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The active regulatory agenda

Introduction

An increasingly active federal regulatory agenda for financial services is having profound effects on every type of organization involved in the capital markets and, by extension, the customers and clients they serve. Numerous new and proposed rules place a tremendous burden on the affected organizations to manage the heavy volume of change; operationalize programs; and stand up the new technology solutions, controls, reporting, and staffing necessary to comply with near-term deadlines.

A competitive job market, high turnover, and untrained or undertrained resources compound these challenges for many firms. The Great Resignation has left many firms struggling to leverage the institutional knowledge necessary to adapt legacy systems, processes, and technologies to new regulatory requirements. Firms continue to navigate pandemic-driven workforce policies and increased recruitment competition with other industries, both of which can compromise their organizational culture and opportunities for talent development.

This white paper discusses the effects of the current regulatory agenda on seven organizational areas across regulated financial services firms, which will have significant impacts on their budgets and balance sheets.

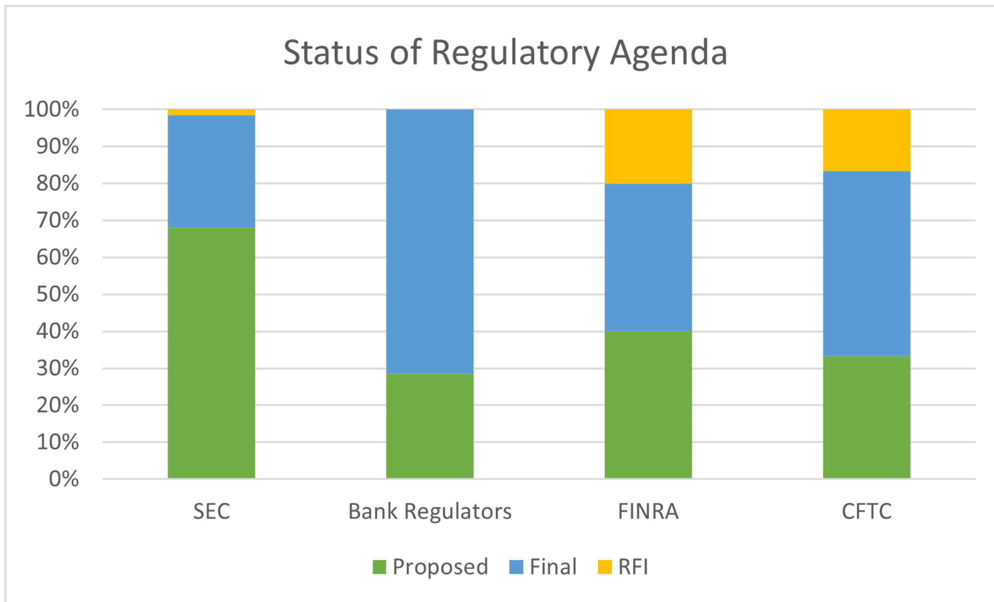
Overview of the current regulatory landscape

Among US financial regulators, the bulk of new and proposed rulemaking is coming from the Securities and Exchange Commission (SEC or Commission). The Commission is pursuing a volume of regulatory change unseen in the past decade. Under Chair Gensler, the SEC is redefining market structure, materiality, and the very universe of entities that it regulates. At the same time, companies subject to financial regulations are facing tremendous challenges, including talent issues, inflation, and a slowing economy.

Some of the most significant and costly proposals from the SEC are expected to be released in the coming months, including substantial changes to equity and debt market structure. Additionally, the SEC is already facing litigation over at least one of its proposals,[1] and the Supreme Court's recent decision in West Virginia v. EPA[2] only increases the likelihood that more of the agency's rules will be challenged in court and mired in uncertainty for years to come.

