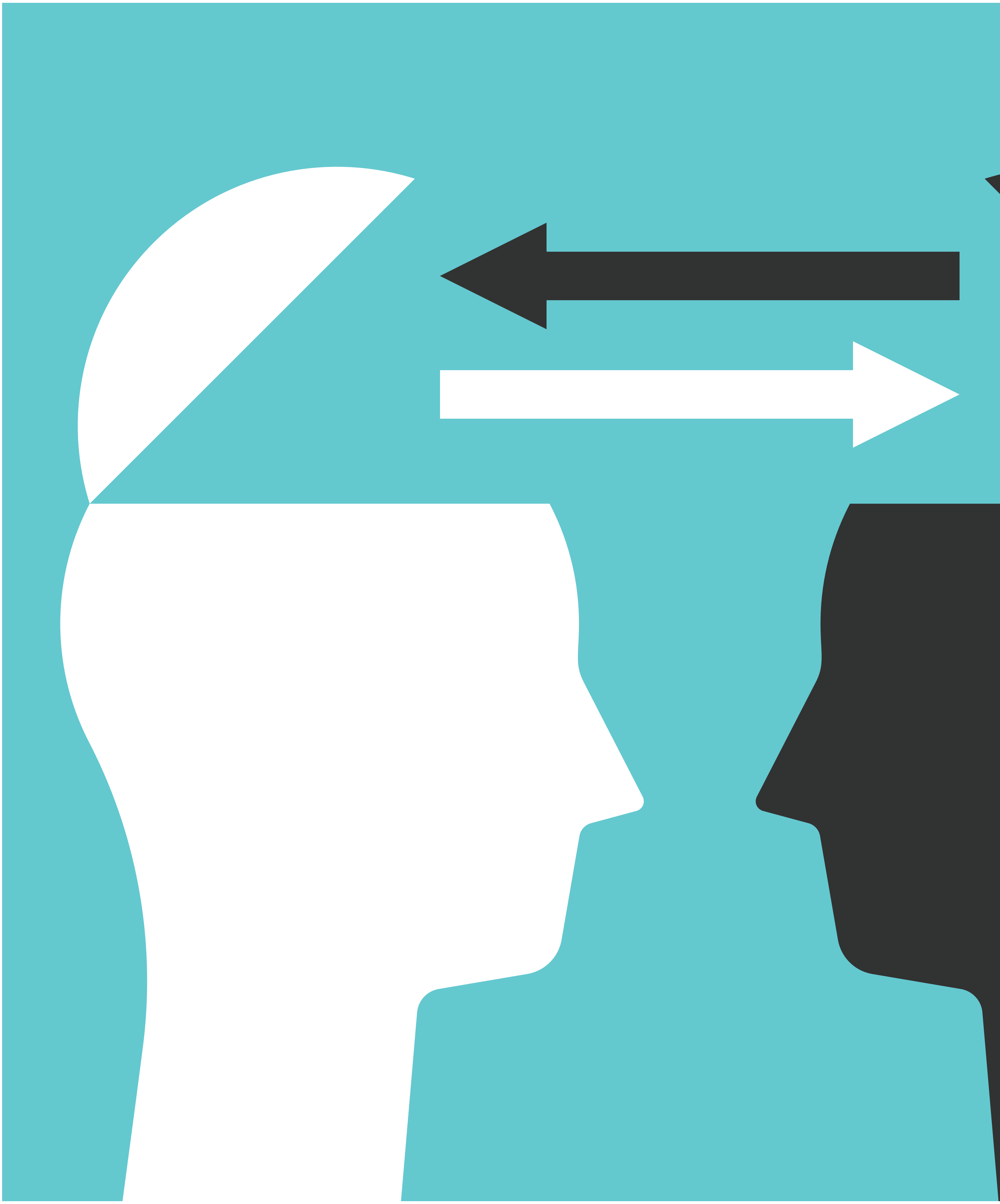

FINANCIAL INDUSTRY REGULATORS SHARE THEIR PERSPECTIVES AND PRIORITIES

A recent panel discussion held by the New York Chapter of RMA provided an opportunity for risk and compliance practitioners to hear directly from regulators on a number of pressing issues.

At the event, called "Senior Leadership Perspectives on Evolving Risks and Regulatory Expectations," held March 6 at the Federal Reserve Bank of New York, agency representatives made clear their regulatory priorities and examination focuses, and fielded numerous questions from the audience.

The discussion was moderated by Yvonne I. Pytlik, a member of the Board of Governors and Executive Committee of RMA's New York Chapter, as well as managing partner at Global Compliance Risk Management Corp. The panelists' comments, which follow, do not necessarily reflect the views of their agencies.

