Deloitte.

Navigating the year ahead

Investment management 2018

United States
December 2017

CENTER *for*
REGULATORY STRATEGY
AMERICAS

This publication is part of the Deloitte Center for Regulatory Strategy, Americas' 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 2018. The issues outlined in each of the reports provide a starting point for an important dialogue about future regulatory challenges and opportunities to help executives stay ahead of evolving requirements and trends. For 2018, we provide our regulatory perspectives on the following industries and sectors: banking, securities, insurance, investment management, energy and resources, life sciences, and health care. For a view of the other trends impacting investment management in 2018, we encourage you to read the Deloitte Center for Financial Services companion paper.

We hope you find this document to be helpful as you plan for 2018 and the regulatory changes it may bring. Please feel free to contact us with questions and feedback at CenterRegulatoryStrategyAmericas@deloitte.com.

Contents

Global foreword

Another year has passed, so what has changed?

This time last year we expected 2017 to be a period of uncertainty for financial services regulation. Financial services firms were challenged by the continuing lack of clarity over the final shape of post-crisis reforms, the implications of Brexit and a new US political administration. We also saw significant pressures on the banking and life insurance sectors from sluggish economic growth and low interest rates in Europe and the US, and competition from new entrants (particularly fintechs).

Looking ahead to 2018, most of these challenges and uncertainties remain.

Economic growth, but how robust?

Global growth prospects improved through 2017 and continue to be broadly positive, albeit more subdued than in the period before the financial crisis. China, Europe, and Japan have all been outperforming expectations, and although India's economy has slowed lately, the long-term outlook is upbeat. There are now signs that the extraordinary monetary easing of the last ten years is starting, slowly, to unwind in Europe and the US, although this stands in contrast to the situation in China and Japan.

There are reasons for caution. Asset markets and prices have seemed impervious to the prospect of tighter monetary conditions and geopolitical tensions. This has left many commentators worrying that markets are in the grips of a bout of irrational exuberance. There are also signs of price bubbles in commercial and residential property markets, as well as leveraged finance markets, and of elevated levels of consumer indebtedness, particularly in the advanced economies.

Supervisors across the globe are very alert to the financial stability risks posed by the political and economic climate, and we expect them to focus on the ability of financial institutions in all sectors to deal with the downside risks of an abrupt shift in market sentiment and any increase in asset price volatility, irrespective of the trigger. Boards are expected to keep their risk appetites under review, and will also need to engage closely with stress testing, whether prompted by supervisors or carried out internally.

What does this mean for the regulatory agenda?

Last year we predicted that there would be no wholesale rolling back of the post-crisis regulatory framework, and this remains our view. The consensus in the US is that there will be some meaningful adjustments to the Dodd-Frank Act, but no large-scale repeal or rewrite. In the EU there remains a considerable volume of legislative work ongoing; and even where there is no new legislation, there is a great deal of "fine tuning" of existing rules. The Asia Pacific region faces a long tail of implementation work, and must also deal with the impact of regulation from outside the region.

At the international level, the Financial Stability Board (FSB) has shifted its primary focus toward a post-implementation evaluation framework, which will be "progressively applied" in the coming years. This is part of a rebalancing away from introducing new rules toward assessing the effectiveness of what has been done over the past decade. Boards will need to be ready to demonstrate to supervisors that they have embedded change and that this is leading to the desired outcomes.

One major area in which there remains a number of significant unanswered questions is bank capital requirements. Although the Basel Committee on Banking Supervision (BCBS) has until now been unable to complete the Basel III package, final agreement on the open issues seems within reach. We do not see any major economies as being in a hurry to introduce yet-more legislation, and we also see those economies being more willing to depart from the letter of global standards where they conclude it is in their interest to do so.

As a consequence, financial services firms need to be prepared to deal with the challenges of diverging regulatory frameworks. At a minimum they will need globally coordinated approaches to understand overlaps, incompatibilities, and potential synergies.

Supervisors are turning more attention to long-term structural issues

Technological innovation, aging populations, and climate change have all caught the attention of the regulatory and supervisory community as emerging risk areas. We expect some supervisors to begin to challenge boards, risk committees, and senior management to demonstrate that they understand the impact on their customer bases, business models, and risk profiles, and are set to take effective mitigating actions where needed.

Fintech: While new technologies present opportunities, regulators want to understand the potential risks and the likely impact on incumbents' business models. The FSB has a clear interest in the subject. The European Commission is expected to deliver a fintech "Action Plan" in January. Similarly, US regulators are considering the implications of new technologies, including third-party relationships among fintechs and banks, and are even exploring special purpose bank charters for fintechs.

Climate change: The FSB has taken the lead internationally with its Task Force on Climate-Related Financial Disclosures, which made its final recommendations in June 2017. A number of regulators in the Asia Pacific region are instituting policies to encourage green finance. The Bank of England (BoE) is also researching climate change and the EU recently proposed to integrate environmental risks into the mandates of the European Space Agency (ESA) as part of its action plan on sustainable and green finance.

Aging populations: Aging populations worldwide will create a widening pool of potentially vulnerable customers and influence demand for different types of financial services, as well as the way in which financial institutions engage with their customers. At the international level, the International Organization of Securities Commissions (IOSCO) is taking forward work on aging populations.

