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

Q3 2024

Content

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Fractional share trade reporting

Fractional shares have become increasingly popular products as they allow retail investors with limited capital to diversify their portfolios. However, current trade reporting requirements don't adequately or entirely capture the nature of transactions involving fractional shares. The Financial Industry Regulatory Authority (FINRA) requires members to report equity sale transactions to a Trade Reporting Facility, the Alternative Display Facility, or the OTC Reporting Facility, depending on the type of security.

Transaction quantity is a required field for this reporting. However, reporting specifications note that quantity must be reported as a whole number. As a result, for fractional shares, members must round fractional shares up to one or truncate the quantity, reporting only the whole number portion.

In March 2024, FINRA announced[1] that it plans to update its reporting guidance such that fractional shares are captured in greater detail. The updated reporting specifications will include a new field designated as "Fractional Share Quantity" field intended to exist alongside the existing "Quantity" field. For fractional shares transactions, members will be required to report information for both fields. They will populate the Quantity field with a whole number as they had before, and the Fractional Share Quantity field will be populated with the true quantity of the trade with decimals up to six digits.

This change will impact FINRA Trade Reporting FAQs 101.14 and 101.15[2] and result in the creation of the new FAQ 101.16. The effective date of the updated guidance will be no earlier than Q1 2025.

Potential actions to take include:

- **Start developing the logic of presubmission controls** to ensure that the fractional shares quantity field conforms to the correct format.
- **Review their existing presubmission controls** to confirm if they are correctly rounding up or truncating the quantity of fractional shares transactions for the existing Quantity field.

For more information around fractional share trade reporting,contact Murat Oztan.

SEA Rule 15c3-3 – Daily Reserve Computation

Under the current provisions of Securities Exchange Act (SEA) Rule 15c3-3, broker-dealers are generally required to perform Reserve Formula computations (pursuant to the "Customer Protection Rule") on a weekly basis (though the Rule provides for some to compute monthly). The purpose of the Reserve Formula computation is to ensure the safekeeping of customer funds by setting aside a money balance sufficient to cover the net customer payable (requirement) in a separate bank account that is not commingled with the broker-dealer's own money.

In July 2023, the Securities and Exchange Commission (SEC) proposed amendments[3] to the Customer Protection Rule whereby carrying broker-dealers (broker-dealers that maintain custody of customer assets) with average total credits of $250 million or greater would be required to compute Reserve Formula on a daily basis. The Securities Industry and Financial Markets Association, along with a number of individual carrying broker-dealers, responded to the SEC with a written response during the subsequent 60-day comment period. Industry responses highlighted that the proposal underestimates the costs and burden of the change and includes broker-dealers that have minimal impact to customer protection.

Currently, carrying broker-dealers are assessing the applicability of the proposed rule, and preparing for implementation by enhancing routine weekly procedures to be performed daily. Notably, during such preparation, broker-dealers are discovering previously unidentified complexities and challenges in the Reserve Formula computation process.

Potential actions to take include:

- Enhance system to perform intraday reallocations of Stock Record in lieu of accumulating specific adjustments.
- Revisit overall computation methodology (inclusion, exclusion, "waterfall," etc.) and modifications to existing allocation hierarchies to better suit current business activity.
- Assess technology efficacy and considerations for implementing updated technology platforms.
- Identify opportunities to automate existing manual procedures.
- Resolve reconciling differences, and illogical or unallocated position balances;
- Move certain procedures offshore to leverage the time difference and obtain key reports earlier in the local workday.

For more information around SEA Rule 15c3-3 – Daily Reserve Computation, contact Murat Oztan.

[1] FINRA, "Advance Notice: Upcoming Trade Reporting Enhancements for Fractional Share Transactions" (March 22, 2024)
[2] FINRA, "Section 101: Reporting Time, Price and Share Quantity" (May 2014)
[3] SEC, "SEC Proposes Rule Amendments to the Broker-Dealer Customer Protection Rule" (July 12, 2023)

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Chevron Doctrine

On June 28, 2024[4], the Supreme court overturned the 1984 *Chevron* decision, which established the doctrine of Chevron deference—a legal doctrine that maintained that courts should generally defer to the interpretations of laws made by administrative agencies (for example the SEC and Commodity Futures Trading Commission). If a law was unclear, then the agency would decide how to interpret the law based on subject matter expertise. The ruling significantly reduces deference to federal agencies in cases where a statute is ambiguous and requires courts to independently determine if an agency's actions are consistent with the law and Congress's intent. Prior to June 28, 2024, courts would generally agree, or defer, to the agency's interpretation of the law.