Regulatory Priorities and Emerging Risks

Pytlik started off the discussions with a broader theme of regulatory priorities and industry challenges amid evolving financial markets and regulatory expectations. She noted that the "complexity of banks and financial institutions has been increasing due to operating risks, technological innovations, new product and service offerings, and distribution channels, as well as external factors."

She then asked the panelists, "Reflecting on the past year and looking forward, what major changes in regulatory priorities do you expect at your respective agencies and their impact on the financial services industry?"

Federal Reserve Bank of New York

William Brodows, senior vice president of the supervision group, Federal Reserve Bank of New York, noted a shift in the Fed's focus. "As we indicated in our November 2018 Supervision Report, our supervisory posture from 2009 to 2018 basically focused on building capital and liquidity and instituting a stress test regime. We feel that work is largely complete now," he said. "Now the goal is to simplify the framework for the smallest firms without compromising safety and soundness."

The Federal Reserve indicated that intention with its October 2018 proposal to relax regulatory standards for noncomplex U.S. banks with less than $700 billion in assets.

"We received a number of comments on the proposal and expect in 2019 we will have something to say on it," Brodows said. This year will also bring a heightened Fed focus on evaluating bank recovery plans and on cyber resiliency, which he defined as "the ability to recover from a data loss or a loss of applications or infrastructure."

"Firms are at very different levels regarding this capability," he said, adding that nation-state hackers are increasingly involved in financial and data theft and corporate infiltration, which "likely has a corrosive effect on the confidence in the financial system, but it is not clear what the implications of this are."

> **“PEOPLE ARE SCRATCHING THEIR HEADS** ABOUT WHAT IS VALID CUSTODY FOR A DIGITAL ASSET. THE STANDARDS ARE UNSETTLED. THE FIRMS ENTERING THE SPACE ARE OFTEN SMALL TO MEDIUM-SIZED, AND THEIR RISK MANAGEMENT REGARDING DIGITAL ASSETS IS NOT AS DEVELOPED AS IT SHOULD BE.”
>
> ROBERT A. SOLLAZZO, SEC

For larger firms, supervisors will continue to conduct horizontal examinations across multiple firms.

The Federal Reserve System published Large Institution Supervision Coordinating Committee (LISCC) supervisory priorities for 2019, which include the following:

- Capital planning, regulatory reporting, counterparty risk, collateral management, and wholesale credit underwriting.
- Internal liquidity stress test assumptions, liquidity position, governance over liquidity data, contingency funding plans, currency risk management, and compliance with liquidity regulation.
- Governance and controls, including information technology and cyber-related risks, internal audit, compliance and business conduct, vendor risk management, and risk committee practices.
- Recovery and resolution planning, as well as LISCC foreign bank intermediate holding company resolution plans.

Office of the Comptroller of the Currency

James M. Gallagher, national bank examiner at the OCC, said his agency is focused on the entire credit environment, including leveraged lending and nonbank financial debt. In particular, there is concern regarding the potential effects of weakened covenants and high consumer debt levels.

"There is a lot of dry brush," Gallagher said. "A trigger could create repercussions through the market."

The OCC's focus areas for Y2019 include:

- Cybersecurity and operational resiliency.

THE PANEL, FROM LEFT: Yvonne I. Pytlik, RMA board member; Carlo di Florio, FINRA; Thomas J. Butler, SEC; William Brodows, Federal Reserve Bank of New York; Robert A. Sollazzo, SEC; and James Gallagher, OCC.

- Innovation and operational changes as technology advances.
- Reliance on third-party service providers to deliver key services.
- Commercial and retail credit loan underwriting, concentration risk management, and the allowance for loan and lease losses.
- BSA/AML compliance management.
- Compliance-related change management to address regulatory requirements.
- Internal controls and end-to-end processes necessary for product and service delivery.

U.S. Securities and Exchange Commission

Thomas J. Butler, associate regional director, Office of Compliance Inspections and Examinations (OCIE) at the SEC's New York Regional Office, said his agency is particularly interested in the cybersecurity "at firms that have merged or been acquired," which creates gaps or vulnerabilities.

Butler said the OCIE 2019 examination priorities, published in December, focus on issues surrounding the following:

- Retail investors, including seniors and those saving for retirement.
- This includes fees and expenses disclosures, conflicts of interest, use of affiliates, portfolio management and trading, mutual funds and ETFs, borrowing from clients, and fraud.
- Compliance and risks in critical market infrastructure.
- FINRA and the MSRB (Municipal Securities Rulemaking Board).
- Digital assets.
- Cybersecurity.
- Anti-money-laundering programs.

