



2022 capital markets regulatory outlook

Tackling an ambitious
regulatory agenda

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Introduction

Broadly speaking, we expect 2022 to be a year of amplified regulatory activity as agencies transition from a planning period to an execution phase. Agencies where key appointees have been confirmed—as well as self-regulatory organizations (SROs)—may be further along the policymaking curve in 2022. The end of 2021 demonstrated that the Securities and Exchange Commission (SEC) has reached execution mode with multiple rule proposals released on the same day in December, and we expect the agency to continue this momentum through the new year.¹

Capital markets firms should anticipate a continuation of the ambitious agenda set forth by SEC Chairman Gary Gensler in 2021, with final rules and their aftereffects stretching into 2023. Issuances and actions that we expect from the SEC in 2022 include: environmental, social, and governance (ESG) disclosure standards; disclosure rulemaking for special purpose acquisition companies (SPACs); a recommendation on payment for order flow (PFOF); continued clarity and enforcement in the digital assets space (especially for stablecoin arrangements that constitute securities); and a recommendation regarding enhancements to Treasury market structure. From the Commodity Futures Trading Commission (CFTC), firms should expect a continuation of the aggressive enforcement of its anti-manipulation and anti-fraud authority over the cash markets.

Hopefully, the year offers firms clarity in areas where rulemaking has been anticipated (e.g., ESG disclosure) or uncertainty is widespread (e.g., digital assets). Meanwhile, the operational impacts of past rulemaking will continue to affect firms' compliance strategies and costs.

The expanding regulatory perimeter

Across all sectors, we expect to see continued extension of the regulatory perimeter in 2022. While 2021 served as a year for the Biden administration to settle into governing, 2022 will be an opportunity to fill remaining key vacancies, which will allow the agencies to better fulfill their regulatory missions. There are frontier topics like climate finance and digital assets that are top of mind for many, but regulatory expansion is not limited

to these areas. Foundational regulations are being tested not only by new technologies but also by new business models. As industries evolve and the lines between them blur, regulators increasingly feel that their entity-based frameworks are not sufficient to address emerging risks. They have even gone as far as enlisting Congress to bolster their authority in rapidly evolving areas.²

To the extent possible, they are also shifting their focus to activities and testing the limits of their authority. Horizontal integration and new business models have created an opening for financial regulators to wield some authority in industries that were not traditionally in their purview (namely, tech). Nevertheless, the agencies wish to address coming challenges proactively rather than reactively and as such, we expect them to move the needle substantially in 2022 in the areas of digital assets, ESG investing and cybersecurity, among others. Despite the activities focus, certain firms may face a barrage of challenges ranging from agency rulemaking and enforcement, to renewed enthusiasm for antitrust pursuits, to possible legislation.

In the area of climate policy, the specter of climate stress tests and scenarios analysis looms large for financial institutions. However, ESG disclosure standards, which the SEC continues to promise, have the potential to impact every public company regardless of industry. Although it is a volatile and even more arduous process than agency rulemaking, legislation remains a wild card that could accelerate the current trajectory.

Firms should expect to devote more attention and more resources to regulatory changes in 2022 and beyond. Attempts by US regulators to “catch up” with their counterparts in Europe and elsewhere present a challenge not only to firms but the regulatory agencies as well. Thus, the present moment is ideal for engagement with policymakers; rather than deny the conversation, firms should seek to inform it.



Impacts from operational change mandates new and old

Consolidated Audit Trail (CAT): The final chapter

Capital markets firms should understand the impact of a fully operational CAT reporting regime.³ As evidenced by regulators' proactive engagement with the industry throughout the implementation process, firms can expect continued and active regulatory engagement—moving past readiness exams and diving deeper into cause exams and regulatory inquiries about the accuracy of data reported to CAT.

Firms should evaluate their data governance and reporting infrastructure in totality to ensure they have appropriately designed oversight and governance controls (including data validation and testing checks) to identify data discrepancies and problems with near-real-time visibility. Also, firms' recovery response plans should consider a multitude of scenarios and outcomes to ensure any issues that arise do not

Regulatory imperatives have driven many firms to adopt more efficient operations at scale, including the push for accelerated securities settlement, which we expect to advance in 2022.⁴ This regulatory mandate is expected to have follow-on effects. For example, securities could settle faster than customers' prospectuses are delivered. To meet the compressed processing timeline, firms will need to migrate away from paper processing and adopt straight-through rather than batch-dependent infrastructures.

