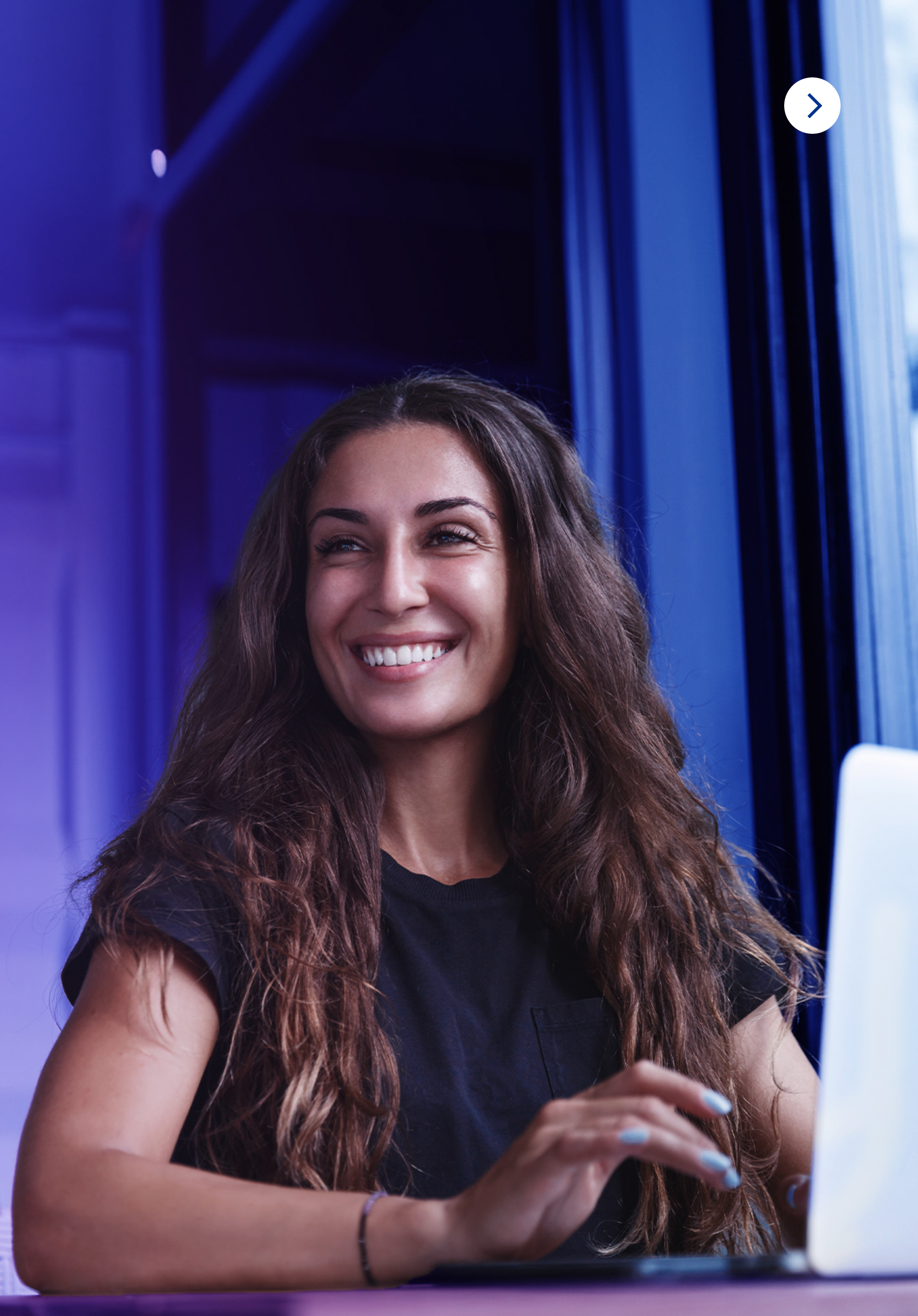
Addressing top-of-mind capital markets and wealth management issues

Q2 2024



Content

CAT reporting developments

The Consolidated Audit Trail (CAT) Reporting Initiative was introduced to enhance transparency in the financial industry, mandating broker-dealers and exchanges to report all transaction details to a central repository. Since its introduction, CAT's reporting specifications have changed frequently. The most recent technical specification was published on March 28, 2024. These updates establish or remove certain reporting events, fields, and field reporting requirements. The dynamic nature of CAT reporting specifications underscores the importance of firms to remain vigilant and adaptable.

