



SIFMA Insights

The 2023 C&L Annual Seminar Debrief

Perspectives & Key Themes from Compliance and Legal Professionals

March 2023

Recently, SIFMA hosted our C&L Annual [Seminar](#). With three days of presentations and events and over 1,700 participants, we gained insights into top-of-mind topics for compliance and legal professionals from across the financial services industry. Inside this note, we recap just some of what was seen and heard, including:

- **The Industry Outlook:** Change is constant. Firms must therefore learn and adapt as the environment changes. The pace of change accelerates every year – firms must make sure their culture keeps up.
- **The Regulatory Landscape:** On equity market structure reform, industry view is this is the most far-reaching set of proposals ever released vs. the SEC’s stated objective is to get best execution for retail; plus, FINRA’s priorities.
- **The Digital Assets Perspective:** ~100% replied the industry needs more regulatory clarity; innovators survive, those who do not innovate do not survive, and those who comply survive.
- **More on Market Themes:** Digital engagement practices – SEC’s focus on labeling misses the point, it’s not the tools but the use; cybersecurity – cannot be a check-the-box exercise, ensuring security requires vigilance.
- **Market Touchpoints:** This report also includes our pre-conference survey and audience polling results.



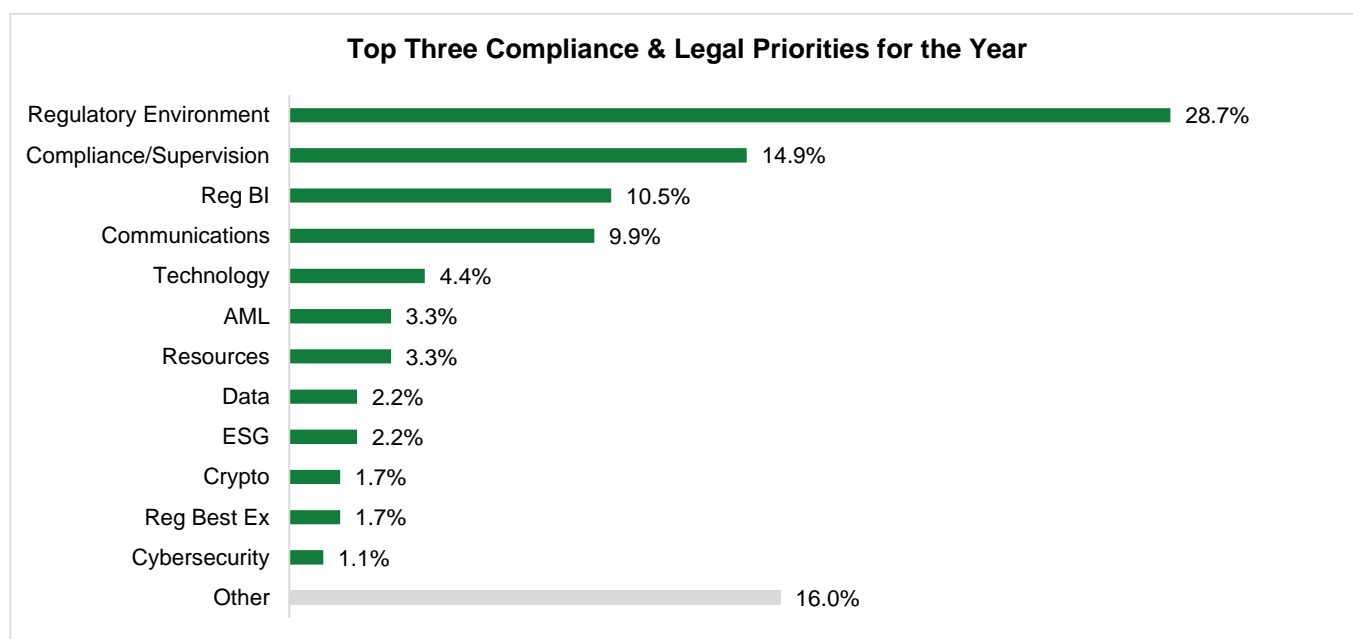
Contents

The Industry Outlook	3
Top Compliance & Legal Themes	3
Market Touchpoint: Industry Themes	5
Market Touchpoint: Macro Themes	6
Market Touchpoint: Economic Themes	7
Outlook – Capital Markets	8
Outlook – Wealth Management	9
The Regulatory Landscape	10
The Industry View	10
The SEC View	12
The FINRA View	14
Market Touchpoint: Complex Products	15
Market Touchpoint: Supervision in a WFH Environment	16
The Digital Assets Perspective	17
When Are They Securities? And Who Oversees Them?	17
Market Touchpoint: Crypto	21
More on Market Themes	22
Market Touchpoint: Market Themes	22
Digital Engagement Practices	23
Cybersecurity	24
Market Touchpoint: ESG	25
Appendix: Pre-Conference Survey Methodology	26
Appendix: SIFMA Insights Research Reports	27
Author	29

The Industry Outlook

Top Compliance & Legal Themes