The pandemic accelerated the pace of digital adoption. Some examples of rapid change include implementation of e-delivery as the default mechanism for regulatory disclosures and transactional documentation, as well as widespread adoption of e-signatures for transacting with customers. Although broader adoption across the capital markets ecosystem is necessary to achieve the

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compound day over day while remediation occurs. It is critical for firms' infrastructure to support daily responsiveness and recovery while reducing occurrences of errors and omissions.

Impact from an accelerated settlement cycle

Digital adoption and the implementation of more efficient operational processes through advanced technologies has been a hallmark of the capital markets industry for years. With middle- and back-office operations seeing their services commoditized in a world of compressed margins, many firms are looking more broadly for new ways to scale their services and introduce new products at cost.

desired efficiencies sought by regulators, to facilitate the coming changes firms should consider taking steps now to secure funding and project planning support.

As firms focus on the processing improvements required by an accelerated settlement cycle, it provides a renewed opportunity to reassess resiliency to outages in time-sensitive, critical business services. Scenario planning—and associated business resiliency improvements—should be expected to be part of the program.



Convergence of technology and the existing regulatory framework

Digital engagement and customer acquisition

Throughout the pandemic, the success of digital trading platforms—along with higher retail participation in equity markets—increased regulators’ attention on how firms engage with retail customers via digital channels.⁵ While 2021 primarily served as a fact-finding period for the SEC and Financial Industry Regulatory Authority (FINRA), we expect a more mature regulatory perspective on digital engagement to emerge in 2022.

The current regulatory regime already governs marketing practices. As such, firms should continue scrutinizing their digital marketing and digital engagement practices relative to existing regulatory standards.⁶ Despite the nuanced understanding necessary to interpret the standards, regulators will likely seek to impose a clear delineation between

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providing resources and making recommendations. Thus, as a first step, firms should consider whether a specific prompt or communication is intended to educate investors or to influence behavior.

Also, firms need a clear understanding of other regulatory expectations related to digital marketing and digital engagement, including supervising third-party social media influencer posts on behalf of the firm; keeping proper records of customer communications; identifying and responding to customer complaints; and managing conflicts associated with giveaway programs and other promotional strategies.

Artificial intelligence (AI)

Regulators in the United States and globally continue to grapple with the policy implications of firms’ ever-increasing reliance on AI models for aspects of their business. A recurring theme from regulators’ speeches and white papers on the topic is the importance of human oversight and intervention.⁷ Chairman Gensler of the SEC has repeatedly indicated his skepticism of overreliance on these models and his concern that the technology could create systemic risk.⁸

In 2022, we expect capital markets regulators to be on the lookout for compliance violations that result from AI-driven processes. Thus, firms should audit their AI-assisted business practices to ensure that they understand both the legal requirements associated with the activity and the models that they rely upon

to complete said activity. Firms will need to have robust risk and control systems in place since it is unlikely that regulators will accept “black box” approaches to any activity that they deem to be under the regulatory umbrella. As regulators increase their understanding of the touchpoints between regulatory requirements and AI technologies, firms will likewise need to mature their approaches implementing these technologies in ways that comply with existing regulations.

Digital assets

We expect federal regulators to use the full extent of their authority to regulate the crypto space in 2022. Presently, there are two key touchpoints between the federal government and digital assets: (1) regulated financial instruments (e.g., securities, commodities) and (2) regulated entities (e.g., exchanges and broker-dealers). In 2022, given the current proposals, legislation might expand the scope of regulated instruments and entities. However, it is even more likely that regulators will use their existing authorities to place requirements on firms and clarify their expectations for the crypto space.



The fourth quarter of 2021 saw several weighty issuances that set the agenda for next year, including a report on stablecoins issued by the President's Working Group (PWG).⁹ The PWG stablecoin report, issued in November 2021, lays out federal regulators' collective vision for the crypto space.¹⁰ The report calls on Congress to enact legislation that creates a cohesive federal framework for stablecoin regulation, including imposing bank-like prudential standards on stablecoin issuers and any entities that facilitate stablecoin arrangements on existing and new payment rails leveraging distributed ledger technology. It also acknowledges that many stablecoins may in fact be securities (a frequent assertion of SEC Chairman Gensler) and recommends that federal regulators use existing authorities to control the space in lieu of congressional action. While legislative action is possible, other priorities may drive the congressional agenda, and gridlock is likely to take hold ahead of the midterm elections.

Additionally, in 2022 we expect the SEC to further clarify its position on when a stablecoin is considered a security—potentially through continued enforcement actions. There is little doubt that the CFTC will also continue to be active in this space—especially given that it has defined one stablecoin, Tether or USDT, as a commodity already. It is unclear at this point which of the two regulators will assume dominance over stablecoins, but firms can expect jockeying from the enforcement divisions of both regulators in this sphere.