Leadership changes

Lastly, we note that by the end of 2018, the most senior leadership of many of the world's most important regulatory bodies will be starkly different from what it has been for the majority of the post-crisis regulatory reform era. Mark Carney's term as chairman of the FSB)has been extended through to December 2018, lending some additional continuity to reform efforts, but this will be his final year at the top of the FSB. We expect Stefan Ingves to stand down as chair of the BCBS in the near future. There is also a great deal of change in senior leadership across national and regional regulatory bodies, particularly in the US. It remains to be seen how far new leaders will uphold the key tenets of the international supervisory agenda of the last decade, particularly its emphasis on cross-border coordination, or whether supervisory priorities will tilt more toward promoting the competitiveness of individual jurisdictions.

On balance we think that these new leaders will emphasize practical supervisory initiatives over (new) rulemaking, as well as the need for firms to demonstrate that they are financially and operationally resilient to a range of threats, both old and new. New leaders will be keen to consolidate the outcomes and achievements of the prudential policy agenda that has dominated the last 10 years and focus their tenures on continuing structural challenges as well as emerging risks and issues.

Acting in the face of uncertainty

While we expect some greater clarity about the regulatory outlook to emerge in 2018, the overriding challenge for firms remains coping with uncertainty, including from the global impacts of Brexit and how markets in Europe and elsewhere will be reshaped by Markets in Financial Instruments Directive (MiFID) II. This will put a premium on firms maintaining strategic flexibility, while at the same time adopting new technologies to react to the threat from "challengers," improve their customer service and outcomes, better manage their risks, and help control costs. With yields and income levels, and hence return on capital, still under severe pressure, cost control will continue to be extremely important. Even though interest rate rises are under way, they will be neither quick enough nor big enough to alleviate pressure on incumbents' business models.

David Strachan
Center for Regulatory Strategy, EMEA
Deloitte UK

Kevin Nixon
Centre for Regulatory Stategy, APAC
Deloitte Australia

Chris Spoth
Center for Regulatory Strategy, Americas
Deloitte US

Introduction

Most investment management organizations are forging ahead with their risk and compliance initiatives, even as regulatory uncertainty will likely remain a significant and ongoing challenge. Even if lawmakers and regulators make certain definitive changes, investment management organizations must continue to drive effectiveness and efficiency of their risk and compliance programs so they meet applicable laws, regulations, and supervisory expectations. And in most cases, they don't have the time or luxury of waiting to see how things will shake out. Fortunately, many of the changes investment management organizations are making to achieve compliance are useful improvements that are worth doing from a risk and business perspective.

Here's a look at the key regulatory trends investment management organizations will likely need to monitor and address in 2018. By embracing regulatory complexity, organizations can accelerate performance and stay ahead of changes so they can better navigate the regulatory landscape.

To stay on top of the latest regulatory news, trends, and insights, we invite you to visit our website at www.deloitte.com/us/about-dcrsamericas.

Mutual fund modernization

In October 2016, the US Securities and Exchange Commission (SEC) adopted new forms, rules, and amendments that require mutual funds to collect a significant amount of additional data and to report that data monthly (Form N-PORT) and annually (Form N-CEN).

To satisfy the requirements, fund sponsors and service providers will need to invest in people, processes, and technology between now and July 2018 to support those mutual fund complexes that have $1 billion or more in assets under management. Smaller fund complexes (those managing less than $1 billion in assets) will be impacted in 2019.

Some key challenges for fund sponsors and service providers include:

Data sourcing and aggregation. Information will need to be captured from multiple sources (e.g., sponsor, administrator, brokers, transfer agents, securities lending agents, compliance, and legal functions), which may require fund sponsors and their service providers to reevaluate data collection and processing.

Operating model decisions. Fund sponsors will need to select a future state operating model to support the reporting function (e.g., selecting a filing service provider or developing new functions internally).

Resourcing needs. The Rule will require fund sponsors to increase resources to accommodate additional filing requirements and compressed timelines (whether completing the filings internally or overseeing a filing service provider).

Service provider oversight. Fund sponsors will need to establish internal processes and controls to perform comprehensive due diligence and ongoing operational assessments of service providers.

The Investment Company Institute[1] has requested a six-month delay in the compliance date for the new filings. If granted by the SEC, this would delay filings until January 2019 for complexes with greater than $1 billion in assets under management.

Asset managers and third-party administrators are trying to prepare for the compliance date (July 2018 first filing), but many have a significant amount of work to do. This includes understanding the new data requirements, performing a comprehensive data analysis/mapping to understand where "gold source" data exists, and developing technology solutions to support the new filing requirements.

Many of the technology solutions are being developed by third-party technology companies, creating a significant dependency for asset managers and administrators to prepare and implement new operating models. In addition, the new forms require complex

It is unclear how these new filings will impact future regulations and requirements, but given that the data will be filed in a structured format by all mutual funds, the SEC staff will have the ability to compare "like" mutual funds against one another and look for anomalies to evaluate and select registrants for further evaluation.

calculations that aren't currently performed by asset managers.