In recent years, we have observed an **escalated focus on CAT reporting in Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) examinations.** In 2023, FINRA issued its first significant enforcement action for noncompliance with CAT reporting, resulting in a multimillion-dollar fine. The firm in question failed to convert its source data into a format suitable for CAT reporting. This lapse resulted in it missing 17 percent of equity and order options events that it was required to report.

This enforcement action serves as a signal for the evolving regulatory landscape and highlights the critical need to enhance CAT reporting processes. In general, regulators show particular concern over whether firms regularly evaluate their supervisory controls, conduct comprehensive testing and reviews reflecting their entire reporting volume, and promptly self-report erroneous events. Additionally, common findings in exams pertain to incomplete submissions, failure to expediently repair errors or submit corrections, inaccurate or incomplete reporting, inadequate vendor supervision, and deficient recordkeeping.

Potential actions:

- **Firms should consider implementing automated quarterly testing,** reconciling books and records and CAT submissions, to monitor for exceptions.
- **Firms should ensure that their technical specification documentation** accurately reflects the actual data within its upstream sources and CAT submissions.
- **Firms should strive to cross-check between** the most up-to-date CAT specifications and their current presubmission controls.

For more information around CAT Reporting Developments, contact Murat Oztan, Financial Services Regulatory & Compliance Risk.

FINRA Rule 4210

On May 22, 2024, amendments to FINRA Rule 4210 were implemented in order to establish margin requirements for "to-be-announced" (TBA) securities and related instruments in the mortgage-backed security market—defining the scope of products as Covered Agency Transactions (CATs). Rule 4210 defines CATs as TBAs and specified pool securities with contractual settlement greater than one business day, or collateralized mortgage obligations with contractual settlement greater than three business days. The amendments are meant to address credit risk exposure arising from such forward-settling contracts in a growing CAT market and align to the best practices of the Treasury Market Practices Group.

The 4210 CAT amendments provide: variation margin requirements only (no initial margin); permission to take capital charges in lieu of margin collection (subject to limitations); and certain exclusions based on amounts, account types, or security products.

Potential actions:

As FINRA Members proceed with 4210 compliance under the new CAT amendments, **several key considerations and implementation focus areas are common** among firms:

- Ensuring that outbound collateral is monitored for capital charges, as receivables that represent "excess" collateral balances above the members' margin requirement with the external counterparty holding the margin collateral should be treated as deductions to net capital.
- If a counterparty indicates that it will provide margin collateral without dispute, and the broker-dealer in good faith expects that it will receive the collateral requested, then the capital charge may be considered applicable after the fifth business day after the deficiency arises.
- Transactions that are novated through a registered central clearing agency (FICC, etc.) are excluded. Transactions in "project loan securities" and transactions with "small cash counterparties" both as defined within 4210(e)(2)(H), may be excluded from computation of 4210 margin requirements, but they are subject to 4210 written counterparty credit risk limits (as required under December 2016 amendments to Rule 4210).
- Noncash assets held by members for CAT variation margin that exceed the counterparties margin requirement are subject to possession or control requirements of 15c3-3.

For more information around FINRA Rule 4210, contact Murat Oztan, Financial Services Regulatory & Compliance Risk.

Syndicate loan ops transformation

Syndicate loans are integral to the financing of large-scale business operations, infrastructure projects, and corporate expansions. As a result of a volume surge by approximately 189 percent from Q4 2023,[1] stakeholders across the syndicate loans' lifecycle face continued pressure to address scale, efficiency, and operational risk due to external constraints (e.g., agent bank errors and delays), as well as internal constraints with manual processes, workflows, and the overarching operating model (e.g., capacity, capability, turnover, etc.).

