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

Q1 2024

Content

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Definition of dealer and government securities dealer

On February 6, 2024, the Securities and Exchange Commission (SEC) adopted new rules[1] that establish qualitative factors in determining what constitutes a "dealer", "government securities dealer", and "regular business" activities under Sections 3(a)(5) and 3(a)(44) of the 1934 Exchange Act:

- **Dealer:** Any person engaged in the business of buying and selling securities for their own account, either through a broker or otherwise.
- **Government securities dealer:** Any person engaged in the business of buying and selling government securities for their own account, either through a broker or otherwise.
- **Regular business** activities in connection with certain liquidity providers: Any person engaged in buying and selling for its own account if that person engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:
  - Regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security and that is communicated and represented in a way that makes it accessible to other market participants; or
  - Earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest.

The final rules **excludes:** (1)any person that has or controls total assets of less than $50 million; (i) Investment companies registered under the Investment Company Act of 1940; and (c)Central banks, sovereign entities, and international financial institutions. The final rules become effective 60 days after publication in the Federal Register. Compliance will be required one-year from the effective date of the final rules.

Potential actions:

- **Regulatory analysis:** Analyze the new rules to understand how they impact the organization's operations, **particularly in terms of buying and selling securities for its own account.**
- **Compliance assessment:** Assess whether the organization's **current trading activities align with the criteria outlined in the new definitions.** This assessment may involve reviewing trading patterns, revenue streams, and other relevant factors to determine if the organization meets the thresholds for dealer registration requirements.
- **Risk management:** Identify and assess any **risks associated with the organization's trading activities under the new regulatory framework.** This includes evaluating potential compliance risks, such as failure to register as required, as well as operational and financial risks arising from changes in trading strategies or business models.

Thought leadership:

- Dealer Definition: SEC Final Amendments

US Treasury Market Transformation

On December 13, 2023, the SEC authorized an amendment[2] to improve risk management and operational effectiveness in the US Treasury securities clearing and settlement market. The rule modifications specify updates to membership standards for covered clearing agencies in the US Treasury market, particularly targeting clearance and settlement procedures for designated secondary market transactions. Based on the current guidelines, which may change based on discussions between the FICC and market participants, the rule enforces 4 vital actions, which will be addressed across two phases:

Phase 1: *Separation of house and customer margin, broker-dealer (BD) customer protection, and access to central clearing:*

- **Segregation of margin for proprietary transactions:** Market participants must institute policies to calculate, collect, and hold margin separately for proprietary and customer transactions
- **Amendments to BD customer protection rule:** Rule 15c3-3 (BD customer protection rule) has been amended to allow the margin required and deposited at a covered clearing agency to be included as a debit item in the customer reserve formula
- **Facilitation of access to clearance services:** Market participants must ensure proper access to clearance and settlement services, including provisions for indirect participants

Phase 2: *Phased requirements to clear specific transactions:*

- **Mandatory clearing for eligible secondary market transactions:** Market participants are mandated to submit repurchase agreement and cash transactions collateralized by US Treasury securities for clearing.

Phase 1 targeted go-live is March 31, 2025 while phase 2 consists of two deadlines: (1) Cash transactions – December 31, 2025 and (2) Repo transactions – June 30, 2026.

Potential actions:

Firms should begin reviewing the **implications of this regulatory change** to their **operating business model.** In preparation, firms that are considering the following activities are well-positioned for an accelerated analysis and implementation:

- **Data-driven impact assessment:** Data-driven impact assessments, and proactive evaluation of key processes, systems, and operational business impact to cost reduction models and process reengineering.
- **Enhanced target operation and clearing model:** Strategic analysis to inform the transformation of the operational and clearing structure for improved efficiency, risk management, regulatory compliance, and scalable growth.
- **Collateral management, margin, and reserve calculations:** Considerations related to collateral management processing, as well as impacts to calculations for margin and customer reserves will all need to be addressed as part of Phase I.