It's unclear how these new filings will impact future regulations and requirements. But given that the data will be filed in a structured format by all mutual funds, the SEC staff will have the ability to compare "like" mutual funds against one another and look for anomalies to evaluate and select registrants for further evaluation. The SEC has indicated that the data provided will help inform mutual fund and investment adviser examinations and could be the basis for future enforcement investigations. Internally, the new forms and data may provide an opportunity for firms to develop data analytic capabilities to identify, assess, and remediate compliance issues before the SEC identifies compliance concerns through its own data analytic capabilities. This can allow firms to mitigate exposure and improve the design and effectiveness of their implemented compliance programs.

Given the magnitude of effort required to achieve compliance by July 2018, mutual fund sponsors should immediately begin to prepare and implement working group teams. Asset managers, to the extent they are looking to leverage their administrators, should also recognize that a significant portion of the data will come from their own internal operating systems—which the administrators will need to receive. Therefore, a significant internal effort needs to be initiated as soon as possible. Total reliance on a third-party service provider will likely not allow the forms to be completed/filed in good order by the compliance date.

Fiduciary rule

The Department of Labor's (DOL) delayed the full applicability date of its "Conflict of Interest Rule" on fiduciary investment advice (the "Rule") from January 1, 2018 to July 1, 2019. Other regulatory agencies have indicated that they're exploring similar rules for wealth management professionals that would require a fiduciary standard of care when delivering advice to retail investors. Specifically, the SEC is considering its own fiduciary rule proposal, and individual states, such as Nevada, have begun to implement legislation related to providing advice to investors under a fiduciary standard. Furthermore, despite delays to DOL rule's implementation dates, the Rule continues to serve as a catalyst for change across the wealth management industry.

Many of the wealth management marketplace implications were highlighted in a 2017 Deloitte & Touche LLP report for the Securities Industry and Financial Markets Association (SIFMA).[2] Key themes included:

Increase in fee-based accounts for retirement investors. The majority of survey participants indicated that fee-based account program participation increased through lowering account minimums and/or revising existing program minimums or launching new offerings. Study participants consistently indicated that the trend toward fee-based accounts was accelerated by the Rule and other factors across the industry.

Reduction in product shelves and enhanced product due diligence. Approximately 95 percent of firms surveyed reduced or consolidated product shelves in response to the Rule. The most impacted products were mutual funds and variable annuities. Study participants noted that mutual fund and annuity offerings were primarily reduced as a result of enhanced due diligence processes and/or product manufacturers' inability to meet compensation changes required by the wealth management organization. Furthermore, virtually all firms indicated changes to product due diligence efforts, primarily through enhanced internal research or third-party research support.

Enhanced rollover and due diligence processes. Virtually all survey participants have further explored firm policies and processes related to the rollover of client assets from retirement accounts. Also, the majority of participants have enhanced their rollover review processes, including increasing the size of oversight teams and/or leveraging vendor rollover review tools.

Implementation efforts to comply with the DOL's fiduciary rule may have slowed in recent months given the delay. But the wealth management industry appears to be continuing to migrate toward a fiduciary model for delivering advice to both retirement and non-retirement clients. This trend toward a fiduciary model will likely continue, and it could accelerate under certain scenarios, including the DOL's Rule moving forward as planned, the SEC drafting its own version of the rule, and/or individual states continuing to pass related legislation.

Investment company liquidity risk management programs

Last year, we discussed the SEC adopting a new rule and form designed to promote better liquidity risk management by registered investment companies. The new rule (Rule 22e-4) requires funds, including exchange-traded funds (ETFs), to establish liquidity risk management programs. ETFs that qualify as "in-kind ETFs" are exempt from some of the rules requirements, and money market funds are exempt from all requirements. The new required form (Form N-Liquid) is used by registrants to report certain breaches of the rule's requirements. The rule lays out numerous elements the SEC staff believes a liquidity risk management program should include, specifically:

- Assessment, management, and periodic review of a fund's liquidity risk
- Classification of the liquidity of fund portfolio investments
- Determination of a highly liquid investment minimum
- Limitation on illiquid investments
- Board oversight

In the months since the rule was adopted, many firms have invested significant time and effort to prepare for its effective date, which for most fund families is December 1, 2018.[3]