To set the scene of the Seminar, we surveyed attendees and select SIFMA members on the top member-identified compliance and legal priorities for the year. As various perspectives on market themes arose during the week, it was a reminder of the importance of market participants coming together to discuss best practices as well as pain points that the industry must work together to overcome.



Source: SIFMA Insights pre-conference survey

Note: Reg BI = Regulation Best Interest; AML = anti money laundering; Reg Best Ex = best execution, referring to the SEC's proposed rule for equity market structure. Other = alternative product considerations, business continuity post COVID, connecting the dots, trade reporting, and vendor management, among others

Several member-identified priorities addressed the regulatory environment and various compliance and supervision issues:

- Regulatory Environment** – SEC equity market structure proposals, SEC's aggressive agenda and enforcement practices, regulation by enforcement, rapidly changing regulatory landscape/activity/processes, areas FINRA and SEC are aggressive on (best ex, payment for order flow, Reg SHO, off-channel communications, Reg BI), being abreast of and implementing regulatory change, bringing new regulatory WSPs completely across the finish line, budget and resources to match expanding regulatory environment, CAT funding model, conflicting state laws (guns, oil), FINRA Rule 3110 changes, horizon scanning for regulatory updates/making sure we're on top of all the new SEC rules/retrospective on newer rules/understanding new rules, managing multi exams and investigations at the same time, marketing rule,

navigating state requirements, new rule implementations, ongoing education to the sales force – how to apply newer regulations and reinforcing not so new ones, options supervision, prepare for SEC examination of security based swap dealers (SBSD), proposed custody rule, regulation change management, reporting/reporting obligations, sanctions, recordkeeping requirements, SBSB large position reporting, advertising/marketing rule, Secure 2.0, securities lending reporting, self-directed IRA, standards of care, MiFID II sunset of 2017 no action letter on July 3, 2023, WORM