Firms that have begun their transformation journey to optimize operations, have emphasized the importance of identifying and analyzing critical pain points across their end-to-end value chain.

Key challenges include:

- **Limited metrics and performance insights:** Key performance indicators (KPIs) and key risk indicators (KRIs) that are primarily centered on volume and exception counts with limited insight into more complex, workflow-driven metrics (e.g., root cause analysis)
- **Lack of end-to-end ownership:** Organizational structures that are hyper-specialized and function in silos, hindering timely communication, end-to-end ownership, and accountability
- **Dependency on manual processing:** Manual notice processing, high-touch data enrichment, and reconciliation are some of the key areas driving operational risk and elevating processing durations due to the dependency on offline knowledge.

Potential actions:

Firms that are interested in accelerating their syndicate loans operations transformation should consider the following activities to successfully position themselves for near-term and long-term benefit realization:

- **Recalibrate and enhance KPI and KRI metrics:** Institute a systematic and procedural capture of data, followed by a cross-lifecycle root cause analysis (alongside other workflow-driven metrics) to enable data-driven insights into bottlenecks, exception patterns, and more.
- **Optimize the organizational model:** Reduce the hyper-fragmentation of work ownership across the value chain to mitigate workflow and sequencing issues, enhancing accountability and decreasing the overall operational risk.
- **Leverage marketplace solutions to accelerate automation opportunities:** Accelerate the automation of highly manual processes by leveraging industry toolkits, enabling the development of desired features/functions in the near-term, while setting the foundation for a strategic, long-term transformation program.

For more information around syndicate loan ops transformation, contact Michael Martinen., Customer and Operations Financial Services.

Artificial intelligence enforcement actions against registered investment advisers (RIAs)

The SEC recently announced settled charges against two advisers for making false and misleading statements about their artificial intelligence (AI) use in investment strategies, resulting in a combined fine of $400,000. The first adviser was fined $225,000 for falsely claiming AI and machine learning capabilities in its investment processes, whereas the second advisor faced a $175,000 penalty for misrepresenting itself as the "first regulated AI financial adviser." Both firms were censured and ordered to cease and desist from violating the charged provisions.

These enforcement actions underscore the importance of accurate and truthful representations of AI capabilities by registered investment advisers (RIAs). Misleading claims regarding predictive abilities not only misguide investors but also result in legal and regulatory repercussions. The SEC's focus on eliminating "AI washing" is a clear message to the investment advisory industry about the critical need for transparency and honesty in disclosing AI and machine learning applications.

Tying into the increased regulatory scrutiny, the 2024 SEC Examination Priorities emphasize the importance of advisers adhering to their fiduciary duties. This includes a focus on marketing practices and the accuracy of representations made to investors, particularly regarding AI and emerging technologies like crypto assets.

These developments signal a growing priority for the regulation of generative AI (GenAI) in the financial sector, highlighting the SEC's commitment to protecting investors and maintaining market integrity amidst rapid technological advancements.

Potential actions:

- **Implement rigorous internal validation processes** for any AI capabilities to ensure that all representations are accurate, truthful, and substantiated by the firm's actual technology and practices.
- **Enhance compliance and oversight mechanisms to** rigorously review and monitor all AI-related disclosures and marketing practices, ensuring full transparency and the prevention of misleading statements about AI capabilities.

Thought leadership:

- Artificial Intelligence & Machine Learning—KPMG Global

For more information around AI against RIAs, contact Michael Sullivan Financial Services Regulatory and Compliance Risk.

[1] White & Case LLP, "The US syndicated loan market shows signs of recovery," Debt Explorer, May 7, 2024 (debtexplorer.whitecase.com).

GenAI for wealth managers

In today's rapidly evolving financial landscape, financial advisers (FAs) and wealth management professionals are constantly seeking innovative solutions to stay ahead. While the buzz is that AI can do anything imaginable for wealth managers, the excitement it provokes centers on its potential to do everything human advisers can do, and more.