Potential effects of the new ruling include:

- Greater focus on regulatory change management
- Decreased regulatory rulemaking
- Agencies could decrease controversial rulemaking in anticipation of prolonged legal challenges
- Agencies will need greater resources to potentially take more cases to trial or deal with new legal challenges
- Fragmented enforcement structure.

Potential actions to take include:

- Examine how this decision will affect current **risk management procedures** and identify cases that could be consequential based on the company's business.
- Since separate courts will now interpret the law, there can be a wide range of possible outcomes based on the specific court or judge presiding over the case. Companies should proactively **identify and monitor** cases with court decisions that could impact their business.
- **Implement, enhance, or emphasize, change management standards** regarding emerging regulatory changes for new and existing interpretations.
- **Evaluate internal resources and relationships with third parties** (e.g., legal firms) to determine if resourcing changes are required

For more information around Chevron doctrine, contact Mike Sullivan.

[4] Supreme Court, "LOPER BRIGHT ENTERPRISES ET AL. v. RAIMONDO" (June 28, 2024)

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The impact of rising sweep account rates and regulatory scrutiny on wealth managers

In recent months, the wealth management industry has seen an increased focus from both regulators and customers regarding sweep account rates (rates provided by wealth managers on customers' idle cash). Traditionally, sweep accounts have been a staple for managing idle cash, providing a temporary resting place for client funds while awaiting investment. This also provided a steady revenue stream for wealth managers who were able to earn spreads on the interest paid to clients compared to the interest earned from deploying the idle cash

Increased scrutiny from regulators and a spate of individual lawsuits have prompted major wire houses to raise their sweep account rates, reshaping the landscape of investment advisory services. To date, the overall reaction from wealth managers has been mixed, with many large firms opting to increase rates.

Regulatory investigations and legal pressures

Regulatory bodies have intensified their focus on sweep account rates, which can be particularly sensitive when the sweep is being deployed either as a part of a relationship with a broker or within a managed account with an investment adviser. It is one thing if a sweep is being used within a self-directed brokerage relationship, as wealth managers provide clarity on disclosures of rates charged. In this case, the wealth manager is not bound by Reg BI or the fiduciary standard imposed when acting as an investment adviser. But, when working with a broker, and that broker is already making recommendations on other commission-based products but fails to call out that the client's idle cash could be put in a higher interest-bearing vehicle than the sweep account, one has to evaluate whether this is a violation of Reg BI. Similarly, if the wealth manager is acting as an investment adviser with a fiduciary standard of best interest, and the sweep is in a managed account for which the investment adviser is making a basis-point fee on the idle cash in addition to the spread the wealth manager is making when sweeping the cash, then the risk level rises. Investigations by both the SEC and FINRA have highlighted concerns about the adequacy of disclosure practices and potential conflicts of interest inherent in sweep account arrangements. This regulatory focus aims to ensure that clients are fully informed about how their cash is managed.

Additionally, individual lawsuits have emerged, challenging the practices of large financial institutions over sweep rates. Plaintiffs argue that these rates are not sufficiently disclosed and that investors are being paid way too little on their idle cash, when they could otherwise be in higher interest-bearing vehicles.

On the flip side, wealth managers argue that the sweep accounts have other features and benefits similar to a checking account (automated clearinghouse, check writing on many, ATM access, etc.) with related costs borne by the wealth manager, thus the lower rates provided are no different.

The legal and regulatory challenges have added pressure to the larger wire houses, many of whom have already reassessed their offering and have committed to raising rates on their sweep accounts. Many wealth managers continue to evaluate their programs in the context of the regulatory scrutiny and changes made by the wire houses.

Implications for the wealth management industry

The increase in sweep account rates is expected to have several ripple effects across the industry. For sweep account holders, this translates into higher interest on cash holdings. For investment advisers and wire houses, the heightened regulatory scrutiny and litigation risks required a reevaluation of business models. Firms are investing in compliance and transparency measures to address regulatory concerns, which can lead to increased operational costs. The need to balance profitability with regulatory compliance is also prompting some firms to adjust their fee structures, potentially passing these costs onto clients in other ways.

Potential actions to take include:

- **Monitor industry developments:** Consider how the competitive landscape is evolving for sweep accounts and changes to regulatory or client expectations.
- **Reevaluate current business models:** Evaluate potential impact on current business models by changes in regulatory expectations and updates to peer sweep programs.
- **Evaluate alternative business models:** Depending upon the outcome of the various regulatory investigations and legal cases, determine the impact on the overall business model and potential for alternative revenue sources.

For more information around the impact of rising sweep account rates and regulatory scrutiny on wealth managers, contact Brian Dunham.

