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2023 capital markets regulatory outlook

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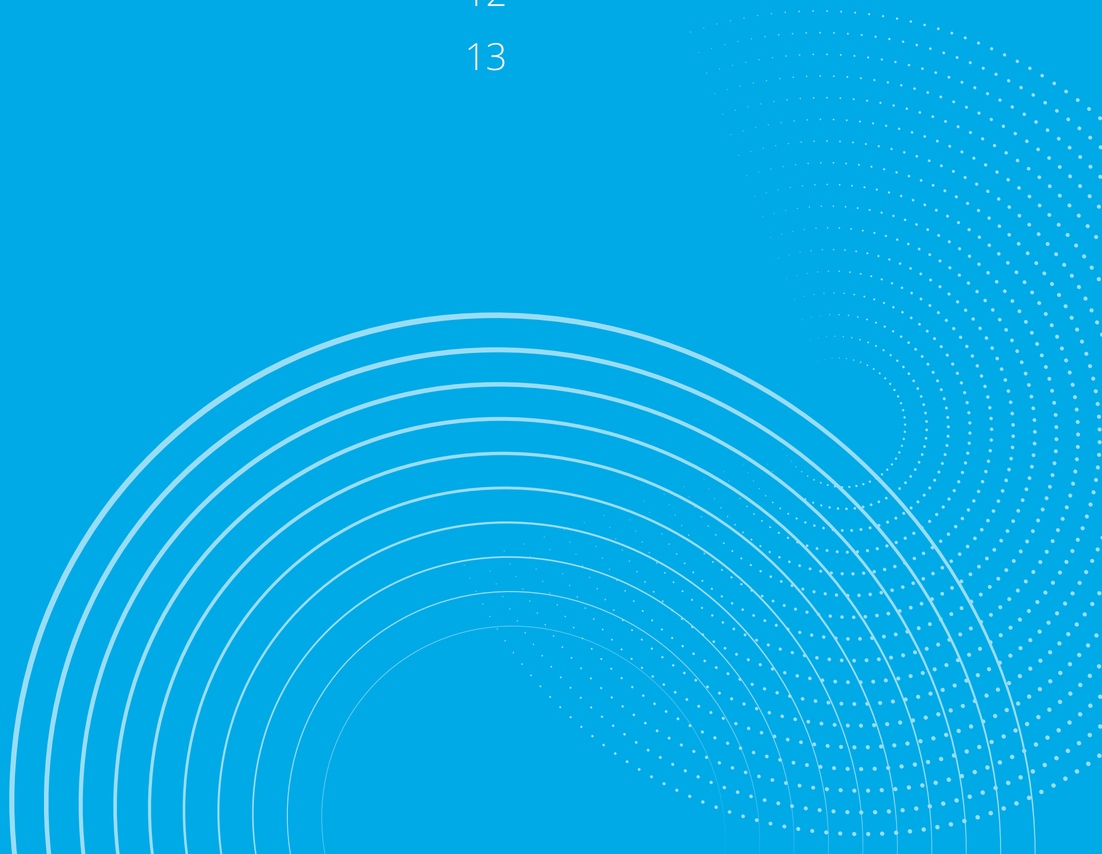

Introduction

The current volume of proposed regulatory change compares to that of the post–Dodd-Frank period. In 2023, we expect the impacts to ripple across firms and markets in transformational and hard-to-predict ways. We identify three themes that firms may want to consider as they assess the sweeping impacts of this agenda on their business:

- ***Regulatory churn:*** In 2022, capital markets regulators developed approaches to emerging technology, outdated rules, and progressive topics. Most of the activity was led by the Securities and Exchange Commission (SEC or Commission), which approved 39 proposals to amend existing or create new regulations. Many of these proposals create new reporting requirements for firms; others will expand the scope of entities required to register with the SEC. Additionally, this ambitious agenda has created a tremendous amount of uncertainty and risk for certain firms. Overlapping implementation timelines and anticipated legal challenges make it difficult to effectively allocate competing resources.
- ***Reinvigorated enforcement:*** In 2022, the number of enforcement actions brought against capital markets firms increased by 9%.[1] Regulators also leaned heavily on existing rules to enforce in areas where new regulations are pending.
- ***On the regulatory horizon:*** Despite the volume of new initiatives undertaken by regulators in 2022, we expect several more topics to be on the regulatory horizon in 2023, including overhauls of firms' digital engagement and cybersecurity practices.