Cryptocurrency exchanges will also face increased scrutiny, and possibly even regulation, in 2022. During 2021, these exchanges have been the targets of heightened regulatory interest, including from SEC leadership, with Chairman Gensler noting that they should register as securities exchanges; and the CFTC, with former Commissioner Berkovitz noting that many should register as derivatives exchanges (e.g., swap execution facilities) and Acting Chair Behnam noting possible expansion of the agency's regulatory authority in this space.¹¹

We expect federal agencies to be very active in many areas during 2022, and the digital asset space will be no exception. However, the legal classification of specific digital assets and services will ultimately determine the extent of regulatory authority in this area. Firms should be cognizant of the evolving definitions and ensure that they are complying with relevant regulations, lest they find themselves targeted with enforcement action in 2022. The PWG stablecoin report should have the entire ecosystem on alert, with firms in the space closely monitoring the situation, planning for intensifying scrutiny, and proactively engaging with regulators.



Changes to market structure

Fractional shares and options trading

The rising popularity of fractional shares and increased volume of options trading through online brokers has created a much larger space for novice investors to stake their claim in the markets.¹² These trends also contributed to increased trading volumes in equity markets, especially during periods of volatility, since less experienced investors tend to be more reactionary to market movements.

Firms should continue assessing the suitability of their products relative to the risk profiles of these novice investors (as well as the firm's obligation for best execution). As firms consider expanding the trading capabilities they offer, they need to understand their obligations related to trading operations and market making, system resiliency, execution quality, and product suitability.

Regarding fractional shares, SEC staff have been raising questions about the accounting for customer purchases of fractional share interests. Although purchases of fractional shares have recently emerged as a popular offering for some fintech broker-dealers, similar purchases have been part of the dividend reinvestment programs that more established firms have offered for years. The questions mostly revolve around whether a broker-dealer should recognize the actual shares as an investment on its balance sheet (with a corresponding liability to the investors, which represents a form of derivative interest in the shares). SEC staff are actively discussing this issue with industry associations and accounting firms. Meanwhile, the SEC's Division of Trading and Markets has informally indicated that it is not inclined to alter the way such transactions are treated under its net capital and customer reserve rules. For broker-dealers that are subsidiaries of financial holding companies, the resulting large increases to their balance sheet totals will affect their compliance with US bank regulators' leverage ratio requirements.

Payment for Order Flow (PFOF)

Market events in early 2021 led to popular scrutiny of the practice of payment for order flow.¹³ In 2022, we expect the SEC to take a concrete position on this practice—including the possibility of a full ban. As such, firms whose revenue relies meaningfully on PFOF would be well advised to look for additional or diversified revenue streams in case the practice is made obsolete by regulatory fiat.

Implementation of security-based and other swap dealer rules

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave the CFTC and SEC jurisdiction over swap dealers and security-based swap dealers (SBSDs) respectively.¹⁴ However, those agencies' capital rules have only recently been finalized. Listed below are several key areas that are still being addressed with the SEC and CFTC through their industry working groups which are actively working with member firms and registrants to resolve the issues.

Differences in approach

The CFTC's approach differed from the SEC's approach in requiring firms to become "provisionally registered" and requiring compliance with each rule as it was adopted. The CFTC's swap dealer capital and financial reporting rules were the last to be adopted, taking effect in October 2021.¹⁵

The SEC did not require SBSDs to register until all its rules had gone into effect. The SEC's capital, margin, segregation, and financial reporting rules were the last to be adopted, also taking effect in October 2021.¹⁶ Only then were SBSDs required to register.

Despite the long period of time that it took to establish the rules, many interpretive and implementation challenges remain. Registrants today vary widely in terms of background. Unlike in the past, when SEC and CFTC registrants tended to have very similar broker-dealer or futures commission merchant (FCM) business models, swap dealers and SBSDs can be foreign and domestic banks or non-banks. Also, different rule options are available for different types of legal entities, including areas of substituted compliance for entities with a prudential regulator.



Capital and margin rules

Under Dodd-Frank, banks do not follow the SEC or CFTC capital and margin rules (although several other SEC and CFTC rules apply, including those related to financial reporting). The SEC and CFTC capital rules differ, with the CFTC providing two different options for financial firms: one incorporating the SEC rule by reference, and the other including attributes of the bank capital rules.

Alternative compliance

The SEC has an Alternative Compliance Mechanism (ACM) whereby dually-registered firms with a predominantly CFTC-related product mix can apply certain CFTC capital and related rules in lieu of SEC rules. Whether this is a viable option for a potential registrant depends on a number of factors, including its entity type.