We think that AI, particularly GenAI, has considerable promise when applied correctly for wealth managers. It is less about replacing the FA and more about enabling advisers to focus on what they do best, which is working directly with clients. By automating repetitive, labor-intensive tasks, advisers can redeploy their efforts to spend more time with clients.

While there are a broad range of use cases for financial advisers the three items below should be at the forefront and will likely have immediate returns on investment:

- **Better prospecting:** AI can create marketing campaigns and personalize them based on client personas. By appealing to prospects' unique needs and interests—particularly those of digitally savvy younger generations—AI can help attract qualified prospects and boost client engagement and retention.
- **Easier onboarding:** AI can help streamline the process by automating tasks such as new-client questionnaires, document management, and end-to-end process review.
- **Financial planning, advising, and reporting:** advisers can use GenAI to draft financial plans that the adviser can then review and fine-tune. GenAI can analyze historical market data, macroeconomic indicators, and individual risk portfolios to optimize portfolios. GenAI can also create performance reports, write commentary, generate recommendations, and help FAs prepare for client meetings.

Potential actions:

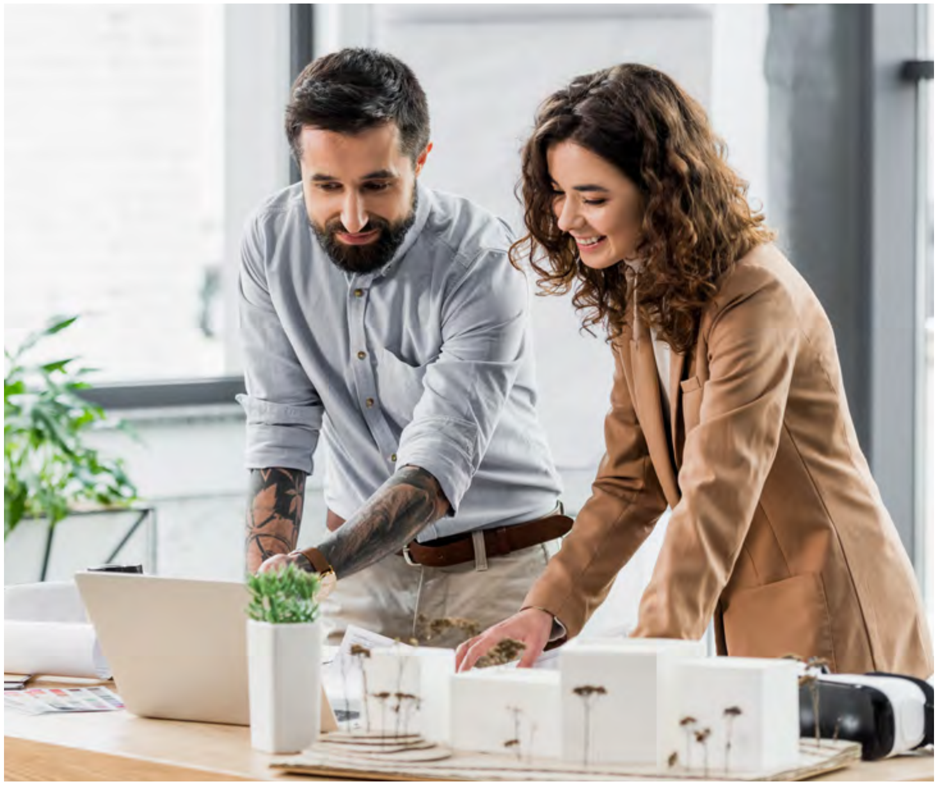
While implementing GenAI solutions, management should be aware of certain challenges to ensure success:

- **Data quality—**GenAI's effectiveness heavily relies on the quality and quantity of data available. Inaccurate or biased data could lead to flawed insights or recommendations to clients.
- **Explainability—**It can be difficult to explain how GenAI algorithms make decisions—this can make it difficult for wealth managers to articulate the results.
- **Regulatory compliance—**in order to ensure the security of sensitive client information, using GenAI in wealth management requires compliance with strict financial regulations and privacy standards.
- **Human Expertise—**while GenAI offers powerful tools, human expertise remains indispensable to interpret results, make strategic decisions, and maintain the human touch in client relationships.