Regulator's Share of Agenda	
SEC	79%
Bank Regulators	8%
FINRA	6%
CFTC	7%

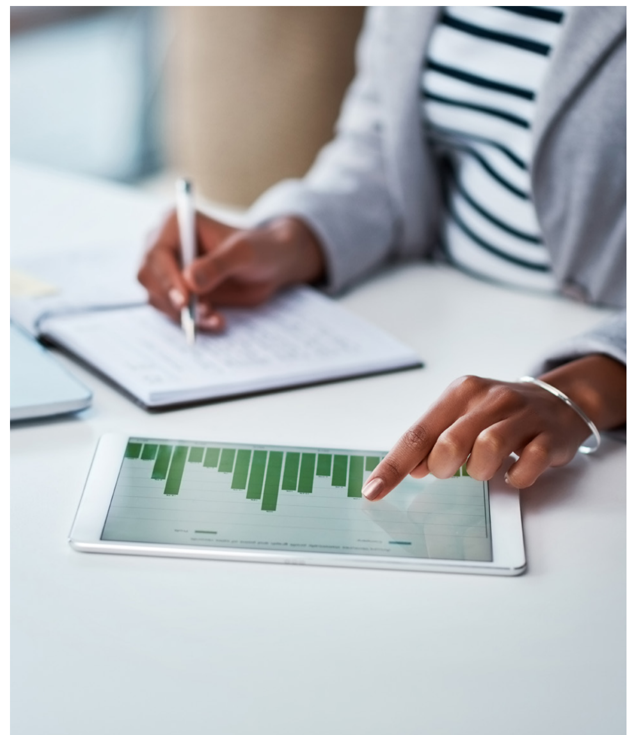
Regulated Entity's Share of Agenda	
Issuers	23%
Banks	9%
Broker-dealers	38%
Swaps dealers	26%
Investment advisers and funds	17%



Regulatory impacts on firms

Firms often need to expend extensive resources to interpret new regulations and implement a sustainable compliance operation. Activities like data sourcing, data lineage, data requirements management, controls, report submission, and submission management response require significant investments of time from regulatory change managers, compliance, business lines, data managers and reference data managers, developers, and operations staff. Many firms need to hire external resources, including outside counsel, consultants, and contractors, to provide advice, specialized skills, and additional capacity.

The following heat maps illustrate the extent of the impact that new and proposed financial services regulations have on different types of affected firms across seven key organizational areas. While individual impacts might vary slightly from firm to firm, in aggregate it is evident that the numerous new regulations being imposed on the industry have significant effects at all levels of the organization.