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Regulatory churn

The large number of rule proposals in 2022 casts a shadow of uncertainty over the regulatory agenda in 2023 (see Figures 1 and 2). How much of the proposed agenda ultimately will translate into rules that the industry must implement? Two big factors that will likely determine this are (1) SEC leadership and oversight and (2) legal challenges to the agenda. Since the SEC has led the financial regulatory agencies in new rulemaking activity, the approach of its leadership (and specifically the chair) is paramount. Chair Gensler has identified a sweeping agenda of regulatory change and likely intends to follow through on that agenda. However, external pressures on the Commission and the realities of effectuating, rather than proposing, change could force prioritization.[2]

Oversight of the agency will be impactful and likely politically motivated. With a Republican majority in the House, we expect more scrutiny of the chair's agenda, particularly from the House Financial Services Committee (HFSC). Legal challenges to forthcoming rules, which are inevitable, especially for the most controversial proposals,[3] are potentially strengthened by recent Supreme Court rulings.[4] Nevertheless, firms should plan as though the proposed agenda will be enacted because, even if only a fraction is finalized, the changes will be impactful, and significant implementation efforts will be required. Additionally, the uncertainty brought on by legal challenges to final rules could linger for years—placing firms in an untenable position if they do not prepare for an outcome that favors the regulators. Some proposals, such as reducing the settlement cycle from T+2 to T+1, are not controversial at the Commission and likely will press forward unimpeded. The proposals we discuss in detail here are among the most transformative introduced by the SEC in 2022.

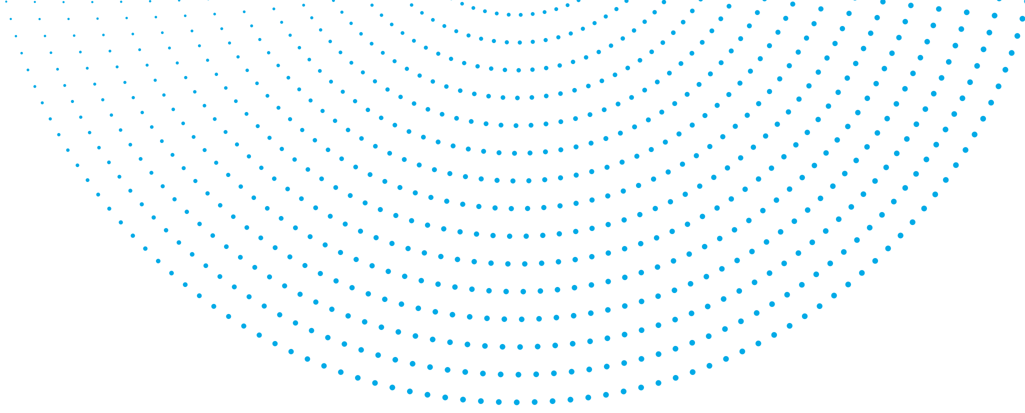
T+1

In the current agenda, T+1 is atypical in the scale of operational implementation effort required and simultaneous unanimous support from the Commission.[5] We expect a final rule to advance in 2023 and the industry has already begun preparations. Like previous efforts to reduce the settlement cycle, transitioning to T+1 will require significant operational change, and because of the heavy volume of regulatory activity, the teams that will be responsible for implementing T+1 are likely to be spread thin by implementing other regulatory mandates as well.

Nevertheless, firms will need to press forward with operational changes, including the creation of a project management office (PMO), development of implementation plans, continuous oversight of the implementation effort, portfolio manager, trader and client education, internal and industrywide testing, and establishment of a migration command center.

Firms may also want to set up overarching PMO teams for the full spectrum of regulatory implementations that will be required in 2023 and conduct assessments to identify synergies, conflicts, and resource constraints to manage risks presented by an array of overlapping implementation efforts. Other steps firms should consider taking include:

- Establishing a governance structure for implementation
- Obtaining commitment from management for resources dedicated to implementation
- Conducting analyses to determine the impacts, gaps, and changes required for implementation
- Developing a road map for implementation, inclusive of gaps identified through firms' analyses



Amendments to the definition of broker-dealer

Two "definitional" proposals expand the scope of entities required to register with the SEC.[6] In effect, these proposals would stretch the regulatory perimeter to new entities. The second of the two proposals extends the broker-dealer regulatory regime to market makers not typically under its umbrella by creating two new rules that define qualitative and quantitative standards for determining what constitutes liquidity provision "as part of regular business" under the Exchange Act.[7] The proposal further defines "as part of regular business" in the Exchange Act. In effect, the proposal would require certain principal trading firms, private funds, and other market participants to register as dealers. This would entail registering with both the SEC and a self-regulatory organization and complying with federal securities laws, including significant reporting and capital requirements.