Thought leadership:

- How AI can be good news for wealth managers

For more information around Gen AI for Wealth Managers, contact Brian Dunham Wealth and Asset Management Strategy.



DOL final retirement security rule

On April 23, 2024, the Department of Labor (DOL) issued a final rule[2] amending the definition of "investment advice fiduciary" under Titles I and II of the Employee Retirement Income Security Act of 1974 (ERISA). The final rule expands upon regulations from 1975 and covers instances where financial services providers (e.g., broker-dealers, insurance agents, and other financial professionals) offer paid investment advice to retirement plan participants, individual retirement account owners, and plan officials who manage plans and their assets. It is intended to adapt to the evolving retirement planning landscape, including 401(k)s and Individual Retirement Accounts (IRAs), and better protect retirement investors from potential conflicts of interest. **The final rule will become effective on September 23, 2024.**

Highlights of the final rule include:

- **Definition of Investment Advice Fiduciary: Under the final rule, an investment advice fiduciary is someone who provides recommendations to retirement investors for direct or indirect compensation.**
- **Definition of fees or other compensation, direct or indirect: The final rule defines** explicit fee or compensation arrangements in connection with recommended investments or the provision of investment advice.
- **Covered recommendations: The final rule** clarifies types of recommendations covered and excludes investment information or education.
- **Prohibited Transaction Exemptions (PTEs): DOL issued** three amendments outlining conditions to receive compensation.

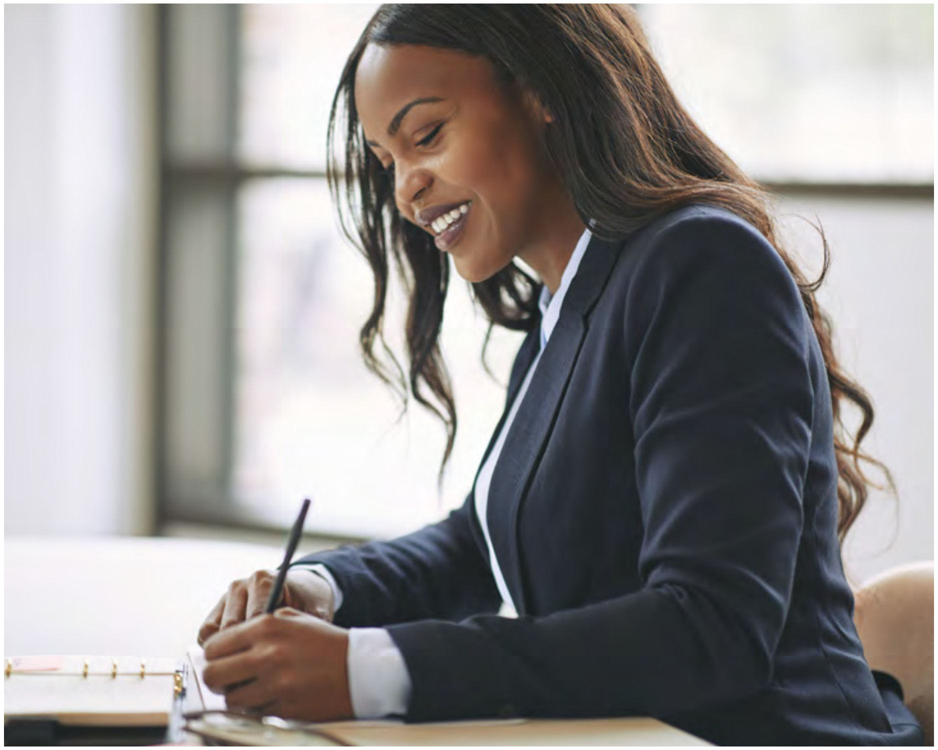
Potential actions:

- **Review and update internal policies and procedures** to ensure compliance with the expanded definition of an investment advice fiduciary.
- **Assess compensation** arrangements and make any necessary adjustments to comply with the defined fees or other compensation requirements.
- **Establish clear communication channels** with retirement investors for transparent disclosure of conflicts of interest and fee information.
- **Provide trainings and education** to help employees understand the new amendments for PTEs.

