Forward look
Top regulatory trends for 2015 in securities

Produced by the Center for Regulatory Strategies

Foreword

This publication is part of the Deloitte Center for Regulatory Strategies' cross-industry series on the year's top regulatory trends. This annual series provides a forward look at some of the regulatory issues we anticipate will have a significant impact on the market and our clients' businesses in the upcoming year. For 2015, we provide our regulatory perspectives on the following industries and sectors: Banking, Securities, Insurance, Energy and Resources, and Life Sciences, and Healthcare.

The issues outlined in each of the six reports will serve as a starting point for the crucial dialogue surrounding the challenges and opportunities for the upcoming year and will assist executives in staying ahead of regulatory trends and requirements. We encourage you to share this whitepaper with the senior executive team at your company. In addition, please feel free to share your questions and feedback with us at centerregstrategies@deloitte.com.

Best regards,

Tom Rollauer
Executive Director
Center for Regulatory Strategies
Deloitte & Touche LLP
+1 212 436 4802
trollauer@deloitte.com

The securities regulatory landscape in 2015 will continue to present significant challenges, with broker-dealers facing new or modified rules and requirements that could significantly affect how they do business. In some regulatory areas, the requirements have been clarified over the past 12 months and firms are now focusing on compliance and refinement. In other areas, the regulations are still emerging or evolving, and firms are looking for clues that can help them prepare.

Here is our view of the key trends securities firms will likely need to focus on in 2015.

1. **Consolidated Audit Trail (CAT) and Comprehensive Automated Risk Data Systems (CARDS):** *New reporting requirements will likely demand significant investments in infrastructure and staff, but may also serve as a valuable catalyst for business improvement and big data analytics.*

Securities and Exchange Commission (SEC) Rule 613 mandated the creation of a consolidated audit trail to provide regulators with valuable consolidated information for market reconstruction and surveillance. To meet the requirement, the Financial Industry Regulatory Authority (FINRA) and National Securities Exchanges are developing a system to collect and identify every transaction that involves an exchange-listed security in a U.S. market. With CAT, regulators will be able to look across multiple asset classes and examine transactions across their entire lifecycle, all the way back to the beneficial owners. For now, the focus is on individual asset classes, and on activities that occur within a broker-dealer once an order is received. Six contractors (including FINRA itself) are currently on the short list to build the centralized CAT processing systems.

Meanwhile, FINRA continues to move forward with its proposed rule for a comprehensive automated risk data system, which would require FINRA's 4,000+ member firms to collect, store and report transaction information for approximately 110 million retail brokerage accounts. The goal of CARDS is to protect the investing public by analyzing data from actual transactions to identify red flags in sales practices and business conduct. Collected information may include: customer account information; customer account activity, including securities and account transactions; customer holdings; and security identification information. On September 30, 2014, FINRA released the second iteration of the proposed CARDS rule to address some concerns raised by member firms and industry watch groups. Key changes include exclusion of some personally identifiable information, such as customer name, address and tax identification number; a shift from daily to monthly data collection (although the granularity of the data will still be at the daily level); and the introduction of a phased implementation approach that gives firms more time to comply.

CAT and CARDS present broker-dealers with major challenges related to data standardization, data privacy, and creation of cohesive systems to transmit authentic data. It will likely require significant investments in technology infrastructure and staff in order to satisfy the new requirements and to respond to new regulatory requests. What's more, firms that are required to comply with both CAT and CARDS may need to assess the overlap between the two requirements, and then identify opportunities to consolidate or integrate production of similar data sets.

Although these new requirements clearly create a significant compliance burden, they might also benefit the affected firms by providing a catalyst to produce broader, cleaner, more cohesive data. This new and improved information could be used to create business value by harnessing the power of big data and analytics to discern trends and patterns that were previously invisible. At a minimum, firms may want to stay one step in front of the regulators as there is value in self-identification rather than being on the receiving end of a regulatory request.

2. Archiving electronic communications: *Proliferation of various electronic communications platforms for business communications — and increasing message volumes — are making it difficult for broker-dealers to meet their archiving requirements.*

Broker-dealers are required to archive all business-related electronic communications — including e-mail, text messaging, IM chat and social media — for at least three years (and during the first two years the archives must be easily accessible[1]). In response, many organizations have amassed large archives of electronic communications, which has given rise to a wide range of challenges, including: high storage costs, difficulty conducting searches and discovery within the archives, and difficulty keeping pace with a rapidly evolving communications environment.

To tackle these challenges, broker-dealers should consider implementing rigorous validation models and protocols (i.e., a "validation platform") to help ensure they are

(1) adequately capturing communications from both internal business applications and external services, and (2) complying with the regulations to retain all of the required data. Broker-dealers may also want to consider implementing defensible programs to dispose of data that is no longer required. Many organizations continue to retain records well beyond the retention periods defined by regulatory requirements or legal holds, needlessly increasing the challenges of managing large and growing data archives, and exacerbating data-related issues such as security and privacy.