[1]Source: SEC "Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection With Certain Liquidity Providers", (February 29, 2024)

[2]Source: SEC "Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities", (December 13, 2023)

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Best execution

Currently, BDs are subject to the best execution requirements of Financial Industry Regulatory Authority (FINRA) Rule 5310. Under this Rule, BDs have the obligation to secure client executions at the best available price. Conceptually, the existing rule requires BDs to route a customer order to the exchange displaying the best price—the national best bid or offer ("NBBO"). In practice, however, many retail BDs route customer orders to a wholesale market maker (e.g., a BD who will execute at a price at least as good as the NBBO). Wholesale market makers are often able to profit from retail orders while providing executions at or better than the NBBO and for this reason may pay retail brokerages for the privilege of executing their customer orders.

Despite FINRA Rule 5310, in December 2022, the SEC proposed Rules 1100, 1101, and 1102[3] to establish its own guidance for best execution. Under the proposed SEC Best Execution Rules, firms will have to draft and follow written procedures specifically outlining their determination of best market and the steps they will undertake in fulfilling best execution standards. BDs would also have to take into special consideration how they will handle transactions in situations with conflicts of interest. Additionally, the company's procedures would have to be evaluated annually by the board of directors.

Potential actions:

- **Review current policies and procedures** to identify potential gaps that need to be addressed in order to comply with the SEC's proposed Best Execution Rules.
- **Take into account existing access to information** such as pricing information and liquidity sources. BDs should also consider if information is adequately preserved to recreate pricing information available at the time of an execution.
- **Assess the extent of conflicts of interest** in present order routing.

Private Fund Rule

On August 23, 2023, the SEC adopted new rules and rule amendments[4] under the Investment Advisers Act of 1940 to enhance the regulation of private fund advisers and to update the existing Advisers Act compliance rule (rule 206(4)-7), with the goal of protecting investors. These new rules require private fund advisers registered with the SEC to:

- Prepare private fund quarterly statements for investors
- Obtain an annual audit for each private fund
- Obtain or distribute a fairness or valuation opinion from an independent opinion provider in connection with adviser-led secondary transactions.

Under the new rules, several prohibited activities—including undisclosed fees, reducing adviser clawbacks, nonuniform fees, and borrowing from private funds—are restricted unless proper disclosure or consent is given. Also, some governing agreements may be eligible for legacy status under the Restricted Activities and Preferential Treatment rules. Several Advisers Act rules, including the Books and Records Rule and the Compliance Rule, were amended to address changes related to private fund advisers' requirements.

The compliance date for the Quarterly Statement Rule and Audit rule is March 14, 2025. For the Adviser-led Secondaries Rule, advisers with $1.5 billion or more in private funds assets under management (AUM) are expected to be in compliance by September 14, 2024. Advisers with less than $1.5 billion AUM are expected to be in compliance by March 14, 2025. Advisers were required to comply with the amended Advisers Act Compliance Rule by November 13, 2023.

Potential actions:

- **Update compliance policies; prepare, distribute, and audit fund statements** according to the newly adopted requirements; and **retain required books and records.**
- **Comply with Restricted Activities and Preferential Treatment Rules** by disclosing and obtaining investor consent **and conduct an annual review of compliance policies.**

Thought leadership:

- SEC Private Fund Adviser Reforms: Final Rules

[3]Source: SEC "Regulation Best Execution", (December 14, 2022)
[4]Source: SEC, "A Small Entity Compliance Guide 2 Source: SEC: Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities", (December 13, 2023)

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Money Market Fund Reform Rule 2a-7

On July 12, 2023, the SEC adopted the final amendments[5] to Rule 2a-7 that govern money market funds under the Investment Company Act of 1940. The issued amendments seek to improve the resilience of money market funds and decrease financial stability risks during periods of market stress.

Major themes outlined in the amendments to Rule 2a-7 include:

- Increase to the minimum daily and weekly liquidity requirements
- Elimination of redemption gates for all money market funds
- Liquidity fees requirements instead of swing pricing
- Mandatory liquidity fee framework
- Reporting of liquidity threshold events

The amendments will become effective 60 days after publication in the Federal Register with a tiered transition period for funds of 6 months and 12 months to comply with amendments and the mandatory liquidity provision, respectively. The effective and compliance dates for amendments to Forms N-CR, N-MFP, and PF are June 11, 2024.