Thought leadership:

- Investment Advice Fiduciary: DOL Final Retirement Security Rule

For more information around the DOL final retirement security rule, contact Michael Sullivan Financial Services Regulatory and Compliance Risk.



[2] Federal Register | The Daily Journal of the United States Government

Proposed AML/CFT rules for investment advisers

On May 21, 2024, the Department of the Treasury and the SEC jointly issued a notice of proposed rulemaking (NPRM),[3] which is designed to enhance the integrity of the financial system by including certain investment advisers within the scope of institutions required to implement Customer Identification Program (CIP) obligations, thereby making it more difficult for illicit actors to misuse financial institutions for money laundering, terrorism financing, or other illegal activities. This proposal complements FinCEN's proposed rule from February 2024 to expand the anti-money-laundering (AML) framework to include investment advisers.

Key parts of this proposal include:

- **CIP:** Investment advisers must develop, document, and maintain a CIP as part of their AML/combating the financing of terrorism (CFT) program.
- **Recordkeeping:** The creation and maintenance of records for the information obtained and verified under the CIP is mandatory.
- **Comparison with government lists:** Procedures for comparing customer information against government lists of known or suspected terrorists or terrorist organizations as designated by relevant authorities.
- **Reliance on another financial institution:** Allows investment advisers to rely on CIP performed by a contracted, compliant financial institution.

Written comments on this notice of proposed rulemaking (NPRM) must be submitted on or before July 22, 2024.

Potential actions:

- **Develop and implement** a board-approved, risk-based AML/CFT program that includes a CIP applicable to all advisory activities.
- **Provide training and education** for employees to help them understand the AML/CFT laws, regulations, and policies.
- **Ensure compliance with recordkeeping requirements** that mandate the creation and retention of records for information obtained and verified under the CIP.

Thought leadership:

- Customer Identification Program (CIP): SEC/FinCEN RIA/ERA Proposal

For more information around the proposed AML/CFT rules for investment advisers, contact Michael Sullivan Financial Services Regulatory and Compliance Risk.

Mainstreet distribution of alternative investments

In the current market environment alternative investments have gained popularity among mainstreet investors. These non-traditional investment options offer enticing opportunities for diversification and potentially higher returns. To respond to the increased demand, wealth managers are solutioning structural challenges around distribution and administration of these products with mainstreet investors.

The surge in popularity of alternative investments among Mainstreet investors can be attributed to multiple factors, including improved access to alternative investments that were once reserved for institutional investors. While alternative investments offer enticing prospects, they are not without risks. One of the primary concerns is lack of liquidity, as these products often have longer lock-up periods, making it challenging for investors to access capital when needed. Additionally, the valuation of these investments can be complex and subjective. Mainstreet investors may lack the necessary expertise and resources to thoroughly evaluate and understand the intricacies of these investments. Bridging the appropriate knowledge of these products to FAs and clients is key to successful distribution by wealth managers.

The distribution to mainstreet investors also faces structural challenges compared to the traditional model of catering to institutional investors. Once such challenge is the scale required to accommodate individual investors. Institutional investors typically invest larger sums of capital, allowing fund managers to achieve economies of scale. However, distributing smaller investment amounts across a larger number of individual investors can be operationally complex and costly.

There are also regulatory constraints that come with alternative investments that have stricter regulations due to the higher risk profile. Meeting regulatory obligations while catering to a larger number of individual investors can be resource-intensive and time-consuming for fund managers.