Some initial actions firms potentially affected by the proposal can consider taking include the following:

- Work with the firm's counsel to interpret and understand the proposal
- Conduct a strategic assessment of opportunities and trade-offs presented by regulation
- Identify the current or future entity that would register and perform a pro forma capital computation
- Conduct a gap assessment of the technology and systems design and implementation capabilities required
- Conduct a gap assessment of the compliance program against leading practices and regulatory expectations

If finalized, firms would have one year to come into compliance following the rule's effective date. This places significant urgency on firms to assess their alternatives and develop a plan before the rule is finalized.

Best execution

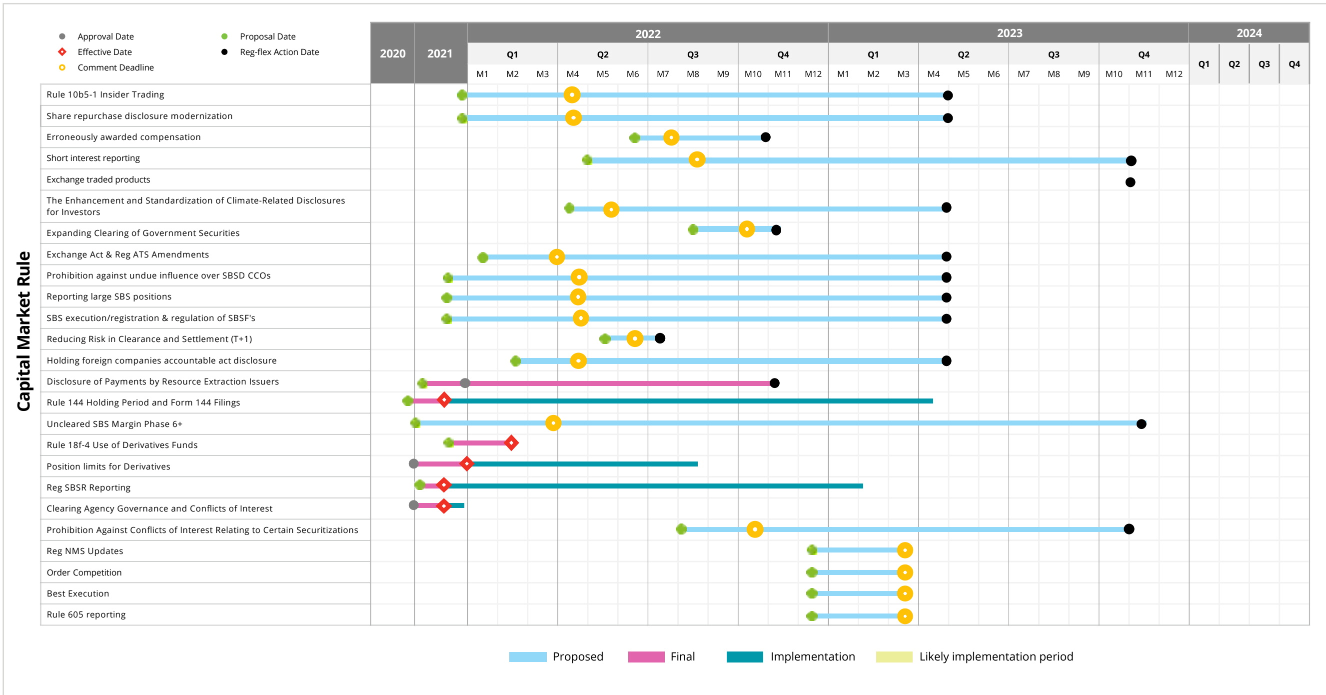
In December 2022, the SEC approved a proposal that would create an SEC standard of best execution for broker-dealers (as opposed to the existing Financial Industry Regulatory Authority (FINRA) standard).[8] The SEC proposal sets similar standards as existing FINRA Rule 5310, including robust policies and procedures regarding best execution and quarterly reviews of customer execution quality.[9] The SEC rule would establish more prescriptive standards for broker-dealers receiving payment for order flow and other "conflicted transactions."

