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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.

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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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