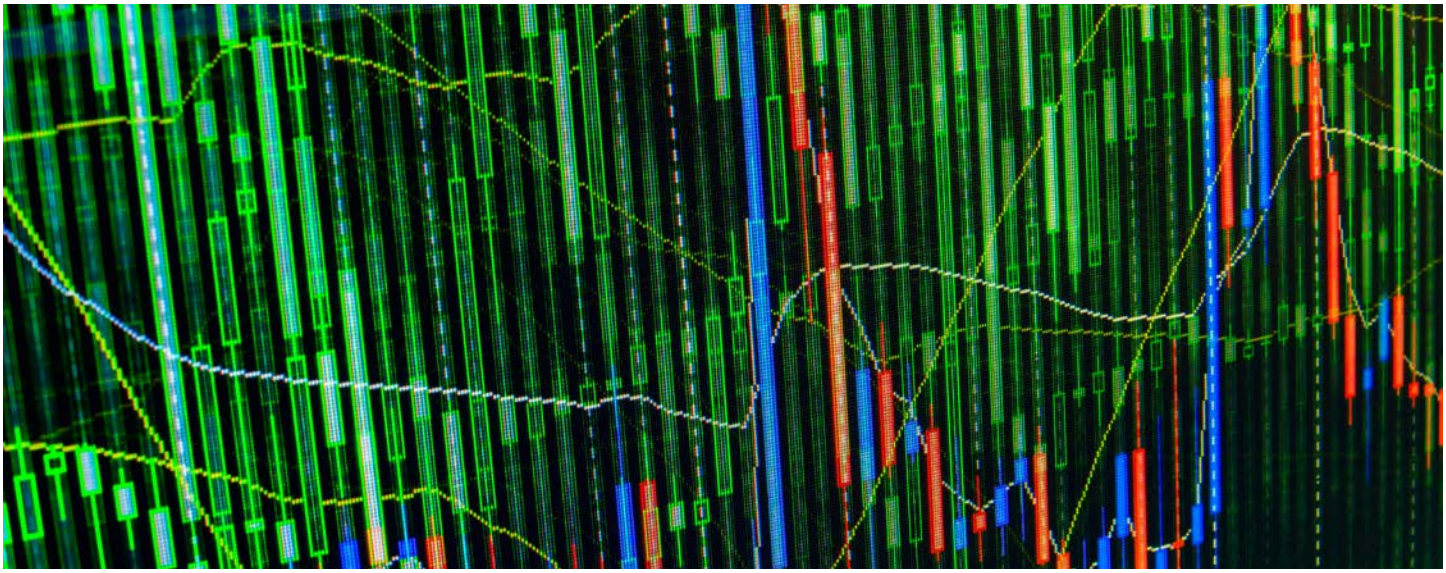
Service providers have developed a number of tools to help fund complexes evaluate and monitor the liquidity of their portfolio holdings. Yet the effectiveness of these tools remains to be seen, since many firms are still in the early stages of developing their programs. Why the delay? Backlash from industry has been a major factor. Fund complexes have voiced concerns that the rule is too rigid, doesn't consider the many nuances of liquidity risk management, doesn't take into account the practical realities of how funds are managed,[4] and ultimately won't achieve the SEC's intent. Among the many requests to SEC staff is a request to delay the effective date. And while discussions with the staff have been productive, there has been no indication to date that the rule will be modified, or that the effective date will be extended.
In our discussions with industry members as they embark on implementing the rule, a number of issues and concerns are arising.

Somewhat surprisingly, the first and foremost issue appears to be "ownership" of the rule. Who within the firm is going to administer the program? While many see this rule as a compliance issue, compliance isn't necessarily its natural home. Some parts of the rule clearly have a compliance element, such as monitoring the limit on illiquid securities. Also, ensuring overall compliance with the program might very well reside with the compliance function, but administration of the program is another matter. For now, many firms seem to be going with a "committee" approach, whether formal or informal, relying on the fact that the rule allows multiple people to administer the program.

Second is the issue of how a fund's securities are bucketed. Some firms have their own methodologies for assessing liquidity that don't coincide with the rule's four-bucket schema. Other firms are relying on outside vendors to provide liquidity data, yet they remain skeptical about the accuracy of that data. Firms with multiple business lines (e.g., registered funds, offshore funds, and institutional accounts) that all use the

same strategy may have a liquidity profile for a security that's different from the vendor data they're receiving.[5]

Third, many funds employ a sub-adviser to manage the investment portfolio, and some funds even have multiple sub-advisers within a single portfolio. Thus, determining who is in the best position to determine liquidity is a significant issue for the industry. The fund itself is responsible for creating the liquidity management program and filing information related to liquidity, and it's in the best position to know about inflows and outflows and the characteristics of the fund's shareholders.[6] On the other hand, the firm managing the money is arguably in the best position to evaluate a security's overall liquidity profile (taking into account investment fundamentals about the security, as well as the firm's overall stake in that security). Who makes the decision? How is information transmitted back and forth between the primary adviser/sponsor and the sub-adviser? If the fund has engaged a vendor and the vendor's information differs from the sub-adviser's information, whose determination prevails in the filing? Many industry participants with significant sub-advisory businesses feel the SEC clearly didn't take this sort of fund management arrangement into account when crafting the rule, forcing many difficult issues associated with the adviser/sub-advisory construct to be sorted out prior to the effective date. Finally, firms are worried about the fact that the liquidity information filed with the SEC will be made public. How this information will be used in the marketplace remains to be seen, but one specific concern is whether it becomes yet another data point by which funds are evaluated by investment consultants and financial intermediaries. Will there be a desire to fall within the industry "pack" so as to not appear to be an outlier? Will that desire alter the way funds are managed, thereby potentially robbing investors of alpha? No one seems to have concrete answers to these questions. Nonetheless, there's widespread speculation about the potential negative impacts of this rule.



"Core Principles" Report: Treasury Department's recommendations.

On October 26, 2017, the Treasury Department released the third of four reports pursuant to President Trump's executive order setting forth the Administration's "Core Principles for regulating the US financial system. The report covers the asset management and insurance industries, and offers recommendations across four broad categories: (1) systemic risk, stress testing, and solvency, (2) efficient regulation, (3) international engagement, and (4) promoting economic growth and informed choices.