Market structure proposals

Also in December 2022, the SEC approved three significant proposals related to equity market structure, which reflect skepticism about the practice of payment for order flow and are intended to improve retail order execution quality. Collectively, the package comprises the most significant proposed changes to market structure in more than a decade. The three proposals are amendments to Regulation National Market System (Reg NMS),[10] the "Order Competition Rule,"[11] and new disclosures of order execution information.[12] The most controversial of the proposals is likely to be the Order Competition Rule, which would require all market participants, including market makers, to route orders to auctions hosted on national exchanges. The rule could potentially upend the business model of some broker-dealers and market makers if enacted in its current form.

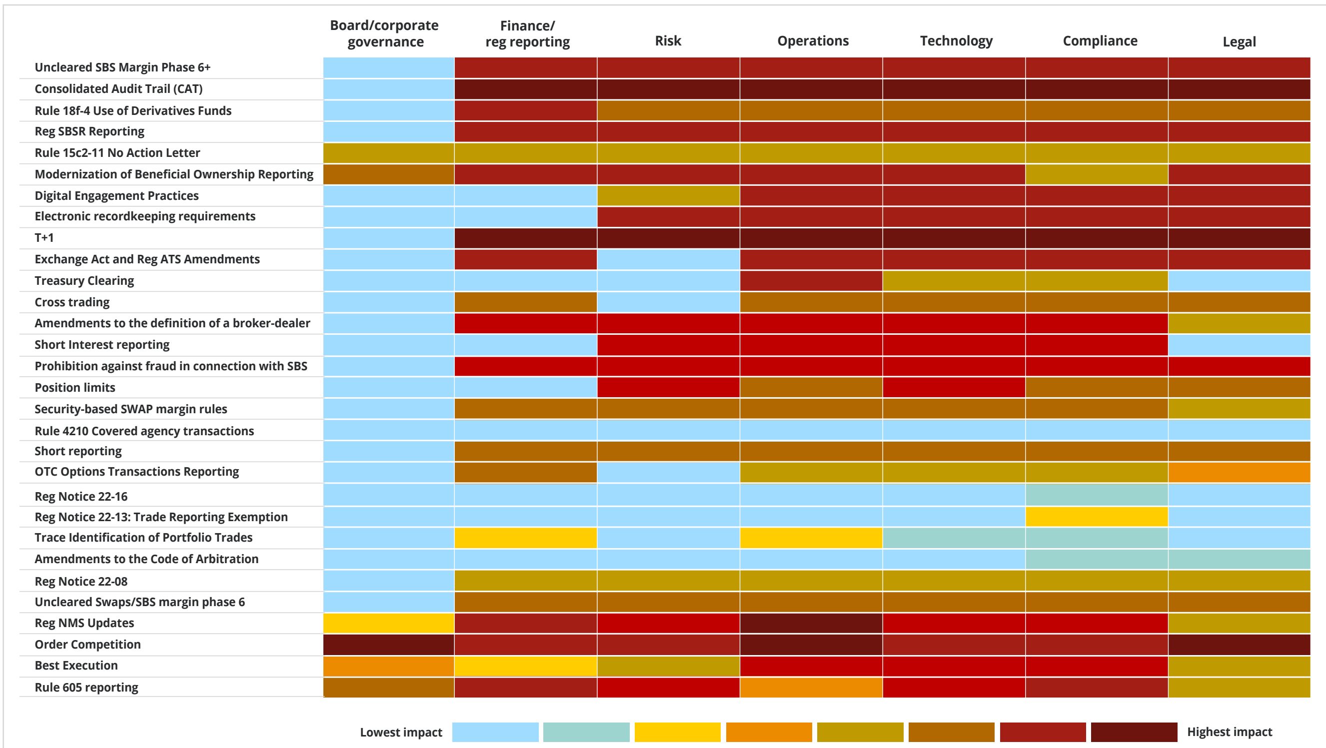
The other two proposals, which would amend Reg NMS and create new disclosure around order execution quality, seemingly seek to achieve the same goal of improving retail order execution through less drastic means. One of the proposals also allows for a sub-penny tick size, which potentially could reduce spreads, but may be technologically complex to implement, particularly given the specification of the proposal, which set a minimum pricing increment relative to a weighted-average spread. Firms have until the end of March to respond to the package of proposals at which point SEC staff will evaluate the comments received before making any recommendations to the Commission for final rules.

