallet and Bank Secrecy Act reviews, disclosures, and whether any technological risks associated with the use of blockchain and distributed ledger technology have been addressed.

### **Financial Responsibility Rules**

The Report stated that the Net Capital Rule and the Customer Protection Rule are particular areas of focus for the Division. As to the latter, a new area of focus is fully paid securities lending activities. With respect to the Net Capital Rule, the Division will focus on making sure firms account for certain types of liabilities such as reward programs, point programs, gift cards, and non-brokerage services.

Interestingly, and likely the result of current economic conditions, the Report notes that examinations will also assess broker-dealer credit, interest rate, market, and liquidity risk management controls to assess whether broker-dealers have sufficient liquidity to manage stress events.

### **Broker-Dealer Trading Practices**

As in prior years, the Division will continue to examine broker-dealer equity and fixed-income trading practices. In particular, the Division’s review will focus on compliance with Regulation SHO, Regulation ATS, and Exchange Act Rule 15c2-11.

The Division also highlighted the upcoming rule change shortening the settlement cycle from T+2 to T+1 and noted that it will assess how firms are preparing for the shortened settlement cycle.

### **Information Security and Operations**

Given the increase in operational risk due to cybersecurity hacks, dispersed operations, and weather and geopolitical events, the Division noted that it will review firms’ practices to prevent service interruptions to mission-critical systems and vendors and to protect investor information, data, and records. Specifically, the Division reiterated its focus on third-party oversight and responses to cyber-related incidents. With respect to third-party vendors and service products, the Division will focus on how firms identify and address the risks associated with their use.

### **Anti-Money Laundering**

The Division will continue to focus on AML programs and whether firms have appropriately designed their AML programs specific to their business model, conducted independent testing, established an adequate customer identification program, and met their suspicious activity reports filing obligations.

### **Closing**

The Report continues with the Division’s mission as expressed in prior years’ reports. However, the Report demonstrates a shift in the Division’s examination priorities from traditional compliance concerns to areas relating to new products and services offered through innovative technology. In particular, the Division noted that it will devote more resources and establish specialized teams to allow it to better address emerging issues and risks associated with crypto assets, financial technology such as AI, and cybersecurity, among others. Overall, while long-standing requirements for firms remain a key priority, the Report reaffirms that all firms must assess, update, and implement policies and procedures specific to their business and the associated risks, with a particular focus on the areas described above.

Lowenstein Sandler will monitor future publications from the Division and provide further updates and analysis in subsequent Client Alerts so broker-dealers can determine whether changes to their policies and procedures are required. Please reach out to one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the 2024 Examination Priorities Report.

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