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Under one roof: Consolidation of regulators

By Rich Flowers, Financial Services Audit partner

Does the old adage "less is more" apply to regulators? This question has prompted much dialogue within the securities industry since the U.S. Treasury Department announced its "Blueprint for a Stronger Regulatory Structure," which aims to consolidate agencies and increase the scope of the Federal Reserve. A key objective of the proposal is to eventually transition from a functional regulatory approach to an objectives-based regime, with a focus on market stability regulation, prudential financial regulation and business conduct regulation. Although such widespread change won't happen overnight, legislators, broker-dealers and investors should be prepared for a potential shift in the regulatory bedrock.

Back to the drawing board

Though the current regulatory structure has evolved in response to events in the marketplace — the Federal Deposit Insurance Corporation's (FDIC) was created as a result of the Great Depression — it is largely a relic of the 1930s structure. What's more, some remedies of the past have evolved into the problems of today. Government guarantees, like FDIC insurance, have been used without appropriate market discipline, as evidenced by the savings and loan crisis and the fall of thrifts during the 1980s. The call for prudential financial regulation is intended to prevent future abuses. Broker-dealers should expect more stringent guidelines with respect to insurance and other guarantees. Existing market conditions and increasing globalization combined with the ongoing need for transparency, consumer protection and market stability all beg to be addressed by a new structure.

The securities industry currently is governed by one federal securities regulator, one federal futures regulator, state-by-state regulators and several self-regulatory organizations (SROs). The proposed Treasury structure follows the trend of self-regulators that have consolidated, such as the merger of the New York Stock Exchange's member regulation, enforcement and arbitration functions with the National Association of Securities Dealers' (NASD) regulatory group to form the Financial Industry Regulatory Authority (FINRA).

Overall synergy will be beneficial for broker-dealers, provided rules are tiered to accommodate the wide range of products and services offered, including a distinction between clearing and nonclearing brokers. A proposed union of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) would simplify the creation of new products by eliminating the existing debate about who regulates what products.

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An essential building block of this new structure should be the establishment of a centralized clearing organization to manage the Treasury Department's proposed federal charter for payment and settlement system oversight. Private firms that are not approved clearing organizations provide much of the information used to confirm transactions. Products outside of the standard settlement process, like credit default swaps, should be incorporated. An all-encompassing clearing organization would help ensure that broker-dealers are held to the same standards when it comes to issues such as determining if net balances are backed by good assets. They also would receive consistent information about securities borrowing, i.e., the definition of margins, which would further protect broker-dealers and consumers.

Building a foundation

Market stability and consumer protection will be cornerstones of the new structure. A renewed focus on information-gathering and potential changes in requirements will help maintain market stability. Broker-dealers will have to be especially attuned to identifying abnormalities in this area and be prepared to point out concentrations that could potentially disrupt the market, i.e., large-position reporting.

The Conduct of Business Regulatory Agency (CBRA) is the proposed watchdog of consumer protection. In the realm of broker-dealers, the CBRA and likely the SROs would focus on issues such as sales practices for auction-rate securities and "naked" short selling. The determination of suitability goes beyond disclosure. Broker-dealers must have a thorough understanding of the client's appetite for risk and appreciation for potential consequences, especially when higher risk is assumed with such endeavors as using homes for nonpurpose loans.

Efforts are already underway for stronger risk management policies such as the SEC's proposed amendments to *Financial Responsibility Rules for Broker-Dealers*, which required, among other things, disclosure of concentration on securities borrowed and identification of procedures used to manage risk. Broker-dealers face additional rule changes with the proposed combination of the SEC and the CFTC. Broker-dealers who proactively prioritize consumer protection have the opportunity to differentiate themselves as leaders in risk management.

Yet compliance is not a shield from risk for broker-dealers. For example, in the case of supervised entities, the SEC supervised the holding companies with a focus on regulatory capital. At larger broker-dealers, regulatory capital is based on a value-at-risk perspective, whereas other broker-dealers base it on allowable assets. The value-at-risk approach was not protective to entities like Bear Stearns, which complied with the SEC's rules regarding capital but still went under because of a lack of liquidity.

Financial statements will remain a focus of regulators, but they do not provide an accurate and complete picture of securities risk. Thus, broker-dealers should have risk models in place to enhance management of liquidity risk. Liquidity risk can be measured in a variety of ways, from capital risk to assets and liabilities. It is vital that broker-dealers measure liquidity risk consistently to support ongoing business decisions and to combat market volatility.

It remains to be seen to what degree this blueprint will shape the overall regulatory structure. However, broker-dealers should be prepared as these reforms will go into effect in some capacity. Broker-dealers who adopt best practices that reinforce consumer confidence and bolster market stability will be able to adapt to a changing regulatory climate. •

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Rich Flowers has been an audit partner in Grant Thornton LLP's Financial Services practice since 2002. Prior to joining Grant Thornton LLP, Rich had been with a Big Five accounting firm for more than 30 years, spending the last 21 years as a partner. He has an accomplished history serving numerous clients in the financial markets industry, from national retail and clearing brokers to investment banking firms and major foreign banks.