In addition to standard electronic communications, recent regulations now require some financial services firms to archive audio recordings such as recorded telephone calls. In their original form, the regulations required that firms be able to quickly and accurately reconstruct trades along with related communications that happen before and after the trade. However, the Commodity Futures Trading Commission (CFTC) recently proposed an amendment[2] to clarify that linking communications records to specific trades would not be required. Assuming the CFTC proposal is adopted, it would provide substantial relief to firms whose voice recording systems do not include the ability to match recordings with specific trades; however, firms would still be required to archive communications records in a searchable manner, thus presenting a continued challenge for compliance and technology groups. Firms would be wise to continue developing clear strategies and governance models to address the CFTC voice communications requirements.

3. Year two of broker-dealer internal control over compliance requirements: *The main focus for many broker-dealers in year one was simply to meet the minimum compliance audit requirements of SEC Rule 17-a5 by the year-end deadline. For year two, the focus will likely shift toward building a strong foundation for efficient and effective long-term compliance.*

Throughout much of 2014, broker-dealers with custody of customer property scrambled to demonstrate effective internal control over compliance with rules for segregation, capital, securities count, and customer statements. In 2015, it will be time for firms to take a step back and ensure their systems and processes that support compliance are as effective and efficient as possible.

In year one, perfection might not have been expected due to the transition. However, in year two and beyond the bar will likely be higher. What's more, according to the new rules, material weaknesses identified by auditors will need to be fully disclosed to the public, giving broker-dealers even more incentive to get things right.

Broker-dealers should develop and implement a strategy for ongoing compliance testing — with risk assessments and overall process testing ideally conducted every quarter. Also, they should take a hard look at their controls documentation and find ways to improve, enhance and streamline their approach. Periodic assessments can help ensure a firm's controls are still operating effectively, and provide an opportunity to update systems, processes and documentation to accommodate new business lines, products and rules. Ongoing compliance will require an effective governance structure and controls framework, as well as continued open communication between finance and operations about compliance issues and challenges.

[1] Financial Industry Regulatory Authority, Inc., "Records to be preserved by certain exchange members, brokers, and dealers SEA Rule 17a-4," 2014, http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037775.pdf.

[2] Commodity Futures Trading Commission, "17 CFR Part, Records of Commodity Interest and Related Cash or Forward Transactions," November 14, 2014, http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-26983a.pdf.

4. T+2: *A new regulatory mandate is being considered to shorten the settlement period for securities in the U.S. from three days after the transaction date (T+3) to two days (T+2). This change would have a profound impact on the securities industry.*

Europe is already in the process of adopting T+2 as its standard. The Depository Trust & Clearing Corporation (DTCC) and Securities Industry and Financial Markets Association (SIFMA) have taken the lead to champion this effort in the U.S. with regulators and industry participants. Proponents contend that a shorter settlement period would provide less time for things to go wrong — for example, having one of the parties try to back out of a deal — and increase clearing deposits. In addition, it would force firms to streamline and accelerate their settlement processes through automation and process redesign, thereby boosting efficiency and reducing operating costs. Also, adopting the same settlement period as Europe would make it easier to process international transactions.

Whitepapers by the DTCC and SIFMA suggest that T+2 will likely become a reality within the next two to three years, although adoption could be impeded or delayed by market events, industry resistance or lack of a regulatory mandate. In any event, maintaining the status quo of T+3 seems very unlikely. Sooner or later, firms will almost certainly be required to make the leap to T+2. What's more, regulators might decide to impose an even shorter deadline, with T+2 serving as a stepping-stone to a one-day settlement period (T+1).

Specific improvements necessary to achieve T+2 will likely include:

- **Migration to trade-date matching:** Removing extraneous processing time and expense from client-side, post-trade processing through consolidation of matching from three steps (allocation, confirmation, affirmation) to two steps (allocation and confirmation).
- **Mandating match-to-settle:** Requiring institutional trades to be matched before settling at the DTCC could significantly improve the settlement rate.
- **Accelerated processes for clearing and settlement:** Providing settlement agents (such as custodians and prime brokers) with settlement instructions as early as possible will help enable prompt matching and timely recall of securities when necessary.
- **System improvements to standing settlement instructions:** Standardizing client-side communications to improve the capture and accuracy of settlement instructions would likely reduce trade breaks and exception management costs.
- **Migration away from physical securities:** Reducing the need for movement of physical securities (with its inherent delays) should increase the speed at which settlement can occur, reduce processing costs, and reduce the complexity of dual-path settlement.
- Regulatory capital impact: Shortening the settlement cycle will make it even more important for trades to be captured properly and affirmed in a timely manner. Otherwise fails will occur that, when aged, will cause capital charges.

Although the formal regulatory mandate has yet to be established, it is never too early for firms to start assessing their settlement systems and processes and looking for ways to improve speed and efficiency. Such improvements could deliver significant short-term benefits — even before the T+2 requirement goes into effect — while helping firms avoid a last-minute fire drill to comply with increased regulatory requirements.