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Trends in organic growth for wealth management firms

As the wealth management industry grapples with the high costs associated with inorganic growth through mergers and acquisitions, firms are increasingly pivoting towards organic growth strategies. The shift is driven by the desire to achieve sustainable growth while managing the challenges that mergers and acquisitions can entail (integration costs, high valuation multiples). In this landscape, wealth managers are focused on strategies to attract new clients and expand their existing client base through enhanced adviser efficiency, improved referral networks, market expansion, increased wallet share, and additional service offerings.

Boosting adviser efficiency

One of the primary ways firms are driving organic growth is by enhancing the efficiency of their advisers. With the benefit of advanced technology and data analytics, wealth management firms are equipping their advisers with tools that streamline client interactions and opportunities, improve portfolio management, and facilitate more personalized advice. By automating routine tasks and leveraging client data to make informed recommendations, advisers can focus more on high-value activities such as building relationships and closing new business. The increased efficiency not only allows for greater client acquisition but also improves client satisfaction and retention.

Expanding referral networks

Referrals remain a powerful tool for organic growth, and firms are placing a strong emphasis on cultivating and leveraging these networks. To boost referrals, many wealth management firms are implementing structural referral programs that provide incentives to existing clients and partners to introduce new prospects. Additionally, firms are investing in client experience enhancements to ensure satisfied clients are more likely to recommend their services.

Entering new markets

Geographic and demographic expansion is another key strategy for organic growth to tap into underserved and emerging client segments. This approach often involves tailoring services and marketing efforts to meet the specific needs of a new client base. Some firms are targeting younger investors or niche markets, offering specialized advice and products that cater to these groups.

Increasing wallet share and service offerings

Firms are also focusing on growing existing client relationships. Increasing wallet share involves deepening engagement with current clients by offering a broader range of products and services. Wealth managers are expanding their service offerings beyond traditional investment management to include financial planning, estate planning, tax advice, concierge capabilities and more.

Potential actions to take include:

- **Consider where to focus:** There are only so many ways to organically grow, but focus on those actions that will have the greatest impact to the overall strategy.
- **Evaluate potential barriers:** Understand and break down potential internal obstacles and create incentives to enable teams to execute the organic growth strategy.

For more information around Trends in Organic Growth for Wealth Management Firms, contact Brian Dunham.

[5] Federal Register, SEC, "Private Fund Advisers; Documentation" (September 14, 2023)

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Private Fund Adviser Rules vacated

On June 5, 2024, the US Court of Appeals for the Fifth Circuit vacated the SEC's Private Fund Adviser Rules (Final Rule). These rules were designed to enhance transparency and protect investors in private funds. They mandated that private fund advisers disclose more detailed information about their fees, expenses, and conflicts of interest. Additionally, the rules aimed to restrict certain practices deemed potentially harmful to investors, such as preferential treatment of certain investors and misleading performance metrics.

The US Court of Appeals for the Fifth Circuit vacated these rules, ruling that the SEC had overstepped its statutory authority. The court found that the SEC's rulemaking power under **Section 211(h)**—the provision adopted in the Dodd-Frank Act—applies to "retail customers" and not to private fund investors. Furthermore, the court determined that the SEC's justification based on antifraud provisions was insufficient. The court emphasized that the SEC's reliance on Section 206(4) of the Investment Advisers Act of 1940, which addresses fraudulent practices, did not provide a strong enough basis for the broad regulatory measures imposed on private fund advisers.

This decision indicates private fund advisers are no longer bound by these enhanced disclosure and practice restrictions. Moving forward, private fund advisers may experience fewer regulatory burdens, allowing them more flexibility in their operations. However, this also means that investors will continue to face risks due to the lack of mandated transparency and protections. Without the requirement to disclose detailed information about fees, expenses, and conflicts of interest, investors may find it more challenging to make fully informed decisions. The ruling could lead to a reassessment of regulatory approaches and potentially prompt legislative action to address the gaps identified by the court.

Potential actions to take include:

- **Enhance voluntary transparency:** Provide investors with detailed information about fees, expenses, conflicts of interest, and other relevant factors voluntarily to foster trust and attract transparency-minded investors.
- **Review compliance strategies:** Assess the impact of the ruling on current practices, policies, and disclosure procedures. Make necessary adjustments to facilitate ongoing compliance with existing regulations.

Thought leadership:

- SEC Private Fund Adviser Reforms: Final Rules

For more information around Private Fund Adviser Rules vacated, contact Mike Sullivan.

Outsourcing by investment advisers

The Securities and Exchange Commission (SEC) proposed a rule to enhance oversight of investment advisers' use of third-party service providers. This initiative, outlined under new rule 206(4)-11[6], promulgated under the Investment Advisers Act of 1940, emphasizes the importance of due diligence, ongoing monitoring, and stringent recordkeeping practices for advisers outsourcing "covered functions"—services crucial for compliance with federal securities laws and, if inadequately performed, could significantly impact clients or the adviser's service delivery. *The final decision regarding this ruling is anticipated to be made in October 2024*. If adopted, firms will be expected to comply with this rule ten months after its effective date.