Potential actions:

- **Assess liquidity levels of money market funds** and add assets if necessary to meet the new requirements.
- **Establish a mandatory liquidity fee framework,** Develop a liquidity fee framework that ensures compliance with the new requirements, including a clear fee structure and process for assessing and applying the fee.
- **Review and update compliance policies and procedures,** including roles, governance, and escalation procedures, to align with the new requirements and ensure regulatory compliance.
- **Evaluate business model and reporting processes** to ensure adherence to thenew requirements.
- **Assess existing legal agreements** and, if necessary, revise contractual arrangements with counterparties.

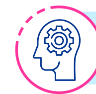
Thought leadership:

- SEC Money Market Fund Reforms & Customer Protection Rule Proposal
- Money market fund reforms

Form PF Rule

On May 3, 2023, the SEC adopted final amendments[6] under the Investment Advisers Act of 1940 to enhance the Financial Stability Oversight Council's (FSOC) monitoring of systemic risk and support the SEC's oversight of private fund advisers for investor protection. The revisions introduce new current reporting requirements for large hedge fund advisers and quarterly trigger event reporting for all private equity fund advisers (new sections 5 and 6), as well as enhanced annual reporting for large private equity fund advisers. These changes aim to provide valuable information for the SEC and FSOC to better understand and identify financial stability. The effective date for these final amendments is June 11, 2024, except for sections 5 and 6 (noted above) which went into effect December 11, 2023.

Subsequently, on February 8, 2024, the SEC and the Commodity Futures Trading Commission (CFTC) jointly adopted a final rule,[7] impacting investment advisers to private funds registered with both commissions. The rule focuses on enhancing reporting by large hedge fund advisers on qualifying hedge funds, refining basic information about advisers and their private funds, providing more detailed reporting on hedge funds' investment strategies and exposures, updating reporting requirements for complex fund structures, and removing aggregate reporting obligations for large hedge fund advisers. These changes seek to offer increased insight into private funds' operations, strategies, and regulatory oversight practices. The compliance and effective date for these amendments are one year after publication in the Federal Register.



Potential actions:

- **Adapt reporting processes** and **systems** according to the enhanced requirements, with particular attention to large hedge fund advisers and private fund data collection.
- **Streamline the preparation, distribution,** and **auditing** of fund statements, **emphasizing transparency** and proper investor consent.
- **Establish rigorous recordkeeping practices** for retention requirements, testing effectiveness.
- **Assess internal controls** to capture detailed reporting on hedge funds' investment strategies and counterparty exposures.

Thought leadership:

- Form PF and Share Repurchase Disclosures: Final Rules
- Form PF Reporting: SEC, CFTC Joint Final Rule

[5] Source: SEC, "SEC Adopts Money Market Fund Reforms and Amendments to Form PF Reporting Requirements for Large Liquidity Fund Advisers", (July 2023)
[6] SEC, "Conformed: Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting", (May 2023)
[7] Source: SEC: "Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers", (February 2024)

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Proposed AML/CFT rules for investment advisers

On February 15, 2024, the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, released a notice of proposed rulemaking[8] (NPRM). The NPRM aims to include certain investment advisers in the definition of "financial institution" under the Bank Secrecy Act (BSA), establish minimum standards for anti-money-laundering/countering the financing of terrorism (AML/CFT) programs for covered investment advisers, require covered investment advisers to report suspicious activity to FinCEN in accordance with the BSA, and introduce several other related changes to FinCEN regulations. Of note, it does not include a customer identification program requirement, nor the AML/CFT program requirements to collect beneficial ownership information for legal entity customers at this time.

These proposed regulations aim to address gaps in the existing AML/CFT regulatory framework for investment advisers who may be at risk of being misused by money launderers, terrorist financiers, or other actors seeking access to the US financial system for illicit purposes. By including certain investment advisers in the definition of "financial institution" under the BSA,
the regulations seek to mitigate these risks and protect US national security.

Written comments on this NPRM must be submitted on or before April 15, 2024.

Potential actions:

- **Develop** and **implement** a board-approved risk-based AML/CFT program applicable to all advisory activities.
- **Build the infrastructure and process to file** reports with FinCEN, including Currency Transaction Reports and Suspicious Activity Reports
- **Comply with Recordkeeping and Travel Rules** that require creating and retaining records for the transmittal of funds and passing certain information (related to the transaction) on to the next financial institution in the payment chain.