Potential actions:

- Assess your business and demand—Evaluate potential demand for alternative investment products across your retail customer base considering regulatory limitations related to less experienced investors.
- Evaluate operational challenges—Evaluate the impact of increased transaction volume and complexity on existing business model processes, scalability, product variability, and manual intensive processes around sourcing and maintaining data. Consider available technology solutions in order to achieve efficiency and scale.
- Consider alternative models—Depending upon the size and complexity of your institution, consider what model makes sense: leverage the platform of an existing provider, utilize a preferred provider to and integrate a subset of products with select service providers, or provide an open network to access all private fund managers

For more information around Mainstreet Distribution of Alternative Investments (AI), contact Brian Dunham Wealth and Asset Management Strategy.

[3] Federal Register | The Daily Journal of the United States Government

Off-channel communications

The enforcement of off-channel communication regulations has historically targeted broker-dealers and dually registered investment advisers, with no clear precedent for such enforcement against stand-alone RIAs. However, on April 3, 2024, the SEC issued its first action against a stand-alone RIA, with a civil money penalty of $6.5 million.

This action has several implications for RIAs, particularly centered around the interpretation of the Investment Advisors Act of 1940:

- **Recordkeeping rules:** The SEC's action emphasizes a stricter interpretation of Rules 204-2(a)(7) and 204A-1, which require RIAs to maintain and preserve comprehensive records of communications, to include all forms of electronic communications.
- **Scope of supervisory responsibilities:** The enforcement action calls out the need for supervisors to actively monitor and enforce compliance under Section 203(e) and Rule 206(4)-7, not just set policies.
- **Personal devices:** This action interprets the use of personal devices for business communications as a violation if not properly monitored and recorded, even if such use is not explicitly addressed within the Advisers Act.

These points illustrate a shift towards a more rigorous and expansive interpretation of the Investment Advisers Act of 1940 by the SEC, with a focus on modern communication methods and proactive supervision.

Potential actions:

- **Adopt advanced electronic communication archiving solutions** that can capture and store all forms of business-related communications.
- **Carry out thorough risk assessments** to identify any potential compliance gaps, especially in the areas of **communication** and **recordkeeping**.
- **Regularly monitor and test compliance systems** to verify they are functioning effectively and are capable of capturing all required records.

Thought leadership:

- Data Retention and Deletion: Devices and E-Comms (kpmg.com)

For more information around Off-Channel Communications, contact Michael Sullivan Financial Services Regulatory and Compliance Risk.

US income tax update

Deferral of BEAT rules for qualified derivative payments

- The Base Erosion and Anti-Abuse Tax (BEAT) is a minimum tax applicable to large multinational corporations. At a high level, the tax is assessed on a corporation's minimum taxable income, which generally equals taxable income plus US deductible payments made to foreign, related entities.
- As a concession to this industry, certain derivative payments made to foreign, related parties do not increase a corporation's minimum taxable income if the taxpayer satisfies Internal Revenue Service (IRS) reporting requirements. These requirements demand access to data that is not currently available to tax departments.
- Under a transition rule, a taxpayer is treated as satisfying the reporting requirements if the taxpayer reports the amount in good faith. The good faith exception was scheduled to expire for tax years starting on or after January 1, 2025. **Notice 2024-43 extends the transition period to tax years beginning on or before January 2027.**

Deferral of section 871(m) rules for non-delta-one equity linked derivatives

- Section 871(m) of the Internal Revenue Code imposes US withholding on dividend equivalent payments made to non US persons on certain contracts (i.e., derivatives, securities lending transactions, and repos referencing US. equity). The burden of withholding and reporting resides with US withholding agents, primarily US. and non-US banks and broker-dealers.
- Since 2017, these rules have applied only to delta-one contracts. For non-delta-one contracts (i.e., contracts with a delta of 0.8 or greater) and other complex transactions, the IRS had previously deferred the effective date until 2025. Expanding the scope will require significant investment to comply. Notice 2024-44 further extends the effective date until 2027, as well as extends the effective date for other substantive rules under section 871(m).

Potential actions:

The industry has been requesting an extension of the effective date for both rules for some time, and the notices should be welcome relief. However, market participants should continue to evaluate their processes and systems in order to implement the rules when(or if) they become effective.

For more information around US income tax update, contact Matt Mosby Financial Institutions & Products.

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- DOL final retirement security rule
- AML/CFT rules for investment
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