Figure 1. Timeline of active SEC capital markets rules



Source: SEC, SEC Unified Agenda, October 2022

Figure 2. Relative impact of SEC capital markets agenda on business lines



Source: Deloitte, The Active Regulatory Agenda, 2022

Reinvigorated enforcement

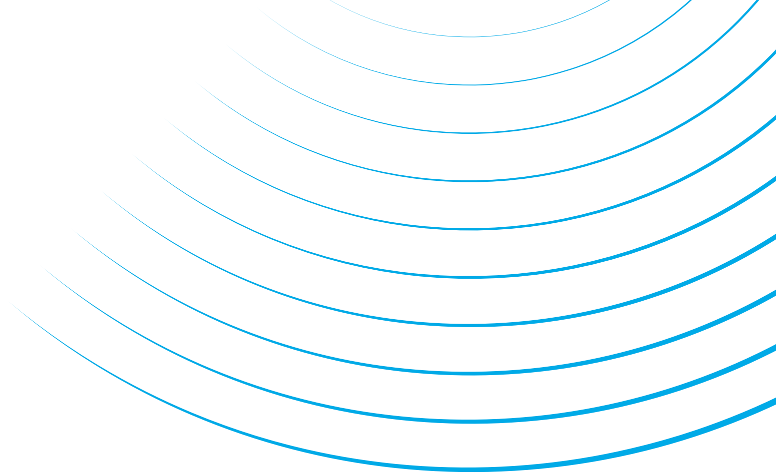
After years of light policing, capital markets regulators have drastically intensified their enforcement efforts. Record fines have been imposed, rigid compliance with existing standards has been required in areas where new rulemaking is forthcoming, and deeply strategic actions have been taken in areas where the law is hotly contested (e.g., digital assets).[13] When paired with the onslaught of new rulemaking activity, firms' government affairs and compliance functions have not been under comparable regulatory pressure for years.

Electronic Communications

In September 2022, the SEC and Commodity Futures Trading Commission (CFTC) levied fines against 11 financial institutions for recordkeeping, monitoring, and supervisory failures associated with business communications conducted outside of permissible channels. The charges primarily stemmed from employee use of personal devices to discuss business matters, a practice that in many cases violated the SEC's and CFTC's record keeping and compliance requirements. Of the entities charged, ten were broker-dealer affiliates and one was an investment adviser affiliate. The fines totaled over $1.8B, ranging from $16M to $225M per institution, and on top of $200M in related fines announced by the regulators in December 2021.[14]

While some of the alleged behavior may have been egregious or reflective of a culture of general disregard for these recordkeeping policies, regulators' expectations place firms in a challenging position. Firms have, in effect, been designated to supervise their employees' use of personal devices in part so that their communications are available to support future regulatory investigations. As the dust settles from this most recent round of fines, many firms are looking to assess their electronic communications and recordkeeping programs considering regulatory expectations. As part of these efforts, firms should:

1. Assess electronic communications policies, procedures, and practices by (a) identifying gaps and opportunities for enhancement; (b) assessing the feasibility of firm-issued devices (as opposed to bring your own device policies); (c) polling employees about their communication practices to establish a sense of the firm's risk profile; (d) enhancing monitoring and surveillance capabilities; and (e) evaluating the existing governance model, including escalation protocols anddisciplinary processes.
2. Conduct analyses on historical electronic communications via lookback data collections that capture historical mobile messages and running enhanced analytics on available data, such as natural language processing (NLP) and artificial intelligence (AI) models. If these tools already exist, determine whether new alerts or surveillance patterns are needed.
3. Evaluate and identify enhancement opportunities in the current technology infrastructure for electronic communications recordkeeping and monitoring, including 1) enhanced solutions to capture communications from mobile applications; and 2) automated surveillance modules that leverage AI, machine learning, and analytics capabilities to detect issues and instances of non-compliance.