Although the report provides President Trump's nominees a roadmap for enacting the Administration's policy priorities, it remains unclear which of the recommendations will be implemented, or how quickly. However, the recommendations—nearly all of which could be enacted without Congressional action—may inform the regulatory and supervisory agendas at the SEC and CFTC, and may also have significant implications for the FSOC's work going forward.

Below are several of the report's most significant recommendations:

Recommendations for Congress

- Eliminate Dodd-Frank's stress testing requirement for investment advisers and investment companies
- Revise the definition of "banking entity" under the Volcker Rule to encompass only insured depository institutions, their holding companies, foreign banking organizations, and affiliates of such entities that are at least 25% owned or controlled

Recommendations for federal regulatory agencies

- Move away from entity-based systemic risk evaluations of asset managers (or their funds), and focus on risks arising from products and activities
- Continue engagement in international forums, but promote the US asset management industry and the US regulatory framework
- Postpone the December 2018 implementation of the SEC's liquidity risk management rule and adopt a principles-based approach to liquidity risk management
- Re-propose or propose a new rule on ETFs and move forward with a "plain-vanilla" ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders
- Withdraw the proposal on business continuity and transition planning
- Exempt SEC-registered investment companies from dual registration with the CFTC
- Permit the use of implied consent for electronic fund disclosures
- Reduce the burden of the Volcker Rule on asset managers and investors
- Re-example the DOL fiduciary rule and delay full implementation until the relevant issues are evaluated and addressed

Data analytics

Technology continues to transform how we communicate, how we shop, how we keep in touch, and how we live our lives. In fact, we're at the exciting start of the fourth industrial revolution. Within the next 10 years, robotic process automation (RPA) and cognitive technologies, such as natural language processing (NLP), will likely be ubiquitous in the workplace. This might require a massive overhaul in how people work. But in the end, the required adjustments will likely be worth the effort.

One popular tool that has already been widely implemented in the investment management sector is RPA. With RPA, software "robots" execute routine business processes by performing repetitive tasks without human involvement. These robots can not only improve process efficiency and accuracy, but they can also reduce costs and increase flexibility and scalability.

Other breakthrough innovations generating a lot of interest include artificial intelligence (AI) and cognitive technologies. Two widely discussed cognitive technology solutions are machine learning applications, which can make predictions and decisions without the need for explicit programming, and NLP applications, which can interpret unstructured data (e.g., free text) and transform it into structured data that can be analyzed. AI and cognitive technologies like these use algorithms to extend what humans or traditional data systems can do on their own.

There are many opportunities to apply automation and AI across the compliance life cycle to drive significant gains in efficiency, quality, and productivity. Examples include combining advanced data analytics with analyses of email communications and external news to detect potential insider trading activities; enhancing testing through robotic automation; and improving regulatory compliance by using NLP applications to extract regulatory requirements and then mapping them to control activities.

Applying these automation tools can meaningfully improve the kind of work performed by compliance functions and by the organization as a whole. These tools

With the SEC using advanced data analytics and other cognitive technologies to identify and prioritize high risk areas, investment management firms and compliance functions could benefit from using those same kinds of tools to gain better insight into their business and compliance processes.

not only reduce costs and provide faster processing with higher quality, but they also allow compliance professionals to focus on higher value tasks, such as investigating and remediating exceptions or redesigning inefficient control activities.

From a regulatory perspective, the SEC has invested heavily in analytic and automation tools to support its examination and enforcement teams. For example, the SEC uses NLP to identify themes within tips, complaints, and referrals. The SEC has also developed sophisticated software and tools such as Advanced Relational Trading Enforcement Metrics Investigation System (ARTEMIS) to identify and assess unusual trading patterns.

With the SEC using advanced data analytics and other cognitive technologies to identify and prioritize high-risk areas, investment management firms and compliance functions could benefit from using those same kinds of tools to gain better insight into their business and compliance processes.

Of course, achieving the potential benefits of these technologies requires planning and coordination. Senior leadership must take a holistic view of technology and develop a strategy and framework that aligns business, compliance, and technology goals and objectives. In addition, organizations must carefully assess opportunities for automation by evaluating which processes to automate and how the various technologies would support business needs and future strategic initiatives.

Although many people are now comfortable embracing and incorporating the latest digital technologies into their personal lives, fully integrating technology into the workforce is still a point of hesitation for many organizations, especially in compliance functions. The reality is that technologies such as AI and RPA are simply too powerful and compelling for any business to ignore. Of course, as is true with any tool, success or failure will ultimately hinge on how you use it.

As automation and cognitive tools become the norm, jobs will need to be reinvented to adapt for future growth. Using robots can allow compliance professionals to spend less time doing manual tasks and more time thinking critically and applying expertise, experience, and judgment. It will also enable organizations to cultivate a more diverse workforce with a wide range of valuable skills and knowledge that seamlessly integrate with the organization's advanced cognitive tools.

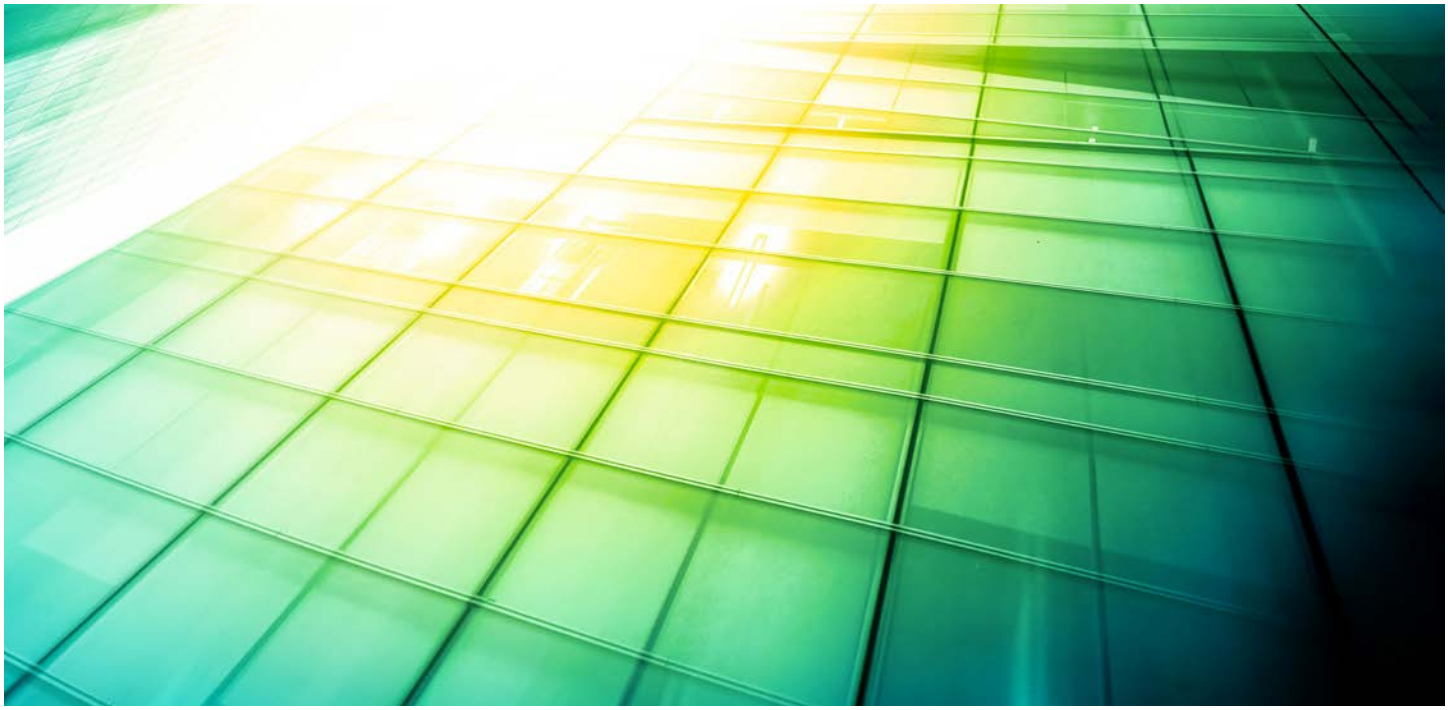
Cybersecurity

The investment management industry has seen a shift as the regulatory environment has driven organizations to take a serious yet fresh look at the state of their cybersecurity risk management programs. Institutions at both the state and federal levels remain committed to protecting investment management firms from the influx of cyber threats and to raising the bar on cyber risk management and reporting. And all signs point to this behavior continuing for the foreseeable future.

A report by the New York State Department of Financial Services (DFS) noted that cyberattacks against financial services institutions are becoming increasingly frequent and sophisticated.[7] To address such threats, the DFS finalized a new cyber regulation, which requires covered firms to conduct a risk assessment and submit an annual certification, among other things. In addition, firms must have a chief information security officer (CISO) and a written cybersecurity policy, and boards must receive reports and be involved in creating standards. Third-party risk must be managed consistent with internal risk management, and any nonpublic data must be encrypted and protected from alteration.

Among numerous other requirements are periodic penetration testing and vulnerability assessment, as well as breach reporting. Audit trail data must be preserved, and entities must track and maintain data that enables the accurate reconstruction of all financial transactions, along with any accounting necessary to respond to a cybersecurity event for at least three years. Any information needed to reconstruct material financial transactions and obligations must be kept for five years. The system must also track and maintain data logging of all privileged authorized user access to critical systems.

One development that holds promise—especially for smaller firms that may not view data security as one of their core competencies—is the opportunity to outsource data tracking and maintenance to a qualified entity. New York's regulation, for example, allows companies to use a qualified outside service for their cyber programs.



Demonstrated compliance with leading practices and cyber regulations may be useful for investment management firms with both consumer and investor stakeholders. To that end, the American Institute of Certified Public Accountants (AICPA) unveiled a cybersecurity risk management attestation reporting framework. The AICPA's framework strives to expand cyber risk reporting to address expectations of greater stakeholder transparency by providing a range of stakeholders, both internal and external, with information about an entity's cyber risk management program effectiveness.

What has become clear from evaluating the requirements from the DFS, as well as the guidance from the AICPA, is that a comprehensive cyber risk management program needs active involvement and oversight from the board. Such involvement and oversight can hold the organization accountable and help shape and address expectations for improved cyber risk reporting that's integral to the achievement of an organization's business objectives.

In an era where cybercriminals could be state-sponsored, part of a political cooperative, or just after the money, how can boards and senior executives assess the soundness of their cybersecurity programs? The banking network SWIFT articulated three overarching objectives:

- "Secure your Environment"
- "Know and Limit Access"
- "Detect and Respond"

These objectives translate to a focus on security, vigilance, and resilience as an approach to reduce an organization's vulnerability, while being prepared to respond quickly and resume normal business.

- Being ***secure*** means focusing protection around the risk-sensitive assets at the heart of the organization's mission.
- Being ***vigilant*** means establishing threat awareness throughout the organization and developing the capacity to detect patterns of behavior that may indicate, or even predict, compromise of critical assets.
- Being ***resilient*** means having the capacity to rapidly contain the damage from an attack and to mobilize the diverse resources necessary to reduce the broad impact—including direct costs and business disruption, as well as reputation and brand damage.

The number of cyberattacks—and the associated costs—will likely continue to rise, as will hackers' sophistication. Much of the new cyber regulation is designed to encourage companies to implement the right level of security, vigilance, and resilience—along with sound governance—to form an effective defense.

Much of the new cyber regulation is designed to encourage companies to implement the right level of security, vigilance, and resilience—along with sound governance—to form an effective defense.

Governance, risk, and compliance

Focusing on governance, risk, and compliance (GRC) is considered an industry norm. But in practice, many firms are struggling to establish an effective GRC strategy and to implement a GRC program. This includes the foundational task of defining the central tenants of GRC and differentiating it from other risk-based programs, such as enterprise risk management (ERM), regulatory/compliance programs, and operational risk.

The overall GRC message is that key business executives—including the chief risk officer, chief compliance officer, general counsel, chief financial officer, chief technology/operations officers, and head of business/product development—should collectively consider whether risks across the business could affect the firm's strategy. This concept seems simple, but consolidating risk information into a single, holistic view of the enterprise can present significant challenges.

An important part of GRC is integrating a variety of disparate disciplines and business activities, including:

- Assessing the strategic alignment of business initiatives against the firm's overall risk management profile
- Vetting new business initiatives against risk/reward
- Determining the firm's risk appetite for business activities, and then measuring against it
- Establishing and maintaining "tone from the top" and a "culture of risk and compliance"
- Evaluating key risks and issues across the entire organization, not just from one methodology (e.g., eliminating a siloed approach to monitoring SOX, ERM, IT risk, compliance risk, operational risk, and internal or audit findings)
- Monitoring effectiveness of the three lines of defense model
- Evaluating the effectiveness of the risk and control environment (e.g., design of risk frameworks across common risk-based methodologies)
- Establishing aggregated reporting to capture key risk and control data across common methodologies

While the chief risk officer might have primary responsibility for leading the charge on GRC, the GRC effort also depends on interdepartmental involvement of key leaders in the first, second, and third lines of defense. Also, firms are increasingly recognizing the value of combining multiple risk methodologies into one streamlined GRC system.

GRC tools continue to emerge, yet many firms are struggling to implement the tools—and to achieve the results they expect. To realize better results, firms should understand that the tools should aid the GRC effort, but not ***drive*** GRC programs.

Operations risk

Financial services operations rely heavily on technology to support their business needs. Historically, these organizations have invested significant time and money to address the requirements of an evolving market (e.g., Euro conversion, rise of complex securities). However, with market volatility coming to the forefront in the last decade, the financial services industry consolidated, leaving surviving firms saddled with a complex, fragmented infrastructure of legacy systems.

Meanwhile, the industry became more complex, and regulators increased their rulemaking. Also, the services that investors expect from investment managers grew, even while investors demanded lower fees. With regulators enforcing compliance with thousands of rules—including the Office of the Comptroller of the Currency (OCC), SEC, Federal Reserve Board (FRB), and Financial Industry Regulatory Authority (FINRA), to just name a few—today's investment managers simply don't have the money to invest in advanced information systems. Instead, they have been forced to focus their scarce investment dollars on compliance with emerging regulations. The result of this cost pressure—and associated underinvestment—is an aging infrastructure.

In the front office, firms lack the agility to quickly launch products and react to changing market conditions. In the middle and back office, organizations need extensive resources and staff to manually execute processes, capture information, cleanse and consolidate data from fragmented sources, and run reporting and analytics.

This inefficient operational model has a huge impact on human capital. Resources and staff spend inordinate amounts of time on administrative, clerical tasks rather than configurable, exception-based workflows. Many activities are manual, "click and repeat" types of processes. Errors are common as staff are forced to interact with numerous, disconnected systems and operate in an environment not conducive to effective governance (with appropriate escalation and approval points). This often leads to problems in recruiting and retention.

In addition to the measurable costs associated with extra resources and staff, businesses face less visible—but equally critical—opportunity costs resulting from delayed reactions to changes in the marketplace.

The industry now finds itself at an important crossroads. Investors are demanding more and paying less, while regulators have slowed rulemaking. Meanwhile, technology innovation is booming. Firms that take advantage of this moment to reconsider and transform their operating models could position themselves for growth and increased market capitalization—and first movers will likely have a competitive edge.

Improved operating models enable faster, more agile responses to changing business conditions. They also make it possible to launch new products more efficiently and effectively, so businesses can better respond to client needs.

Workflow and exception-based processes lower costs and increase quality and governance, while creating opportunities for employees to focus on value-added work. Similarly, analytics and cognitive technologies can unlock insights and information that enable firms to increase sales, improve the client experience, drive down costs, and potentially improve the overall investment process.

Transforming a firm's operating model in today's financial markets is a complex challenge. To make it happen, consider a phased approach when designing the target state. Understand what "good" versus "best" looks like—and what each scenario costs. Identify the tangible and intangible benefits of each scenario. Understand the investment required and build leadership consensus around the path forward. Build a plan to enable the change, executing at a pace that's appropriate for your firm.

Meeting investor and regulator demands takes time and money, both of which are in short supply for today's investment managers. However, the benefits of operating model transformation can be significant—generating positive financial and nonfinancial results for firms and their constituencies alike.

Taking decisive action in uncertain times

Regulatory uncertainty remains a fact of life. But in most cases, waiting for absolute certainty isn't a viable option. Instead, investment management organizations should keep moving forward as planned, with deliberate linkage between regulatory strategy; business strategy; and building infrastructure for governance, regulatory reporting, and risk management that scales and is flexible. Senior management will need to take decisive action while also paying close attention to emerging regulatory developments and staying as flexible as possible. The good news is that many of the changes investment management organizations are currently implementing make good sense from a business perspective—not just a regulatory perspective—and are worth doing no matter how the future unfolds.

Endnotes

1 Letter from Paul Schott Stevens, Investment Company Institute president and CEO, to the Honorable Jay Clayton, Securities and Exchange Commission chairman, July 20, 2017, https://www.ici.org/pdf/liquidity_sec_clayton_ltr.pdf.

2 "The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors," a Deloitte-facilitated study published by the Securities Industry and Financial Markets Association, August 2017, https://www.sifma.org/resources/submissions/deloitte-study-on-the-dol-fiduciary-rule-august-2017/./

3 The compliance date for smaller fund complexes (i.e., those with net assets of less than $1 billion) is six months later, June 1, 2019.

4 The investment portfolios of many funds today are not managed by their sponsor. Rather, many funds engage a third-party sub-adviser to perform portfolio management services. Moreover, many funds employ multiple sub-advisers within a single portfolio, managing separate "sleeves" of the fund.

5 For example, a small holding of a security within a fund might be quite liquid, but when combined with a firm's overall holding of that same security, the liquidity profile might change. Firms question whether vendor data can take that complexity into account.

6 A fund in which large sums of assets are held by single organization will likely have a different liquidity profile than a fund in which assets are held by many smaller shareholders. Funds with significant numbers of retirement account shareholders could have a different profile from funds with largely retail clients.

7 New York State Department of Financial services, "Report on Cyber Security in the Insurance Sector," February 2015.

Contacts

Leadership

Nicole Sandford
Regulatory & Operational Risk Leader
Partner | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
nsandford@deloitte.com

Alok Sinha
Advisory Financial Services Leader
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
asinha@deloitte.com

Peter Poulin
Advisory Investment Management Leader
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
pepoulin@deloitte.com

Chris Spoth
Executive Director, Center for Regulatory Strategy Americas
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
cspoth@deloitte.com

Authors

Adam Berman
Partner | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
aberman@deloitte.com

Mike Brodsky
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
mbrodsky@deloitte.com

Mike Chung
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
michung@deloitte.com

Mark Hornbrook
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
mhornbrook@deloitte.com

Mark Nicholson
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
manicholson@deloitte.com

Garrett O'Brien
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
gobrien@deloitte.com

Bruce Treff
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
btreff@deloitte.com

Maria Gattuso
Principal | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
mgattuso@deloitte.com

Bob Zakem
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
rzakem@deloitte.com

The Center wishes to thank the following Deloitte professionals for their insights, contributions, and support for this report:

Liz Bock, Manager | Deloitte Risk and Financial Advisory, Deloitte & Touche LLP
Lara Burkhart, Senior Manager | Deloitte Risk and Financial Advisory, Deloitte & Touche LLP
Zach Dressander, Senior Marketing Specialist, Deloitte Services LLP
Jessica Golden, Senior Consultant | Deloitte Risk and Financial Advisory, Deloitte & Touche LLP
Marin Knight, Senior Manager | Deloitte Risk and Financial Advisory, Deloitte & Touche LLP
Alex LePore, Senior Consultant | Deloitte Risk and Financial Advisory, Deloitte & Touche LLP
Ryan Press, Senior Marketing Specialist, Deloitte Services LLP

CENTER *for*
REGULATORY STRATEGY
AMERICAS

About the Center
The Deloitte Center for Regulatory Strategy 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.

Deloitte.