He is a knowledge leader in the securities industry and serves as an adviser on regulatory, operational and technical matters for many of Grant Thornton LLP's financial services clients. He currently serves as the sole public accounting representative on the FINRA Financial Responsibilities Committee and previously served on the American Institute of Certified Public Accountants (AICPA) Stockbrokerage and Investment Banking Committee. He is also a board member of the Financial Management Division of the Securities Industry and Financial Markets Association (SIFMA) and an executive committee member of the Internal Audit Division of SIFMA.

Rich served as an active contributor to the *Brokers and Dealers in Securities – AICPA Audit and Accounting Guide*. He has represented the public accounting industry in presentations to the FASB regarding specialized industry accounting matters, including the implementation of Statement of Financial Accounting Standards (SFAS) 125 and issuance of SFAS 127 regarding deferral of effective date of certain provisions of SFAS 125, and development of FASB Interpretation (FIN) 41 regarding netting provisions of repurchase agreements.

He earned a B.S. in business from Ithaca College in Ithaca, N.Y., and an MBA in accounting and finance from the Amos Tuck School at Dartmouth College in Hanover, N.H.

On the radar: Emerging issues for broker-dealers

By Rich Flowers, Financial Services Audit partner

In the world of broker-dealers, the hot-button issues of previous quarters can cool quickly as new changes and trends are constantly emerging. However, it is not always easy to discern a "flash in the pan" from the makings of a long-standing practice. Here are some key items to watch in the coming months and beyond:

Combination of clearing agreement rules

An ongoing issue for broker-dealers is compliance with the combined clearing agreement rules: New York Stock Exchange Rule 382 (NYSE 382), which allows broker-dealers to delegate functions and responsibilities to clearing firms, and National Association of Securities Dealers Rule 3230 (NASD 3230), which requires clearing firms to forward complaints about an introducing broker-dealer to the designated authority. The Financial Industry Regulatory Authority (FINRA) has recently expressed concern about the accuracy of the information customers receive.

Customers receive confirmations from the clearing broker for each transaction, but many are delivered electronically and some customers opt out of receiving them. Introducing broker-dealers can better gauge if customers are receiving complete information by providing web access to view the actual transactions. Clearing broker-dealers should be prepared to explain how they ensure that customers receive complete and accurate information when it's sent from the introducing broker-dealer.

Day trading

To be eligible for the reduced margin requirements, broker-dealers must record the time and tick information for each trade as evidence of the day trades' sequence. If a trade is completed outside of the clearing broker-dealer's trading system, that data is not eligible for the reduced margin. Instead, customers would be subject to the aggregate basis — the maximum exposure throughout the day. Thus, broker-dealers should employ a method to obtain this information in a timely manner.

Auction-rate securities

Given recent failed auctions, auction-rate securities (ARS) should not be marketed as cash equivalents. Because the margin rates were increased for ARS, it is critical that broker-dealers clearly communicate the nature of risk with these products.

Rogue trading prevention

Recent industry events illustrate the importance of supervisory controls with respect to rogue trading. Firms should re-examine their own practices, incorporating password protection with frequent resets and monitoring large profits in an arbitrage area. They also should monitor personnel involved in trading, the use of intercompany tickets and unusual cancellation or corrections processing. FINRA recently issued a notice outlining sound practices for brokers to consider, including mandatory vacation policies and increased scrutiny of red flags. A vigilant supervisory policy protects both firms and market stability.

Portfolio margining

A growing number of broker-dealers are offering portfolio margining, which establishes margin levels by assessing the net market risk of a portfolio of positions in an account. The minimum level of risk is determined by analyzing the risk of an account's components and recognizing any offsetting risks, accurately reflecting the risks of open positions and minimizing the chance of over- or under-margining. Broker-dealers must obtain approval from FINRA before providing this service

Revised accounting principles

A main challenge for broker-dealers will be applying the revised accounting principles to existing products, specifically, the application of repurchasing financing under Financial Accounting Standards Board Staff Position on Financial Accounting Standard (FAS) 140-3 and the proposed elimination of qualifying special purpose entities from FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Products that originally had safe-harbor provisions are subject to new interpretations under these rules. The safe-harbor rules apply to classifications of certain repos and collateral in the presentation on X-17A-5 Part II of the SEC's Financial and Operational Combined Uniform Single (FOCUS) Report.

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Rule changes and additions

The recent formation of FINRA from the NASD's regulatory group and the NYSE's member regulation, enforcement and arbitration functions has resulted in a push to harmonize the groups' regulations. Changes include various early-warning notifications and approvals for withdrawals of equity, which were previously only a NYSE requirement.

Broker-dealers should be alert to these proposed rules, which may be on the horizon.

As markets fluctuate, new rules will emerge. For further guidance on how to remain at the forefront amid an evolving legislative landscape, contact Grant Thornton LLP's national financial services marketing director, Cynthia Keveney, at 212.624.5495. •

Newsletter content is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information on the issues discussed in the newsletter, consult your Grant Thornton LLP client-service partner.

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For additional information on the issues discussed in this newsletter, contact Cynthia Keveney, financial services marketing director, at 212.624.5495.

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