The active regulatory agenda

Estimated Impact of Regulatory Implementation on Business Lines

		Board/Corporate Governance	Finance/Reg Reporting	Risk	Operations	Technology	Compliance	Legal
Aggregate Impact								
Investment Advisers and Funds	Investment Advisor Marketing							
	Fair Value							
	Treasury Clearing							
	Universal Proxy							
	Amendments to Form 13F							
	Cyber risk management for IAs, RICs,							
	Digital Engagement Practices							
	T+1							
	Proxy voting advice							
	MMF reforms							
	Amendments to form PF							
	Enhanced reporting of proxy votes							
	Amendments to "Fund Names" Rule							
	ESG Disclosures for Investment Advisers and Investment Companies							
	Electronic submission of Adviser Act Orders							
	RIA Compliance Review Amendments							
Swaps Dealer	Uncleared SBS Margin Phase 6+							
	SBSD CCO Annual Report							
	Electronic recordkeeping requirements							
	Edgar Manual/Filing Updates							
	Prohibition against undue influence over SBSD CCOs							
	Prohibition against fraud in connection with SBS							
	Reporting large SBS positions							
	SBS execution/registration & regulation of SBSF's							
	SDR reporting amendments							
	Governance Proposal for Derivatives Clearing Organizations							
	FCM Registration							
	Capital Comparability Determination (FSA of Japan)							
	Climate-related financial risk RFI							
	Uncleared Swaps margin phase 6							
	Security-based SWAP margin rules							
	Uncleared Swaps/SBS margin phase 6							
Broker Dealers	Treasury Clearing							
	Uncleared SBS Margin Phase 6+							
	Consolidated Audit Trail (CAT)							
	Rule 18f-4 Use of Derivatives Funds							
	Reg SBSR Reporting							
	Rule 15c2-11 No Action Letter							
	Modernization of Beneficial Ownership Reporting							
	Digital Engagement Practices							
	Electronic recordkeeping requirements							
	T+1							
	Exchange Act & Reg ATS Amendments							
	Cross trading							
	Amendments to the definition of a broker-dealer							
	Short Interest reporting							
	Prohibition against fraud in connection with SBS							
	Position limits							
	Security-based SWAP margin rules							
	Rule 4210 Covered agency transactions							
	Short reporting							
	OTC Options Transactions Reporting							
	Reg Notice 22-16							
	Reg Notice 22-13: Trade Reporting Exemption							
	Trace Reporting Amendments for Identification of Portfolio Trades							
	Amendments to the Code of Arbitration							
	Reg Notice 22-08							
	Uncleared Swaps/SBS margin phase 6							
Banks	Revision to IRB framework							
	Revisions to CVA framework							
	Revisions to operational risk framework							
	Revisions to market risk framework							
	Output floor							
	Revision to standardized credit risk							
Issuers	Universal Proxy							
	Rule 15c2-11 No Action Letter							
	Modernization of Beneficial Ownership Reporting							
	Rule 10b5-1 Insider Trading							
	Share repurchase disclosure modernization							
	Pay vs Performance							
	Proxy voting advice							
	Reporting of executive compensation votes							
	Erroneously awarded compensation							
	Reg M Update							
	Holding foreign companies accountable act disclosure							
	SPAC disclosures							
	Climate risk disclosure							
	Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals under Exchange Act 14a-8							
	Cybersecurity Risk Management, Governance, and Incident Disclosure							

Impacts to parts of the organization

The board and corporate governance

The board of directors oversees the creation and implementation of the rules, controls, and procedures that make up the firm's corporate governance structure, which is used to direct and manage its operations. Adapting to new regulations often requires firms to make changes to their corporate governance structures. The greater and more complex these changes are, the more involved the board must be to ensure that the firm not only meets the new regulatory requirements but also appropriately balances the various interests of its stakeholders and accomplishes its objectives, all of which can detract from the board's primary responsibilities.

Finance and regulatory reporting

A firm's financial statements and required disclosures provide investors, analysts, and regulators critically important information about its performance and regulatory compliance. Firms have robust systems and processes to ensure that the collection, assessment, and presentation of this information is reliable, trustworthy, and, when applicable, audited and verified by independent accountants. Regulatory changes that create new reporting requirements can impose significant burdens on these systems and processes. These burdens are compounded when the new regulations require firms to build new tools and technologies or make speculative judgments about the impact of uncertain future events, and when the volume and breadth of new reporting requirements increase, all of which could jeopardize the integrity of a firm's financial statements and disclosures.

Risk

Regulatory changes create a variety of new risks for regulated entities, which can interact in unpredictable ways and place strains on firms' risk management function. Because major regulations are frequently amended due to unintended consequences or shifting political headwinds, these risks can be present far beyond a new regulation's effective dates. Economists have found that regulatory uncertainty is associated with increased stock price volatility as well as decreased investment and employment in the affected industries.[3]

Compliance risk: As a result of the inevitable uncertainty created by shifting regulatory standards, even well-intentioned firms run the risk of being subject to enforcement action by their regulators. When the volume and pace of regulatory change increases, compliance risk is heightened, which can lead firms to divert resources from core business functions to regulatory compliance activities.

