

# Securities Adviser

News and analysis for the securities and commodities industry April 2010

## Regulatory scorecard: Game-changing issues for broker-dealers

**Richard Flowers**, Financial Services Audit partner

The rules of play may soon change for the securities industry. A bevy of pending regulations, such as Sen. Chris Dodd's financial reform bill, have been proposed to tighten the reins on Wall Street and calm public outrage. Political forces are not the only ones bringing about change. The broker-dealer community itself has been enacting its own reforms. Navigating these numerous new rules can be challenging. Here are the major issues facing broker-dealers, as well as a rundown of what they can expect in the months ahead.

### Cost-basis reporting requirements

Beginning in 2011, broker-dealers and other financial intermediaries will be required to track and report not only cost-basis information, but also the adjusted cost basis of any security that is sold.

This mandate was included in the Emergency Economic Stabilization Act of 2008 as a means to generate tax

revenue and enhance transparency for investors. The comment period for this IRS proposed rule interpretation ended Feb. 8, 2010. Despite the fact that many tax questions remain unanswered, implementation is not expected to be delayed. The onus is on financial services firms and their tax advisers to ensure compliance beginning in 2011.

Although the first compliance date is not until 2011, compliance will be a large undertaking, and firms should analyze and budget for system changes as soon as possible. The mandate requires applicable firms to have cost-basis reporting implemented for:

- all stock transactions acquired on or after Jan. 1, 2011;
- all mutual funds and dividend reinvestment plans acquired on or after Jan. 1, 2012; and
- all financial instruments, such as debt securities and options, acquired on or after Jan. 1, 2013.



Firms that have not begun to analyze and address the new requirements may face IRS penalties as well as reputational risk. Broker-dealers need to identify business processes and systems that will need to be updated as a result of cost-basis data requirements — and prepare implementation strategies, budgets, and project and staffing plans. Broker-dealers must also prepare for uncertainties and stay abreast of new developments. (Read more.)

[continued>](#)

## Regulatory scorecard: Game-changing issues for broker-dealers (continued)

### Economic nexus

A major issue broker-dealers will confront is economic nexus. When you sell a product to an entity in another state, that state could consider the transaction conducting business within its borders and thus, charge income tax on it.

Many states view economic nexus as an opportunity to generate revenue, especially given the current economic environment. A number of companies have filed lawsuits regarding this issue, but many of these lawsuits have yet to be resolved. Although each state's nexus rules vary, broker-dealers face potential tax liabilities and an uncertain tax position. For example, the New York corporate tax reform proposed in July 2009 may be used as a benchmark for negotiating a settlement of state income tax on the basis of economic nexus. Broker-dealers should be aware of this tax position and carefully assess the benefit of lower state taxes, taking into account the concurrent filing requirement for states in which they may have economic nexus.

### Flash trading and co-location

The SEC has been concerned that flash trading and co-location practices create an unfair advantage at best and violate the law at worst. In September 2009, the SEC proposed a ban on flash orders. According to the SEC, "a flash order enables a person who has not publicly displayed a quote to see orders less than a second before the public is given an opportunity to trade with those orders. Investors who have access only to information displayed as public quotes may be harmed if market participants are able to flash orders and avoid the need to make the order publicly available."

Thanks to a flash order exception to Rule 602 of Regulation NMS, flash trades are currently permitted. The proposed rules would do away with such an exception and would prohibit all markets from displaying marketable flash orders.

Another time-saving practice likely to come under scrutiny is co-location. Co-location allows traders to move servers closer to an exchange matching engine for even faster trading.

### TRACE reporting

The scope of the Trade Reporting and Compliance Engine (TRACE) was expanded last year to incorporate foreign securities. As of March 1, 2010, government-sponsored entities will also need to report into TRACE, thus improving the transparency and availability of pricing information.

Traditionally, broker-dealers have had 15 minutes to report the order into TRACE. As technology has advanced, reporting has become more rapid. As a result, both sides of the trade do not get reported at the same time, rendering one side late in its reporting and resulting in a fine.

### FOCUS filing

The SEC has proposed rules related to Form X-17A-5, *Financial and Operational Combined Uniform Single Report*, or FOCUS report. Certain broker-dealers would be required to file Part II of the FOCUS report and Form BD-Custody within 17 business days after the end of the calendar quarter and within 17 business days after the annual financial statement audit date if it is not the same date as the end of a calendar quarter.

The SEC is in the process of revising Form X-17A-5 to include an information schedule for each broker to report (in FOCUS reports) the manner in which it maintains custody of securities and their estimated amount by security class. It is anticipated that auditors will be required to perform certain procedures on this information. The concept is that such a report will enable the SEC and other regulators to identify potential situations where a broker-dealer may be taking undue risks relating to customer assets.

continued >



## Regulatory scorecard: Game-changing issues for broker-dealers (continued)

In addition, it is expected that the income statement line items will be expanded to provide additional information on the manner in which broker-dealers are generating revenue and expenses. The original FOCUS filing permitted the inclusion of a variety of revenue items under the caption “other,” drawing regulator concern because the ambiguous description made it more difficult to identify possible abnormalities.