Butler said there is also a focus on firms that have never been examined, on firms that have gone years without an examination, and on bespoke indices "produced by the same [firm] who produced the [related] products."

The SEC always prioritizes tips, complaints, and referrals, he said.

Meanwhile, Robert A. Sollazzo, associate regional director at the SEC, New York Regional Office, said the agency has made progress on the fifth pillar of BSA-AML, the obligation to know your customer and its business—and to continue monitoring a customer.

As part of its AML focus, the SEC is "looking at pure money movements, downloading cash blotters and seeing where there are suspicious movements," he said. There has also been progress regarding the supervision of microcap and other low-price securities.

A new and growing concern is the cryptocurrency space. "Initial coin offerings [ICOs] are being sold to investors," Sollazzo said. "Secondary markets are developing. In addition, some ICOs are taking place outside of the regulatory framework. A big issue is custody. People are scratching their heads about what is valid custody for a digital asset. The standards are unsettled. The firms entering the space are often small to medium-sized, and their risk management regarding digital assets is not as developed as it should be."

Financial Industry Regulatory Authority (FINRA)

Like the SEC, FINRA also stressed the protection of senior investors in its published priorities. Carlo di Florio, FINRA's chief risk officer and head of strategy, said seniors are becoming a bigger concern as baby boomers age, and that—among other efforts—FINRA is working to ensure the investments they buy fit the suitability standard. "We are seeing a lot more harm in this space," di Florio said.

One investment that recently failed the suitability standard for many investors was a certain product that lost 80% of its value on a day the Dow fell 4%. "We found there was not enough due diligence" in the offering of the investment, di Florio said, which "did not belong in the hands of retail investors who didn't understand how it operated."

With seniors in mind, FINRA has also passed a rule whereby firms will make a contact person available if an investor wants to reach out with questions and concerns. "We are making sure we protect senior investors," he said.

For its published priorities for 2019, di Florio said, FINRA decided to focus on new issues, as well as issues that had not been discussed in previous priorities statements, including the following:

- Online distribution platforms.
- Fixed-income markup disclosure.
- Regulatory technology.
- Sales practice risks, including suitability, senior investors, outside business activities, and private securities transactions.
- Operational risks, including supervision of digital assets, business and customer due diligence, and suspicious activity reviews.
- Market risks, including best execution, market manipulation, market access, short sales, and short tenders.
- Financial risks, including credit risk, funding, and liquidity.

Di Florio also noted that firms should expect exams in ongoing areas of focus, referencing FINRA's recent Exam Findings Report as a good source of additional insight. Ongoing issues and items noted in that report include the following:

- Suitability for retail customers, including targeted examination of volatility-linked products.
- Complex products.
- Share-class conflicts and disclosures.
- Reasonable diligence for private placements.
- Net capital and customer protection.
- AML/ KYC.
- Data quality and governance.
- Cybersecurity programs (see FINRA's 2018 Report on Cybersecurity).
- Supervision and risk management of the above areas.

> "**NEW, COMPLEX PRODUCT OFFERINGS,** INCLUDING WITH ROBO-ADVISORS AND DIGITAL ASSETS, MAY PRESENT RISKS TO INVESTORS, AND REGULATORY TECHNOLOGY EVOLUTION ALSO INCREASES CERTAIN RISKS."
>
> YVONNE I. PYTLIK, RMA NEW YORK CHAPTER BOARD MEMBER

Evolving Technology Risks in the Markets and Regulatory Focus

As noted by moderator Pytlik, "The financial services industry continues to experience rapid growth in financial technology, which provides products and services to customers, and innovative online distribution platforms. New, complex product offerings, including with robo-advisors and digital assets, may present risks to investors, and regulatory technology evolution also increases certain risks."

She asked the panelists, "What are the evolving technology risks in the markets, and what is your regulatory focus?"

Di Florio said firms are doing a good job of using regulatory technology (regtech) to improve monitoring and surveillance. One risk, he said, is that firms are placing greater reliance on third parties that supply technology, which creates information and cybersecurity risks.

Sollazzo said third-party regtech could also introduce errors. He gave the example of systems that help institutions comply with Reg SHO, which concerns short-selling practices. "Sometimes order management systems have defects. Broker-dealers are not necessarily vetting the system when there is a change or making sure they are not causing violations of various rules. Firms might feel it is not their fault, but they are responsible."

Financial institutions must understand the information security risks raised by third-party arrangements, di Florio said. He recommended a recently published FINRA white paper, "Technology Based Innovations for Regulatory Compliance ('RegTech')."