Operational risk: Compliance with regulatory changes frequently induces firms to develop and implement new systems and processes, which creates operational risk. Operational risk increases and becomes more difficult to manage as the volume of regulation grows and with regulatory changes that have significant implications for firms' operations, such as the Consolidated Audit Trail (CAT)[4] reporting system and the migration to a T+1 settlement cycle.[5]

Financial risk: The rising investments needed to comply with new regulations pose meaningful financial risk to firms, especially when coupled with the potential for fines. Limited resources and cost pressures across an organization may restrain budgets associated with regulatory implementation, placing additional burdens on the teams designated to lead such efforts and increasing the financial risk of an enforcement action.

Reputational risk: Enforcement actions harm a firm's reputation, which can result in costs that are significantly greater than those associated with regulatory compliance. Enforcement actions are also likely to increase future regulatory scrutiny.

Competitive risk: The fixed costs that regulation imposes on regulated entities can place heavily regulated firms at a competitive disadvantage relative to less regulated peers, which increases with their regulatory burden. For example, the SEC has issued several significant disclosure rule proposals for publicly traded companies[6] that impose direct compliance costs associated with reporting and may have even greater indirect costs that result from the market's response to reported information. By contrast, privately held firms will face neither the direct nor indirect costs of these proposals and might even economically benefit from the information gap across the public and private markets created by them.

Operations

Implementing the spectrum of regulatory change being pursued today will require firms to design, build, implement, and maintain new systems and processes. When regulators issue multiple new regulations with significant operational impacts over a short period of time, firms need to devote considerable resources to accounting for any interconnection or interaction between the rules. In this scenario, the total compliance costs are often greater than the sum of the costs of each individual regulation. Firms may need to stand up new teams or draw resources from other functions to navigate the complex regulatory environment. Short, overlapping compliance deadlines further stretch firms' resources and risk exacerbating the talent and retention challenges they face, potentially harming their competitive positions.

Technology

Technology teams often shoulder much of the compliance burden as they are responsible for developing and implementing the new systems, processes, upgrades, and other technological solutions that operationalize firms' compliance strategies. When the volume of regulatory change is as intense as it is presently, these teams can become bottlenecks. Meanwhile, firms may not have the luxury of adding the necessary headcount to reduce the burden on these professionals due to budgetary constraints and talent shortages.

Compliance

In recent years, many firms have created regulatory change functions that are mission critical in the current environment as they are responsible for mobilizing the organization to respond to regulatory change. These teams manage the broad spectrum of new and shifting regulatory requirements, and high volumes of regulatory activity inundate these teams with information and new mandates, creating a significant challenge as implementation efforts are forced to compete internally for the same resources and personnel.

Legal

A firm's legal department is responsible for managing its legal risks, advising on compliance matters, and leading the team that represents the company in litigation when necessary, including litigation resulting from regulatory enforcement action. By subjecting firms' activities to a new set of prohibitions and mandates, and by opening new avenues for regulatory and private legal action against firms, new regulations impose significant burdens on legal departments.

Considerations for firm size

Large firms

Within large and diversified firms composed of multiple types of regulated entities (e.g., issuer, bank, broker-dealer, swaps dealer, investment adviser and fund), certain organizational areas—such as board/corporate governance, financial/regulatory reporting, risk, compliance, and legal—support all business lines across the firm. The same can also be true of back-office functions and capabilities, such as operations and technology. For example, the same teams and functions within a large public company that offers investment management and broker-dealer services may be responsible for complying with seven separate rules related to just two regulatory issues: climate and cybersecurity. The SEC has issued three climate disclosure proposals (one for public issuers and two for investment management firms) and two cybersecurity disclosure proposals (one for public issuers and one for investment management firms), while FINRA is expected to issue a climate and a cybersecurity proposal for broker-dealers.[7] These are in addition to the web of existing federal, state, and global standards.

As illustrated in the consolidated heat map, the 66 separate federal regulatory proposals to be imposed on large and diversified firms create greater and more complex risks, compared to those facing small or monoline firms, that accumulate within organizational areas and multiply across the firm. These compounding effects can create stability risk for individual firms and the broader market.