Thought leadership:

- Financial Crimes & AML: FinCEN Proposal and Treasury Actions

[8] Source: Financial Crimes Enforcement Network ,"Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers", (February 2024)

Evolving workplace in wealth

The days of providing solely retirement benefits are behind us. Employees are looking for more than just a retirement plan and/or matching contributions from their employer. As the workforce changes, younger employees especially are looking for benefits that have an impact on their **current financial situation**, not the idea of retirement that is far out into the future. Pairing these expectations with the passing of Secure Act 2.0 at the end of 2022, the landscape has evolved to the need to offer workplace wealth, not just retirement benefits.

Some of the key trends that have been taking shape in the workplace wealth space have been:

- **Holistic financial wellness programs** – These programs encompass a range of services, including debt management, budgeting, emergency savings, financial coaching, along with more traditional retirement planning.
- **Integration of health and wealth** – Integrating health and wealth benefits to provide a more holistic approach to employee well-being and providing programs that address both healthcare costs and financial planning or providing incentives for participation in wellness programs that have financial benefits.
- **Focus on financial literacy and education** – Providing financial education programs to empower employees to take control of their financial futures. These programs often cover a wide range of topics, from the basics of investing and retirement planning to more complex financial strategies.
- **Matching contributions for student loan payments** – To help employees burdened by student loans, SECURE Act 2.0 allows for employers to make matching contributions to retirement plans on behalf of employees making student loan payments, as if these payments were retirement plan contributions.

With employees expecting more benefits from their employers, employers are asking more from their benefits vendors, which has led to an ever-changing vendor landscape:

- **Consolidation:** Providing benefits that meet employee/employer expectations takes scale and we've seen wealth management firms successfully enter workplace wealth space by merging their current wealth management capabilities with acquisitions in the more specialized areas. Key examples of this are Morgan Stanley acquiring Solium and E*TRADE, J.P. Morgan acquiring Global Shares and Vestwell acquiring Gradifi (from Morgan Stanley).
- **New entrants providing specialized services:** Through the evolution of technology, especially AI/Gen AI, there has been an increase in FinTech firms that are focused on certain components of the workplace wealth ecosystem. For example, firms providing financial literacy/education through a combination of easy-to-use interfaces and access to financial professionals has increased in recent years. It is still uncertain whether these specialized Fintech companies will be able to achieve significant growth or if they will be acquired by larger, established players.

Higher employee expectations are here to stay and employers who want to attract top talent will continue to ask for more from their benefits providers to meet those demands.

Potential actions:

- Conduct a market scan and competitive landscape to **identify opportunities to enhance or outsource current offerings.**
- Follow the changing employee expectations and employer **demands and evaluate current gaps and capabilities** that could be addressed through development, partnerships, and acquisitions.

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GenAI in wealth management

In a time when wealth managers are caught between declining fees, rising costs, and shifting investor preferences, firms are starting to reimagine their missions, operating models, cost structures, and value propositions. GenAI is reshaping investing and how financial advisers guide, inform, and engage their clients.

The potential uses cases for GenAI in wealth management are extensive. Early adopters have focused on deploying solutions around new account onboarding, client portfolio recommendations, ongoing financial planning, and personalized communications across multiple marketing channels.

Efforts have been focused on quick wins and use cases that can be tested with appropriate levels of human oversight as a starting point to build momentum for the GenAI journey. As large language models are trained and the data is improved, a new set of use cases will be developed, tested, and implemented.

While there are a broad range of tasks and processes that can be streamlined there are four general uses of GenAI that can by applied by wealth managers:

- **Synthesizing information**—Sorting and organizing large sets of structured and unstructured data to perform portfolio optimization, forecasting, and sentiment analysis to anticipate market movements.
- **Monitoring change**—Identify shifts in trading data and trends that might prompt different investment choices or identify irregularities that could be used in risk management (flagging violations of policy and client objectives) and compliance (including scanning for regulatory changes).
- **Decision support**—Recommending possible actions or remediations based on data and published information to provide personalized financial advice and identifying ways to optimize a client portfolio.
- **Generating content**—Client communications, training materials, charts, drafting compliance reports.