5. New liquidity requirements for broker-dealers: *The SEC is considering liquidity requirements[3] and leverage limits[4] for larger broker-dealers, similar to what international regulators are doing in the banking industry.*

Both initiatives are currently being vetted with industry committees. And while nothing specific has yet been proposed, if limits do go into effect, broker-dealers would be required to limit the amount of assets they hold and to lock up a significant portion of those assets in the form of unencumbered cash and government securities. This could severely impact their overall return on equity.

Broker-dealers are not banks and the SEC's plans are stirring up some controversy. Although the leverage ratio being discussed is similar to the standard for banking, it does not take into account that most broker-dealers already take much higher capital charges on their assets — some as high as 100 percent.

The liquidity initiative for securities firms is similar to the liquidity initiative for banks in that both would require stress testing to assess the potential funding shortfall an institution might face in the event of a severe credit crisis in which it is unable to borrow money, and both would require a liquid asset reserve in that amount. However, the Federal Reserve Board's proposed liquidity requirements for banks would only apply to "large and internationally active banking organizations" (e.g., those with more than $250 billion of consolidated assets), whereas the SEC is talking about applying its liquidity requirements to securities firms that are much smaller.

Broker-dealers should keep this trend in mind since liquidity requirements and leverage limits might change their assessment of new and existing activities that consume balance sheet assets without adding enough to the bottom line.

6. SEC scrutiny of dual registrants: *In 2015, the SEC is expected to continue its scrutiny of firms dually registered as broker-dealers and investment advisers ("dual registrants").*

According to the SEC,[5] one of its most significant initiatives in 2014 was to focus on issues related to organizations that operate as both investment advisers and broker-dealers — and this trend will likely continue or increase in 2015 and beyond. The SEC believes these organizations pose a unique and significant risk to the marketplace and investing public, and is "actively looking for undisclosed and unmitigated conflicts" among dual registrants that move client assets from commission-based brokerage accounts to fee-based wrap accounts.

In particular, the SEC is looking for proof that such client asset moves "provide a corresponding benefit to the customer."[6] Also, the SEC is studying the issue of investors who move from the suitability standard of brokerage accounts to the fiduciary standard of investment advisor accounts, and is evaluating the controls that dual registrants have put in place to monitor whether the selected investment program is appropriate for each client.

Given this increased scrutiny, dual registrants need to be very careful when shifting customers from commission-based accounts to fee-based accounts. That means developing and following clear and consistent processes for handling such moves, and then rigorously maintaining good records and documentation that can help them defend their actions if called out by regulators.

[3] US Securities and Exchange Commission, "17 CFR Parts 240, 241, and 250 Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities," September 8, 2014, http://www.sec.gov/rules/final/2014/34-72472.pdf.

[4] Office of Information and Regulatory Affairs, Office of Management and Budget, Executive Office of the President, "Broker-Dealer Leverage Ratio," Fall 2014, http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201410&RIN=3235-AL50.

[5] US Securities and Exchange Commission, "Remarks to the 2014 IAA Investment Adviser Compliance Conference," March 7, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541711090#.VJmliACCPB.

[6] IBID

Moving Forward

The regulatory landscape for securities continues to evolve, making it imperative for firms in the industry to keep a watchful eye on new or modified requirements. For updated information about the latest regulatory trends and developments, please visit the Deloitte Center for Regulatory Strategies blog here.

Contacts

Marjorie Forestal
Principal
Deloitte & Touche LLP
+ 1 212 436 6633
mforestal@deloitte.com

Gina Greer
Partner
Deloitte & Touche LLP
+ 1 212 436 5868
ggreer@deloitte.com

Michael Jamroz
Partner
Deloitte & Touche LLP
+ 1 202 879 5310
mjamroz@deloitte.com

Susan Levey
Director
Deloitte & Touche LLP
+ 1 212 436 2659
slevey@deloitte.com

Felicia Sokalski
Partner
Deloitte & Touche LLP
+1 973 602 6237
fsokalski@deloitte.com

Tom Rollauer
Executive Director
Center for Regulatory Strategies
Deloitte & Touche LLP
+1 212 436 4802
trollauer@deloitte.com

The Center wishes to thank the following additional Deloitte professionals for their contributions and support:

Lara Hamilton, Senior manager, Deloitte & Touche LLP
Beth Leesemann, Marketing manager, Deloitte Services LP

DCRS
Deloitte Center
for Regulatory Strategies

About the Deloitte Center for Regulatory Strategies
The Deloitte Center for Regulatory Strategies provides valuable insight to help organizations in the financial services, health care, life sciences, and energy industries keep abreast of emerging regulatory and compliance requirements, regulatory implementation leading practices, and other regulatory trends. Home to a team of experienced executives, former regulators, and Deloitte professionals with extensive experience solving complex regulatory issues, the Center exists to bring relevant information and specialized perspectives to our clients through a range of media including thought leadership, research, forums, webcasts, and events.

www.deloitte.com/us/centerregulatorystrategies

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, “Deloitte” means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see HYPERLINK "http://www.deloitte.com/us/about" www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2015 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited