# Addressing top-of-mind capital markets and wealth management issues

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# Content

# Regulatory landscape

The **regulatory environment is intensifying** due to high-volume issuances such as T+1 daily reserve and equity market structure, increasing complexity of policies, and requirement of broader supervision. Firms, broker-dealers, wealth managers, and auditors all agree that the pace of regulatory change is rapid and is likely to **present challenges to the industry** from a volume, complexity, timing, and capacity standpoint.

There is a **renewed focus on risk management**, **governance**, **accountability**, **and transparency** across traditional offerings and new products, and technologies. Operational resilience, third- and fourth-party risk assessments, and robust cybersecurity are critical in response to the evolving regulations and threats landscape.

Regulators continue to prioritize **customer and investor protections**, ensuring fair treatment and responsiveness. Public policy and legislative interest in **artificial intelligence (AI) and machine learning (ML)** has increased, focusing on regulating automated systems and technologies throughout their lifecycles to ensure compliance, trustworthiness, and user safety.

Firms should consider recent events when updating risk management practices and contingency fundings plans.

## Potential actions:

- **Anticipate increased regulatory scrutiny** in areas like digital assets and crypto, third-party risk management, merger and acquisition activity, use of AI and ML, and new technologies including large language models (LLMs).
- **Inflationary times prompt heightened regulatory focus** on earnings stability, fee income (including overdraft/insufficient funds), consumer complaints (responsiveness, equitable treatment), and disclosures.

## Thought leadership:

- Ten Key Regulatory Challenges of 2024
- Examinations: SEC 2024 Priorities
- National Conference on the Securities Industry

# FINRA Rule 4210

In January 2014, The Financial Industry Regulatory Authority (FINRA) proposed amendments to its Rule 4210 to establish margin requirements for Covered Agency Transactions (CATs) in the mortgage-backed security market, addressing credit risk exposure, and aligning with Treasury Market Practices Group best practices.

Rule 4210 defined CATs as "to-be-announced" and special pool securities with contractual settlement greater than one business day, or collateralized mortgage obligations with contractual settlement greater than three business days. The proposed amendments aimed to manage risks associated with forward-settling contracts in a growing CAT market, including provisions for establishing written procedures to determine counterparty credit risk limits, and enhance market transparency.

After several revisions and proposals, in July 2023, the Securities and Exchange Commission (SEC) approved a 2021 proposal of the amendments to Rule 4210[1], and in August 2023 FINRA published Regulatory Notice 23-14[2] indicating the 2021 amendments would become effective on May 22, 2024. The 2021 CAT amendments provide variation margin requirements, the option to take capital charges instead of margin collection and clarified exclusions.

## Potential actions:

- **Establish a written methodology for credit risk limit determination** that is current and suited to the scope of CAT trading activity.
- **Assess operational needs** for new account types to record collateral movement, or system enhancements to effectively monitor for margin calls and capital deductions.
- **Assess existing legal arrangements** and re-establish amended Master Securities Forward Transaction Agreement's with counterparties where needed.
- **Review and enhance compliance policies and procedures**, highlighting updated roles, "house limits" for internal credit risk notifications, escalation processes, and regulatory reporting.

[1]Source: Consumer SEC, Rulemaking by Self-Regulatory Organizations, July 27, 2023. [2]Source: FINRA, Regulatory Notice 23-14, Amendments to Covered Agency Transaction Requirements under FINRA Rule 4210; Announcement of Effective Date, August 18, 2023

# Weekly-to-daily reserve formula

In tandem with efforts to prioritize customer interests, in July 2023, the SEC, proposed amendments[3] to its Customer Protection Rule, whereby the "carrying broker-dealers" (broker-dealers that maintain custody of customer assets) with average credits totaling $250 million or more would be required to compute reserve account calculations daily rather than on a weekly basis.

Securities Industry and Financial Markets Association (SIFMA), along with several individual carrying broker-dealers, responded to the SEC with a written response[4] during the subsequent 60-day comment period. Industry responses highlighted that the proposal underestimates the costs and burden of the change and even includes broker-dealers that have minimal impact to customer protection.

Many in-scope carrying broker-dealers are preparing to implement daily reserve formula computations while facing challenges of adapting routine weekly procedures to be performed daily. Additionally, many are experiencing complexities in promptly resolving reconciliation discrepancies and addressing illogical or unallocated position balances.

## Potential actions:

- **Perform a comprehensive assessment of current issues and design solutions** to address high priority items first, as the impact of such items will be magnified after conversion to a daily computation.
- Identify **opportunities to automate** existing manual procedures.
- **Move certain procedures offshore** to leverage the time difference and obtain key reports earlier in the local workday.
- Leverage the **change to a daily routine** to more effectively monitor aging of breaks and other differences that require resolution.

[3]Source: SEC, SEC Proposes Rule Amendments to the Broker-Dealer Customer Protection Rule, July 12, 2023. [4]SIFMA, Daily Computation of Customer and Broker-Dealer Reserve Requirements under the Broker-Dealer Customer Protection Rule, September 11, 2023

# Transition to T+1 settlement

With US T+1 settlement transition fast approaching, industry participants are ramping up their internal testing and external coordination with others in the industry, including vendors and clients. Heading into 2024, most firms have accelerated their preparation activities for **regression and end-to-end testing** with a key focus on **operational resilience**.

Firms who are well into their test execution have highlighted 4 key areas in their operating model which require **additional coordination and strategic planning**:

- **FX:** Increased risk of delayed FX funding for securities settlement due to time zone constraints.
- **ETFs:** Additional focus on non-US domiciled ETFs, which pose settlement challenges for underlying basket components due to time zone differences and regulatory requirements across jurisdictions.
- **Stock Borrow/Loan:** Shorter time frame to complete recalls/buy-in processing, inclusive of notices to borrowers, collateral management, and settlement, leading to a higher probability of delays or failures.
- **Dual-listed securities & ADRs:** Industry alignment and consensus on best practice processing is ongoing.

## Potential actions:

**Potential actions:**

Firms should begin **widening their scope** beyond the core T+1 change requirements, **allocating resources** for initiatives such as:

- **Robust business continuity & resiliency:** Creation of an enhanced firm-wide business continuity and resiliency framework, designed to react to increased demands of compressed timelines.
- **Real-time KPI monitoring & reporting:** Development of a robust monitoring and reporting structure with emphasis on data-driven metrics and insights, tailored to T+1 processing benchmarks with a view to T+0.
- **Enhanced Operating Model & Technology:** Review and enhance the operating model framework and associated technology to strategically position firms for continued excellence into the T+0 transition.

## Thought leadership:

- Accelerated Settlement: T+1 is coming. Are you ready?
- Buy-side | Accelerated Settlement: How far along is your firm in the T+1 transition journey?

# Use of predictive analytics

On July 26, 2023, the SEC issued proposed rules[5] to address **conflicts of interest** associated with the **use of predictive data analytics by broker-dealers (BDs) and investment advisers (RIAs)**. The proposed rules seek to "*eliminate, or neutralize the effect of, conflicts of interest with investors through the use of technologies that optimize for, predict, guide, forecast, or direct, investment-related behaviors/outcomes*."

As technology-based products rapidly evolve and become increasingly relied upon, the aim is to sharpen focus on the use of **AI**, **ML**, **and chatbot technologies** in investment decisions, investor communications, and directing investment behaviors.

However, concerns exist over the broad definition of the term "**covered technology**" in SEC's proposal. Firms should monitor this rule and its potential adoption, but also take proactive steps to ensure compliance.

BDs, RIAs, and chief compliance officers must prepare for increased regulatory scrutiny on **appropriate controls, policies**, **procedures**, **and potential investor harm due to conflicts of interest**. Regulators are set to review the covered technology, assessing if it is supervised, the evaluation methods utilized, and the benefits to the firm for investment advice.

## Potential actions:

- **Proactively address potential conflicts of interest around covered technology** by implementing the steps suggested in the proposal.
- **Integrate covered technology into existing compliance program**, including policies and procedures, training of approved use for such tools, monitoring and testing, controls implementation, recordkeeping requirements, evaluations, assessments, and disclosures.

## Thought leadership:

- Regulatory Insights: "Covered Technologies" and Conflicts of Interest: SEC Proposal
- Regulatory Insight: Examinations: SEC 2024 Priorities
- Ten Key Regulatory Challenges of 2024 (Responsible Systems)

[5]Source: Consumer SEC, SEC Proposes New Requirements to Address Risks to Investors From Conflicts of Interest Associated With the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, July 26, 2023. [6]Source: SEC, Investment Company Names, September 20, 2023

# Fund Names Rule

The SEC issued final rule[6] amendments to Section 35d-1 of the Investment Company Act of 1940, commonly referred to as the **fund "Names Rule"**, with the goal of preventing misrepresentation of funds' investments and risks.

The industry supports protecting investors from misleading and deceptive fund names, and compliance with the final tiered amendments. The rule was initially proposed alongside an environmental, social, and governance (ESG) proposal to counter "greenwashing."

**While the ESG proposal is still under review**, the Names Rule, effective as of December 11, 2023, requires implementing **many ESG considerations**.

## Potential actions:

- **The 80 percent investment policy requirement** expands the requirements to any fund name that includes terminology "*suggesting that the fund focuses on investments that have, or whose issuers have, particular characteristics*."
- **Allow temporary departures from 80 percent**, reviewed quarterly, in exceptional circumstances.
- **For derivatives, use notional amounts**, excluding hedging calculations and allowing cash deductions.
- **Unlisted closed-end funds and business development companies (BDCs)** require shareholder vote for a change in policy.
- **Enhance prospectus disclosure, reporting, and recordkeeping** related to terms used in names, Form N-Port.
- **Require** 60 days' notice to fund shareholders for any change in the 80 percent investment policy.

## Thought leadership:

- Regulatory Insight: Names Rule: SEC Final Amendments
- Regulatory Insights: Examinations: SEC 2024 Priorities
- Regulatory Alert: SEC Proposed Names Rule and ESG Investment Practices Disclosure

# Securities dealer guidance

Dealers in securities must generally mark-to-market their securities for US tax purposes unless held for investment and identified as such in their tax books before the close of the acquisition day.

Earlier this year, the Tax Court in YA Global v. Commissioner, 161 T.C. 11 (2023)[7] concluded that a **securities dealer's books and records must clearly reference the applicable US tax code section if the dealer does not want to mark-to-market the security**. An identification made for financial statement or regulatory purposes (but does not reference the US tax rules) is insufficient.

## Potential actions:

- **Review and update existing section 475 identification statements** to confirm the documentation aligns with the dealer's intended US federal income tax treatment.
- **To the extent errors are identified** with existing section 475 identification statements, the dealer should **consider steps to address the errors**. For example, a dealer may consider filing a method of accounting change with the IRS. A method of accounting change can eliminate the risk of interest and penalties associated with prior year tax returns.

# Trust department considerations

Wealth management and trust professionals in financial institutions are evaluating policies and procedures to address **key risk areas for personal trust clients**, focusing on:

- The implementation of the Beneficial Ownership Information Reporting Rule[8], enacted as part of the Corporate Transparency Act that goes into effect on January 1, 2024 and **requires fiduciaries to report information on trust beneficiaries**.
- **Potential legislative changes affecting personal trusts**, such as the sunsetting of the Tax Cuts and Jobs Act[9] in 2025.
- An **increase in IRS focus** on certain trust transactions.
- The **implications of gift and generation-skipping transfer taxes**, with high-net-worth individuals utilizing wealth transfer strategies to maximize the Unified Credit[10]

## Potential actions:

- While the Beneficial Ownership Information Reporting Rule is not a tax requirement, trust departments should consider whether they can **leverage existing information needed for tax filings** to satisfy the Beneficial Ownership Information Reporting Rule requirements.
- Trust departments should be **evaluating potential consequences** resulting from the 2025 sunsetting of the Tax Cuts Jobs Act, and consider **developing a business strategy** to discuss these consequences with their customers.

## Thought leadership:

- Final regulations: Beneficial ownership information reporting

[7]Source: United States Tax Court, YA Glob. Ins.v. Comm'r of Internal Revenue, November 15, 2023. [8]Source: Department of the Treasury, Beneficial Ownership Information Reporting Requirements, September 30, 2022. [9]Source: Congress.gov, Public Law 115–97, December 22, 2017. [10]Source: IRS, Estate Tax, November 27, 2023

# M&A deal market in wealth management

Despite **higher interest rates and macro-economic challenges, M&A transaction volume** in the wealth management industry **remains steady**, and the industry has experienced minimal negative impact of the high interest rate and subdued economic environment.

The sustained deal activity and overall consolidation within the industry has been driven by the fragmented market with **more than 13,000 independent firms** along with an **aging advise population**. Additionally, the continued flow of capital from private equity firms attracted to the industry by the **"sticky" client base** and **recurring revenue** in the wealth management market has allowed **pricing to remain resilient** and avoid declines seen in transactions of other industries.