Regulators, in turn, are also faced with new issues caused by or related to technology. Butler noted the issue of a firm's non-email communications in relation to the examination process. "Chats oftentimes occur off-line," Butler said. "What is the interplay with what the firm has to maintain in records and employee texts and social media messaging related to the firm?" he asked. "Are firms allowing employees to use their own individual platforms or telling them to leave their personal devices at the door?"

Butler also noted that the European Union's General Data Protection Regulation could have an impact on U.S. regulators. "There is emerging interest in the U.S. in adopting similar rules, notably in California. What is our ability to do our regulatory oversight in light of that?"

In addition to regtech, the panel discussed technology's impact on the industry overall. Di Florio said, "FINRA welcomes the responsible innovation that is occurring with fintech, blockchain, AI, and other positive developments, but at the same time is focused on the risk and regulatory considerations that need to be taken into account. For instance, industry participants and regulators together are paying more attention to which governance, risk management, and controls are necessary to support responsible innovation with artificial intelligence."

Brodows said he is also concerned about AI and other business innovations "surpassing controls."

"Every time we meet with a bank there is something new, and there is always a business imperative to get something new to market," he said.

Butler provided the example of robo-advisors, which provide portfolio advice for individuals via the Internet. He raised the possibility of a market disruption where, as portfolio values fall, individuals have trouble implementing alternative investment strategies with the company providing the robo-advisors.

Despite concerns and unanswered questions, there was agreement on the panel that innovation will continue.

"Fintech is going to transform financial services," Sollazzo said. "The question is, who will be the winners and who will be the losers?"

Gallagher said it appears that the largest institutions have the resources to experiment with and implement advances such as AI and blockchain, while small and midsized firms with fewer resources could struggle to "remain relevant."

Sollazzo listed the advantages of the fintech firms. "They are not encumbered by old systems. They don't have cultures that are staid. That gives them more flexibility to adopt products and customize them."

Panelists agreed that smaller firms are also lagging in cyber defense. Di Florio noted that "FINRA issued a Cybersecurity Report in 2018 that focused on several areas where small and midsized firms continue to have challenges, including branch-office controls, phishing attacks, insider threats, mobile devices, and penetration testing."

Brodows pointed out another area where the approach to cyber is uneven. "Boards are informed at varying levels by management about the [cyber] risks the firm is facing," he said. "Some firms are more aggressive in discussing in detail with the directors. We're looking at what is flowing to the board and what role management is playing in keeping them informed."

Both Gallagher and Sollazzo noted that the race to bring new technology and products to the financial industry will add to risk. Getting "caught up in who can be first to market," Gallagher said, is "where mistakes may well be made."

In the last segment of the round table, regulators discussed a range of practices and lessons learned from regulatory examinations or supervisory oversight, including the following key points:

- In general, banks are improving in key areas of supervisory focus, such as capital planning and liquidity management. However, some weaknesses persist, particularly in areas related to governance and controls.
- Banks should be attentive to the heightened risks in the corporate bond and loan markets, particularly the leveraged lending market.
- Investment advisors and asset management firms should focus on best execution, advisory fee and expense, cash solicitations, electronic messaging, and targeted examination for registered investment companies (mutual funds).
- Broker-dealers should focus on suitability, volatility-linked products, FI markup disclosures, and diligence for private placements.

Panelists Respond to Audience Questions

In the Q&A session led by Pytlik, the panel fielded several questions from audience members on the following topics.

Transition to the CECL Standard

Gallagher said regulators are aware of worries that implementing the new current expected credit loss (CECL) standard during an economic downturn could "exacerbate the problems."

"We understand the concerns," he said, but "that's not a reason to not prepare. Get ready to implement CECL."

Transition from Libor

"We believe there is decent awareness and preparedness," Gallagher said. "Twelve to 18 months ago, there was quite a bit of emphasis on the derivatives side. The loan side since picked up, and we have seen plenty of attention to the transition in that space as well at this point."

Culture

"One very positive thing that has occurred is the focus on culture and conduct," di Florio said. "Many large institutions spend a lot of time thinking about how to set the tone from the top, align incentives and rewards, and deploy surveillance technology to ensure early issue detection, response, and remediation.

"There are balanced scorecards, internal audit plans, and other risk management mechanisms now to support and evaluate it," he said. "Many banks have goal-setting that reflects culture and conduct explicitly."

There are cases where "bonuses flow or don't flow," based on whether culture-related goals are met, di Florio said, which is powerful because "compensation incentives and rewards are what drives behavior in the financial system."

Pytlik added, "Culture, conduct, ethics, and compliance are critical to a broader risk-governance and regulatory risk management framework." Ⓡ