Reg S-P and Reg S-ID actions

As the SEC intensifies its focus on cybersecurity and likely moves to finalize multiple cyber proposals in 2023, Reg S-P and Reg S-ID remain existing enforcement tools, which we expect will be strictly enforced prior to the new rules going into effect.[15] To this end the SEC published a Risk Alert on Reg S-ID in December 2022.

Reg S-P requires broker-dealers, investment companies, and investment advisers to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.”[16] Reg S-ID, also known as the Identity Theft Red Flags Rule, requires firms to establish “Identity Theft Prevention Programs,” and recent enforcement actions emphasize that these programs should be tailored to the firm. In response to this new enforcement focus (the SEC only brought its first Reg S-ID–related enforcement action in 2018), there are several steps that firms can take to refresh their Identity Theft Red Flag programs:

1. Assess the existing program to identify any gaps or outdated components.
2. Evaluate all sources where identity theft escalation could originate. Broadly, these areas include (1) front office and customer support teams, (2) third-party vendor management teams, (3) cybersecurity and technology teams, and (4) anti-money laundering (AML) fraud teams.
3. Ensure that the program is integrated with current policies and procedures for the teams supporting that support the Identity Theft Prevention Program.
4. Ensure that procedures for detecting and mitigating identity theft red flags are adequately documented in the Identity Theft Prevention Program.
5. Identify and document escalation channels.
6. Create and document a procedure to update the program at least annually.

Since the SEC is directing serious attention to cybersecurity issues but neither of its new proposed cybersecurity rules specifically target broker-dealers, we expect these programs likely could be under an enforcement microscope for the foreseeable future.

Digital assets

The digital assets industry experienced something of an enforcement blitz in 2022 as the federal government sought to keep pace with—and codify its approach to—innovation. The SEC generally has led these efforts, but other market regulators, notably the CFTC, have recently redoubled their efforts. President Biden’s March 2022 “Executive Order on Ensuring Responsible Development of Digital Assets” mobilized a “whole of government” policy response. A sharp contraction in asset prices, brought on by a reversal in interest rates, drew deep scrutiny from the government as retail investors suffered steep losses and firms collapsed, taking investor assets with them. These events were reflected in the tone of a series of reports connected to the executive order that was issued in the fall.

For their part, market regulators made concerted efforts to “use the full extent of their existing authorities” to regulate the asset class, as instructed by the executive order. As the Hill and federal government grew in their thinking, their attention also turned to decentralized finance. Last fall, the CFTC brought its first charges against a decentralized autonomous organization (DAO), and the SEC held public hearings related to an enforcement case that it initiated against a DAO last January.[17]

Although a significant amount of uncertainty remains, our Digital Assets Policy Primer outlines the remaining tensions points in the policy framework and likely direction of travel on key issues, including the legal classification of assets and regulatory framework for stablecoins and exchanges.[18] In 2023, there will be narrow windows for legislation, but absent that, firms likely will continue to face enforcement action from the market regulators until they feel that the industry is sufficiently complying with existing regulatory standards.

6.25
1.05
0.35
19.90
206.00
68.00
High/Low

The regulatory horizon

Many more significant proposals are forthcoming from the financial regulators. While the SEC is likely to lead the pack in terms of breadth and volume of significant changes, other capital markets regulators are considering impactful issues for the industry as well. These topics on the regulatory horizon include digital engagement, complex products, and market data fees.

Electronic recordkeeping

In October 2022, the SEC adopted amendments to the recordkeeping rules for broker-dealers, security-based swap (SBS) dealers, and major SBS participants. The amendments to SEC rule 17a-4 allow for an "audit-trail" recordkeeping format as an alternative to the existing requirement for electronic recordkeeping in a write once, read many (WORM) format.[19] The amendments to rule 18a-6 create a requirement for SBS entities to maintain electronic records using either an audit-trail or WORM format. The amendments also create a new requirement under rules 17a-4 and 18a-6 for firms to produce electronic records to the SEC "in a reasonably usable format" if requested.

Other aspects of the proposal adapt the existing rules to make them either more technology neutral or to reflect current business practices (e.g., the emergence of cloud storage). The compliance date for the amendments to rule 17a-4 is six months after the rule's publication in the Federal Register (or approximately May 2023), and for the amendments to rule 18a-6, 12 months post-publication, or approximately November 2023.