Potential actions:

- **Assess your business,** align the building blocks for success and pick use cases. Take a renewed view at the overall business strategy; be clear about the vision and expectation of using AI; and start small with a multidisciplinary approach including representatives from risk, legal, compliance, cybersecurity, and information technology.
- **Consider the availability and quality of data.** To develop top use cases invest in high-quality training data to help identify gaps and/or biases in the data. Continue to make investments around enriching client and market data.
- **Regularly assess risk associated with the usage of AI-powered solutions,** including cybersecurity threats to the models or data, potential violations of regulatory and fiduciary rules, and risk around the cost of investment.

Thought leadership:

- Generative AI in asset and wealth management: The art of possible

Digital asset regulations

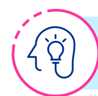
In the second half of 2023, the Internal Revenue Service (IRS) and Treasury issued proposed regulations[9] addressing digital asset information reporting requirements. At a high level, these rules require a broker effecting sales of digital assets to report the sales to both the IRS and the broker's customers.

The definition of broker is extremely broad and could include capital market participants that stand ready to effect sales made by others. For example, capital market participants could be subject to reporting requirements if they provide facilitative services, such as providing access to digital asset trading platforms, order matching services, market making functions to offer buy and sell prices, or escrow-like services.

As currently drafted, reporting obligations for certain transactions would be effective for sales occurring on or after January 1, 2025.

In response to the proposed regulations, market participants should:

- Begin assessing the impact of the proposed regulations on current business models.
- Communicate with peers to understand the issues they are seeing, and coordinate feedback on the regulations; while the stated comment period has passed, feedback would likely still be welcome by the government.
- Understand how existing systems would need to be updated to capture the required information. Under the proposed regulations, brokers must disclose information that extends beyond the data sets that brokers may need for traditional securities.



Thought leadership:

- Tax IRW Ops Insights Quick Tips & Updates

[9] Source: Federal Register, "Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions", (August 2023)

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IRS Audits on High-Net-Worth Customers

High-net-worth clients may be encountering an increase in IRS enforcement activity. The IRS is intensifying work on taxpayers with total positive income above $1 million that have more than $250,000 in recognized tax debt. Specific areas of focus include:

- Targeted IRS campaigns (e.g., partnership and S-corp issues) and reportable transactions (e.g., syndicated conversation easements)
- Foreign-source income and assets
- Private foundations
- Charitable contributions
- Related-party transactions

In response to the heightened focus by the IRS, wealth management and trust departments should be ready to assist clients with their IRS examinations, including:

- Educating clients on areas of IRS focus.
- Helping clients prepare for future exam activity, including maintaining common books and records that could be placed in an audit-ready repository.
- For clients under exam, wealth advisers should have a framework in place to support investment-related matters that arise during the audits.

Expansion of dividend equivalent sourcing rules (Section 871(m))

Section 871(m) of the Internal Revenue Code imposes U.S. 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 (e.g., banks, BDs).

Since 2017, these rules have applied to delta-one contracts. However, for non-delta-one contracts (i.e., contracts with a delta of 0.8 or greater) and other complex transactions, the IRS deferred the effective date until 2025.

The government has already deferred the application of the rule to contracts other than delta-one contracts for several years. It is uncertain whether they will do so again. In light of the uncertainty, market participants should be evaluating whether and when to notify relevant stakeholders and update their systems and controls.

Stock excise tax & securities dealers

Beginning in 2023, corporations must pay an excise tax equal to 1 percent of the fair market value of stock repurchased during the year, net of the fair market value of any issuances during the year. The tax return for 2023 is due at the end of April 2024.

The rule provides for the government to issue regulations that exclude repurchases made by a securities dealer in the ordinary course of its business. As of the first quarter of 2024, the IRS has not issued any regulations addressing the excise tax. The only substantive guidance is an IRS notice that provides certain requirements to qualify under the exception, including that the dealer disposes of the stock within a period of time that is consistent with the holding of the stock for sale to customers in the dealer's ordinary course of business.

Until the government issues regulations, dealers may want to consider the guidance in the IRS notice when computing their tax liability for 2023. In addition, dealers should continue to monitor for updated guidance.

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