Smaller firms

Regulations create disproportionately large burdens on small- and medium-size firms, as they are required to meet the same standards as their larger peers but often with fewer financial and talent resources. Well-capitalized and well-resourced firms can absorb the additional fixed costs imposed by regulations more easily than lesser capitalized firms, or firms with thinner margins, which places those firms at a competitive disadvantage. For example, former SEC Chief Economist Mark Flannery found that the "proposed prohibitions" in the SEC's private fund advisers rule proposal "may challenge the viability of small, minority, and women-led funds."[8] This is one reason that regulation has been demonstrated to drive industry consolidation.

Congress requires federal agencies to analyze the anticipated economic impacts of their regulations. However, regulators often limit this analysis to estimating the direct costs associated with compliance (current estimates anticipate an average cost of more than $1 million per firm per rule[9]), rather than also accounting for indirect costs that may result from changes to or reductions in market activities. Further, each proposal's assessment is typically conducted in an isolated fashion, even though two or more proposals may overlap or interact such that direct or indirect costs multiply. Incomplete or imbalanced economic impact analyses magnify the risk that regulatory changes may have negative unintended consequences, which increases with the volume and breadth of regulatory changes. Therefore, it is critical that agencies consider the aggregate impact of their activities.

Conclusion

The current volume of simultaneous regulatory change may overwhelm firm resources and staff, which can lead to negative unintended consequences for financial markets and all those who rely on them. Like the entities that they regulate, agencies also have limited resources to meet competing demands. The heavy volume of significant rule proposals has strained agency staff and will likely place serious burdens on firms once finalized. The overlapping and near-term implementation deadlines may create pools of risk across organizations with the potential to disrupt financial markets themselves.

Regulatory agencies are likely to achieve better outcomes by proceeding in a more methodical and streamlined manner. This would require regulators to prioritize among the many outstanding proposals and advance to the final rule stage only those that address a clear market failure. Finalizing only the strongest and most urgently needed regulations or using a phased approach may potentially help ensure that firms are able to implement the required changes successfully.

Effective policy that strengthens the financial markets and protects investors requires constructive dialogue between industry and government. This discourse brings balance to the priorities and responsibilities of both the private and public sectors, which is critical to ensuring that the US capital markets retain their position as the global gold standard.

Contacts*

Bob Walley
Principal
Deloitte & Touche LLP
+1 917 952 5173
rwalley@deloitte.com

Irena Gecas-McCarthy
Principal
Deloitte & Touche LLP
+1 212 436 5316
igecasmccarthy@deloitte.com

Meghan Burns
Manager
Deloitte & Touche LP
+1 202 220 2780
megburns@deloitte.com

Endnotes

1. Chamber of Commerce of the United States of America, Business Roundtable, and Tennessee Chamber of Commerce & Industry v. Securities and Exchange Commission and Gary Gensler, No. 3:22-cv-00561 (Mid. Dist. Tenn., July 28, 2022).
2. Jan Wolfe, Amara Omeokwe, and Andrew Ackerman, "Supreme Court climate ruling adds obstacles to SEC policies," Wall Street Journal, July 1, 2022.
3. https://nbloom.people.stanford.edu/sites/g/files/sbiybj4746/f/qje_bbd.pdf
4. Securities and Exchange Commission (SEC), "Amendments to the national market system plan governing the Consolidated Audit Trail," 2020.
5. SEC, "Shortening the securities transaction settlement cycle," 2022.
6. Ibid, p. 1.
7. SEC, "The enhancement and standardization of climate-related disclosures for investors," and "Cybersecurity risk management, strategy, governance, and incident disclosure," 2022.
8. Drew Maloney (American Investment Council), Letter addressed to Vanessa A. Countryman (SEC) regarding "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Release No. IA-5955; File No. S7-03-22 (February 9, 2022))," April 25, 2022.
9. Statistic reflects the average per firm cost of rule proposal as reported in the SEC's economic analysis for those proposals where a quantitative cost estimate was provided.

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