Substituted compliance

Foreign entities can apply for—or have their home regulator apply for—“substituted compliance” in which foreign rules can be used as substitutes for the equivalent US requirements. The CFTC is still reviewing applications; however, the SEC has already approved applications filed by a few countries. As with ACM, dealers should conduct a thorough analysis of all sub-compliance areas to determine the feasibility of applying for full or partial substituted compliance. Some areas might require additional work to comply with the sub-compliance order (e.g., chief compliance report, risk mitigation) and should be examined carefully.

Financial reporting

SBSDs will be required to submit a Financial and Operational Combined Uniform Single (FOCUS) report to the SEC.¹⁷ However, line-by-line instructions for the FOCUS report are not currently available, and a number of line items still require clarification from the SEC. With so many different entities filing regulatory reports based on varying factors such as different capital rules, it is not surprising that financial regulatory reporting has been a challenge for both the industry and its regulators. For example, although banks generally file their reports with bank regulators, the SEC has created its own form modeled after a form used by US bank regulators, which presents challenges for non-US SBSDs. Further complicating matters, bank regulators changed their form before the SEC rule went into effect. The SEC is looking to have FINRA collect filings from banks and non-broker-dealer swap dealers, even though they are not FINRA members. However, so far FINRA has not been able to do so. Also, some filings with other regulators are not public and may be filed later than expected by the CFTC and SEC.

Books and records

The SEC's recordkeeping rules are significantly more specific than the CFTC's rules. In particular, SEC rules 18a-5 and 18a-6 list detailed record attributes and/or content that must be retained, which could pose challenges for some dealers. Another key difference is the required retention period for records, which is three years for the SEC and six years for the CFTC.



New and enhanced disclosure requirements

The SEC's prevailing policy model is to protect investors and markets by improving the information available to them. As such, the regulator frequently increases or adjusts the information that firms are required to disclose.

Preparing to comply with new and evolving disclosure filing requirements will be a key feature of firms' 2022 compliance efforts. In addition to standardized climate disclosures, which we expect in the first half of 2022, the SEC is in the process of implementing several other disclosure initiatives.

Share repurchases

In December 2021, the SEC released a share repurchase proposal that creates a new disclosure form, Form SR, which issuers would be required to file with the SEC within 24 hours of making a stock repurchase.¹⁸ The new form would provide to the SEC the following information:

- **Date of the repurchase**
- The class of **securities purchased**
- Total **number of shares** (or units) purchased, whether or not the purchases were made according to a publicly announced plan
- **Average price paid** per unit
- Total number of units purchased on the **open market**
- Total number of units purchased relying upon the **safe harbor** in Exchange Act Rule 10b-18
- Total number of **units purchased** (as part of a publicly announced repurchase plan)

The information will be required to be reported using Inline XBRL. Thus, firms may need to make some technology adjustments to comply with the proposal. In addition, firms will need to determine roles and responsibilities associated with making these disclosures in a timely and accurate fashion and ensuring that stock repurchases reflect publicly announced plans.

Enhanced disclosure for special purpose acquisition companies (SPACs)

In response to record SPAC activity in 2021 the SEC's Investor Advisory Committee (IAC) took up the topic of SPAC transactions last year, making several specific policy recommendations.¹⁹ Improving disclosure was among the policy actions recommended by the Committee. We expect the SEC to revisit the issue of SPAC disclosures in 2022, most likely with a formal policy proposal not dissimilar from the one proposed by the IAC. To this end, firms should ready their compliance teams with the data and tools necessary for reporting. In addition, the IAC recommended that the SEC remove SPAC transactions from projections-related safe harbor. If the SEC were to implement this piece of the IAC's proposal, performance projections associated with SPAC transactions would be held to the same standard as those associated with IPO transactions. Thus, SPAC firms should review their practices for making projections and enhance them as necessary.

Looking ahead

The rulemaking process is very procedural, and the impacts of any major regulatory proposals to emerge in 2022 will not be felt overnight. Nevertheless, firms should remain alert and engage with policymakers while their efforts can have maximum impact (before the final rule stage). Since firms are likely to live with the rules that are proposed in 2022 for potentially years to come, it is well worth their effort to engage with the process early and often.

Similarly, firms must not lose sight of their ongoing and impending obligations. In conjunction with new rulemaking, we expect regulatory enforcement to be more vigorous than in recent years. Given the gravity of some of the areas under regulatory consideration, 2022 might frame the business and regulatory environment for financial services in the United States for the foreseeable future.

Endnotes

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