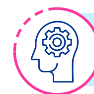
The SEC is proposing the following:

- Pre-engagement **due diligence and ongoing monitoring**, including a review of performance and a periodic reassessment of whether to retain or renew the engagement of a service provider.
- Related **recordkeeping** requirements.
- Form ADV amendments to collect information about advisers' use of service providers.
- Due diligence and monitoring requirements for advisers utilizing third-party recordkeepers, with a requirement to obtain certain assurances.

Proposed Rule 206(4)-11 will apply to SEC-registered advisers that outsource the following defined "covered functions":

- A function or service that is necessary to provide advisory services in compliance with the Federal securities laws.
- If not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services.

Any clerical, ministerial, utility or general office functions or services would be excluded.



Potential actions to take include:

- **Develop Due Diligence Frameworks** for assessing and selecting third-party service providers.
- **Strengthen Recordkeeping Practices** by establishing comprehensive systems to document due diligence, monitoring efforts, and agreements with service providers.

Thought leadership:

- Third party risk management: SEC Investment Adviser Proposal

For more information around outsourcing by investment advisers, contact Mike Sullivan.

[6] SEC, "Outsourcing by Investment Advisers" (October 26, 2022)

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Regulation S-P: SEC final amendments

On May 16, 2024, the SEC adopted final amendments to Regulation S-P[7], which governs the treatment of nonpublic personal information about consumers by certain financial institutions. The amendments apply to broker-dealers (including funding portals), investment companies, registered investment advisers, and transfer agents (collectively defined as "covered institutions"), and are intended to modernize and enhance the privacy protections provided to consumer financial information by requiring the adoption of incident response programs.

The final amendments are largely consistent with the SEC March 2023 proposal, with certain modifications based on comments received and to align with requirements in other rulemakings, such as notification requirements in the SEC's Public Company Cybersecurity Rule.

Some of the important changes in the final rule include:

- **Data security:** In addition to customer data breach notifications, rulemaking expands expectations around broader data risk management governance and controls (e.g., third-party risk management, monitoring/detection, disposal, cybersecurity, and privacy).
- **Aligning rulemaking:** Changed to align with other regulatory actions such as SEC cyber proposals/rules, national security reporting, and Gramm-Leach-Bliley Act.
- **Perimeter expansion:** Expands "covered institutions" (including transfer agents); recognizes the increased use of technology and service providers and the corresponding increase in data security and privacy risks.

The final amendments become effective sixty days after publication in the Federal Register. Larger entities will have a compliance period of eighteen months, while smaller entities will have twenty-four months from the date of publication.

Potential actions to take include:

- **Review and update internal policies and procedures** to ensure compliance with incident response program and customer notification requirements.
- **Develop a comprehensive incident response program** for potential data breaches.
- **Implement recordkeeping and retention practices** to meet new requirements.

Thought leadership:

- SEC Proposes Amendments to Regulation S-P

For more information around Regulation S-P: SEC final amendments, contact Mike Sullivan.

Final digital asset tax reporting regulations

In June, the Internal Revenue Service (IRS) and Treasury released final regulations[8] addressing tax reporting requirements for brokers that take possession of digital assets being sold by their customers. Of relevance for this industry, the term "broker" includes trading platforms, digital asset hosted wallet providers, digital asset kiosks, and certain processors of digital asset payments. For example, if a customer executes trades with a broker-dealer in which it exchanges digital assets for cash or securities, then the broker-dealer would be subject to the reporting requirements.

The regulations will phase-in during 2025 and 2026. Beginning in 2025, the broker is required to report gross proceeds received by its customers on digital asset sales. In 2026, the broker is also required to report the customer's tax bases with respect to sales of digital assets. However, cost basis reporting is only required for sales of digital assets acquired on or after January 1, 2026. For 2025, the IRS included penalty relief if the broker makes good-faith efforts to comply with the rules.

Potential actions to take include:

- Financial services companies that transact in digital assets should **evaluate the impact of the final regulations**. The rules are complex and will require market participants to **update reporting systems and obtain new information from their customers**.
- Brokers should also **educate their customers** on the new tax reporting requirements.

For more information around final digital asset tax reporting regulations, contact Matt Mosby.

[7] SEC, "https://www.sec.gov/newsroom/press-releases/2023-51" (March 15, 2023)
[8] IRS, "Treasury, IRS issue final regulations requiring broker reporting of sales and exchanges of digital assets that are subject to tax under current law, additional guidance to provide penalty relief, address information reporting and other technical issues" (June 28, 2024)

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