In its 2010 examination priorities letter, the Financial Industry Regulatory Authority (FINRA) highlighted the area of inventory and collateral valuation. FINRA stressed the importance of broker-dealers having processes in place to obtain reliable valuations for complex products from sources independent of the trading desk. In addition, price verification should be consistent across the firm to include collateral for financing functions.

Other key areas of recent concern are the expansion of fully paid customer securities for lending programs and notification to customers of potential loss of rights, including SIPC coverage and proxy voting rights. This notification requirement is included in FINRA Regulatory Notice 10-03, and broker-dealers should have appropriate procedures in place to meet these requirements.



### Sen. Dodd's financial reform bill

The financial reform bill proposed by Sen. Chris Dodd, chairman of the Senate Committee on Banking, Housing, and Urban Affairs, presents a number of potential changes for the financial services industry, with specific provisions on securitization. Dodd is calling for an end to the over-the-counter (OTC) derivatives market — the poster child for reform — by requiring such contracts to be standardized and cleared through a central clearing facility. This will prompt margin requirements and virtually eliminate the risk of clearing failure, but it may cause duress for corporate treasurers who prefer to have uniquely designed contracts to hedge their portfolios.

Credit risk retention is a major concept under the proposed legislation. Broker-dealers and originators of financial assets would be required to retain a portion of the credit risk of asset-backed securities (ABS), defined by the bill as any “self-liquidating financial asset,” including collateralized mortgage obligations and collateralized debt obligations. Broker-dealers and others subject to the rule would be prohibited from hedging this retained risk, although the SEC and the federal banking agencies may grant exemptions.

In addition, ABS would be subject to further disclosure requirements. Broker-dealers would have to disclose asset-level or loan-level data necessary for investors to perform due diligence, the nature and extent of the broker-dealer's or originator's compensation, and the amount of the originator's risk retention.

continued>

**Credit risk retention is a major concept under the proposed legislation.**

## Regulatory scorecard: Game-changing issues for broker-dealers (continued)

The effective date for ABS backed by residential mortgages would be one year after the rules are published in the *Federal Register*. The effective date for all other ABS would be two years after the rules are published in the *Federal Register*. The bill has passed the Senate Banking Committee and will proceed to the Senate floor.

An area which calls for more clarity is the shift from rules-based accounting under U.S. GAAP in favor of International Financial Reporting Standards (IFRS), brought to the forefront by the infamous Lehman Repo 105 accounting case. Under U.S. GAAP, the accounting treatment for classification of a transfer as a purchase or sale versus financing is rule-specific. However, under a principles-based format like IFRS, the concepts and fair play are the focus, with the accounting treatment reflecting the true nature of the transaction. It remains to be seen whether this issue will be addressed as financial reform moves forward.

### A game plan for broker-dealers

With the industry facing increased scrutiny from regulators and investors, broker-dealers are under more pressure than ever to demonstrate transparency and compliance. They must be prepared to keep up with constantly emerging changes and new rules that aim to level the playing field. •



### About the newsletter

*SecuritiesAdviser* is published quarterly by Grant Thornton LLP. The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Grant Thornton International Ltd and its member firms are not a worldwide partnership, as each member firm is a separate and distinct legal entity.

For additional information on the Financial Services practice, contact Jack Katz, national managing partner of Financial Services, at [Jack.Katz@gt.com](mailto:Jack.Katz@gt.com).

To subscribe to *SecuritiesAdviser*, fill out the online request form at [www.GrantThornton.com/securitiesadviser](http://www.GrantThornton.com/securitiesadviser).

### Contact information

**Cynthia Keveney**  
National Marketing Director  
Financial Services  
[Cynthia.Keveney@gt.com](mailto:Cynthia.Keveney@gt.com)

Editor: Emily Ford  
[FinancialServices@gt.com](mailto:FinancialServices@gt.com)

© Grant Thornton LLP  
All rights reserved  
U.S. member firm of Grant Thornton  
International Ltd

[www.GrantThornton.com](http://www.GrantThornton.com)

Content in this publication is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information on the issues discussed, consult a Grant Thornton client service partner.

This document supports Grant Thornton LLP's marketing of professional services, and is not written tax advice directed at the particular facts and circumstances of any person. If you are interested in the subject of this document we encourage you to contact us or an independent tax advisor to discuss the potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this document may be considered to contain written tax advice, any written advice contained in, forwarded with, or attached to this document is not intended by Grant Thornton to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.