In response to the rule, firms should consider:

- Conducting a gap assessment of existing recordkeeping systems and processes to assess compliance with existing recordkeeping requirements and determine whether improvements or cost savings can be realized because of the rule amendments.
- Updating or creating policies and procedures for providing electronic records to the SEC if requested.
- Upgrading recordkeeping systems and processes as identified by the gap assessment.

Branch office inspections

The FINRA is considering updating its definition of a branch office and rules for branch office inspections to reflect trends in remote work and digital transformation. A core issue is the treatment of employees' homes as branch offices. Like the regulatory expectations around electronic communications, treatment of employees' homes as branch offices would extend the regulatory perimeter beyond the traditional image of "the firm."

Complex products

While FINRA routinely reviews its rules for complex products, the current review has new significance given the growth of retail investing in complex products. In 2022, FINRA issued a request for information on the suitability of complex products for retail. There are many approaches that the regulator could take, but likely any new regulatory requirements would prescribe expectations for firms' screening and approval processes for complex product trading. Thus, firms may want to think proactively about their processes and ways that they can demonstrate that they are adequately screening customers before allowing them to trade complex products.

Looking forward

Taken in aggregate, the intensity of proposed change to the capital markets regulatory framework is remarkable both in number and significance of rulemaking. The weight of the regulatory agenda will impact firms and potentially financial markets themselves as bedrock practices are reimagined and reshaped in the coming year against a backdrop of challenging macroeconomic conditions. The risk introduced by the rapid pace and heavy volume of change is not isolated to individual firms but also spread across the industry and, therefore, potentially across the broader economy. This is an important consideration for the regulators themselves in 2023, as they seek to finalize key tenets of the proposed agenda.

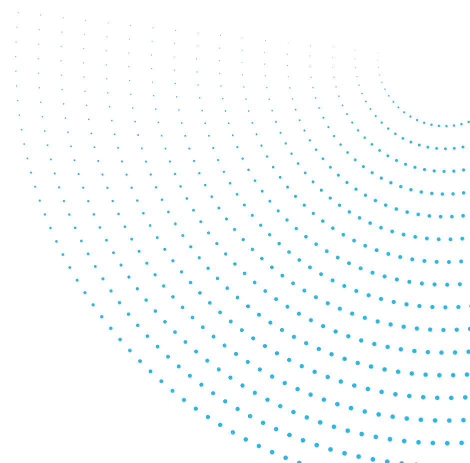
For their part, firms need to make investments in the systems and teams that support regulatory requirements despite the massive amount of uncertainty they face. Having a detailed and coherent regulatory strategy likely has not been so important since the passage of Dodd-Frank. While some prioritization is required by all stakeholders (firms and regulators alike), the coming year may eventually be viewed as a deeply transformative period in the regulation of financial services. Therefore, functions navigating the change need to be given tantamount investment and support.

While regulatory change should be atop the C-suite and board agenda in 2023, what could be viewed as a tumultuous period from a regulatory perspective could also be an opportunity to evaluate strategy more broadly. Regulatory change creates new trade-offs but might present new opportunities as well. An informed debate about the implications of the massive regulatory agenda on the individual firm is likely is helpful for determining an optimal approach. Recognition by leadership that regulation is a core business issue in 2023 will be essential.

The weight of the regulatory agenda will impact firms and potentially financial markets themselves as bedrock practices are reshaped in the coming year against a backdrop of challenging macroeconomic conditions.

Endnotes

1. US Securities and Exchange Commission (SEC), "SEC announces enforcement results for FY22," press release, November 15, 2022.
2. "Commission" refers to the five Commissioners that head the agency, whereas SEC refers to the agency broadly.
3. Controversial proposals include the Order Competition proposal approved at the end of 2022, among others.
4. US Supreme Court, West Virginia vs. Environmental Protection AgencyWest Virginia et al. v. Environmental Protection Agency et al., decided June 30, 2022.
5. SEC, "Shortening the securities transaction settlement cycle," February 9, 2022.
6. SEC, "Further definition of "As a part of a regular business" in the definition of dealer and government securities dealer," March 28, 2022.
7. Ibid.
8. SEC, "Regulation best execution," December 14, 2022.
9. FINRA "5310. Best execution and Iinterpositioning," accessed December 18, 2022.
10. SEC, "Regulation NMS: Minimum pricing increments, access fees, and transparency of better priced orders," December 14, 2022.
11. SEC, "Order competition rule," December 14, 2022.
12. SEC, "Disclosure of order execution information," December 14, 2022.
13. SEC, "Enforcement," accessed December 18, 2022.
14. Deloitte, "Meeting regulatory expectations for preserving and monitoring electronic communications," September 30, 2022.
15. SEC, "Regulation S-P," accessed December 18, 2022; and SEC, "Observations from broker-dealer and investment adviser compliance examinations related to prevention of identity theft under Regulation S-ID," December 5, 2022.
16. SEC, "Final Rule: Privacy of Consumer Financial Information (Regulation S-P)," effective November 13, 2003; modified November 18, 2003.
17. SEC, "SEC seeks to stop the registration of misleading crypto asset offerings," press release, November 18, 2022.
18. Deloitte, "Digital assets policy primer: Fall 2022," 2022.
19. SEC, "Electronic recordkeeping requirements for broker-dealers, security-based swap dealers, and major security-based swap participants," October 12, 2022.