There has been continued flow of transactions executed by private-equity backed "RIA aggregators" focused on independent advise firms. These firms pay **higher EBITDA multiples** and offer a platform for advises to **outsource middle, back-office, and compliance tasks to the larger enterprise**, enabling economies of scale and focus on client relationships and business growth. There is uncertainty around the sustainability of the higher multiple acquisitions if the current interest rate and the subdued economic environment continue.

Though aggregators dominate the independent RIA market, larger firms are attracting advises away from large institutions and wire houses. The deal market will likely be impacted by fintech companies challenged in raising capital, with strategic buyers potentially acquiring firms for their digital transformation efforts.

## Potential actions:

- Develop an **M&A playbook** that enables a repeatable evaluation process to remain competitive in the market.
- Follow the potential market shift and **evaluate current gaps and capabilities** that could be addressed by strategic acquisitions.

# Cash sorting dynamics

The cash sorting landscape has transformed wealth management and brokerage dynamics. Traditionally viewed as a passive aspect of portfolio management, the **strategic allocation and sorting of cash** has gained newfound significance as customers shift to low-risk, high-yield asset classes due to higher interest rates.

This dynamic is tied to broader market trends, impacting customer cash balances, with wealth managers using technologies and analytics to **optimize their cash management strategies**. Organizations are offering new products such as **high-yield savings accounts and focusing on increased focus on FDIC coverage-related products** to retain existing cash balances and bring in new funds.

Anticipating cash balance changes enables **capital deployment** during investment opportunities, ensuring capital and liquidity in volatile markets. The cash sorting cycle's future trajectory remains uncertain. Cash management in response to cash sorting is for not only **risk mitigation**, but also **capitalizing on emerging opportunities and providing lower-cost funding sources**.

As wealth managers adapt, **dynamic cash allocation** and responding to balance changes become crucial differentiators. Companies will need to **address capital, liquidity, and funding requirements**, while balancing capital deployment for generating meaningful returns. They also need to consider potential adverse scenarios and their appetites for acquisitions and maintaining "dry powder."

Brokerage clients are scrutinizing portfolios to ensure alignment with investment objectives, maximizing returns, and managing risk. Wealth managers and fiduciaries maintain focus on client goals and how they are affected by the economic and interest rate environment, maintaining trust and satisfaction.

## Potential actions:

- **Assess funding levels under various cash sorting scenarios**, understanding profitability impacts and any potential mitigating actions in a "higher for longer" market. Consider **historical customer cash ratios** to overall balances and analyze anomalies across certain client types.
- Ensure advises deliver value, **align portfolios with investment objectives**, and analyze the impact of current economic and interest rate environment.
- **Identify gaps in the product suite to meet client needs**, considering the diversification effect on overall funding and liquidity costs and needs.

# Securities lending market

In October 2023, the Securities and Exchange Commission (SEC) adopted a new final rule[11] (Rule 10c-1a) under the Securities Exchange Act that will require the reporting and publication of specific information regarding securities lending transactions. In particular, the final rule requires "covered persons" to provide securities loan information concerning "reportable securities" to a Registered National Securities Association (RNSA) in the format and manner required by the RNSA and within specified time periods. Currently, only FINRA is an RNSA. Major themes outlined in the rule include the scope of coverage, reporting requirements, responsibilities of covered persons and reporting agents, and compliance dates. The new rule aims to increase transparency in the securities loan market, enhancing monitoring and mitigation of risks by market participants and regulators.

The rule requires entities involved in securities lending activities to report details about their securities loans to a central repository, including underlying securities, loan terms, and parties involved in the transaction. The rule applies to broker-dealers, investment advisers, and some institutional investors, while clearing agencies engaged in central counterparty or central securities depository activities are exempted.

## Potential actions:

- Read the final review and evaluate if it's applicable to your business, including if your company meets the definition of a "covered person" or if the securities your company transacts in meets the definition of a "reportable security" or "covered securities loan".
- Covered persons should evaluate the need to enter into a written agreement with a reporting agent to fulfill the covered persons reporting obligations.
- Reporting agents should establish, maintain, and enforce policies and procedures to ensure compliance with the rule and work with covered persons to develop a process such that required information is provided by the covered person in a timely manner.

## Thought leadership:

- Reporting of Securities Loans: SEC Final Rule

[11]Source: SEC, Reporting of Securities Loan, October 13, 2023