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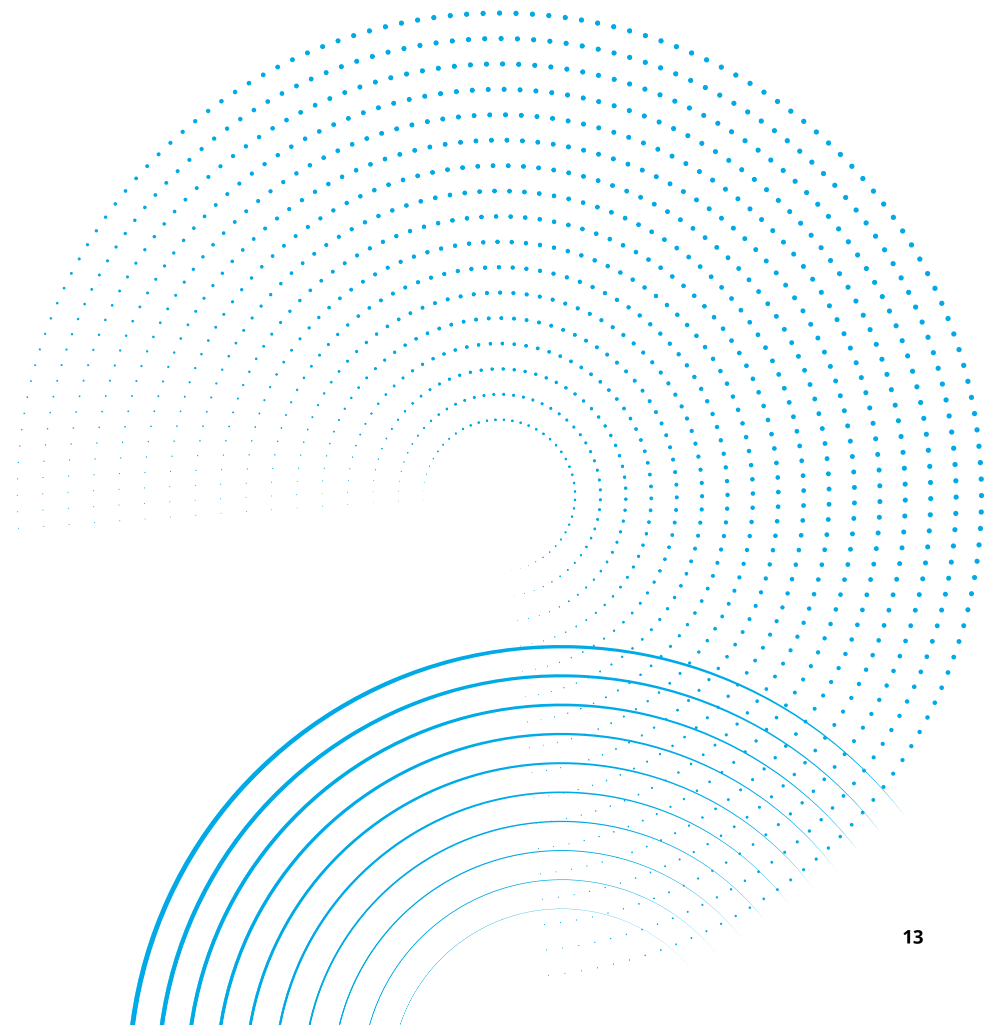

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