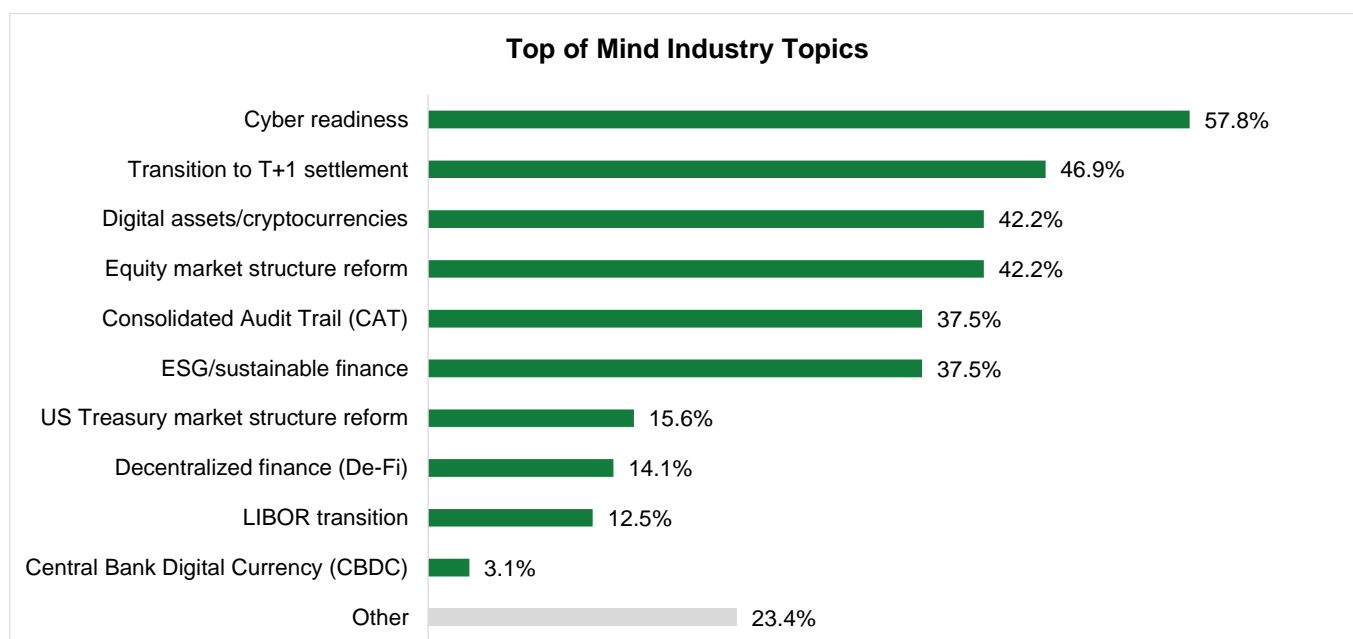
- **Compliance/Supervision** – books and records/changes to record storage regulations/records destruction, complete and clear disclosures/disclosure management, compliance program management/technology enhancements, complex products oversight, documenting rationale of recommendations, employment law compliance, ensure supervisory reports are targeting highest risk issues, examination management, investment advisor disclosure/procedures, mitigating risk when working with third party suppliers, procedure/policy reviews, remote inspections/testing/expiration of temporary guidance/tools and techniques, risk assessments/management/framework
- **Reg BI** – DOL fiduciary rule/advice, duty of care/obligation, application to digital engagement practices, compliance, exams, reasonably available alternatives, updates
- **Communications** – supervision and archiving, digital communications with clients, e-communications surveillance/technology/compliance; off-channel/off-platform communications/supervision, FINRA's stance/exams on communications and texting on personal devices/text messaging compliance/WhatsApp, mobile devices – corporate versus bring your own device (BYOD), rules/surveillance around unapproved communications channels
- **Technology** – cloud storage and controls, financial planning tools, keeping up with emerging technologies for books and records, supervision, new tools, reporting needs for Reg BI compliance, upgrades, testing and strengthening policies and procedures, upgrading surveillance technologies
- **Anti money laundering (AML)** – BSA, compliance, sanctions, and national security
- **Resources** – staffing, budget, allocation, and supporting new businesses, training and culture to keep up with employee growth
- **Data** – data in general, protection, and privacy
- **ESG** – ESG in general and disclosures
- **Crypto**
- **Regulation Best Execution (Reg Best Ex)** – referring to the SEC's proposed rule in equity market structure
- **Cybersecurity**

Market Touchpoint: Industry Themes

Our pre-conference survey asked respondents what general industry topics are top of mind for them, including:

- Cyber readiness came in on top with 57.8% of responses
- The transition to T+1 settlement came in #2, at 46.9% of responses
- There was a tie for third place, with both digital assets/cryptocurrencies and equity market structure reform coming in at 42.2%

Survey Question: What industry topics are top of mind for you? (please select all that apply)



Source: SIFMA Insights pre-conference survey

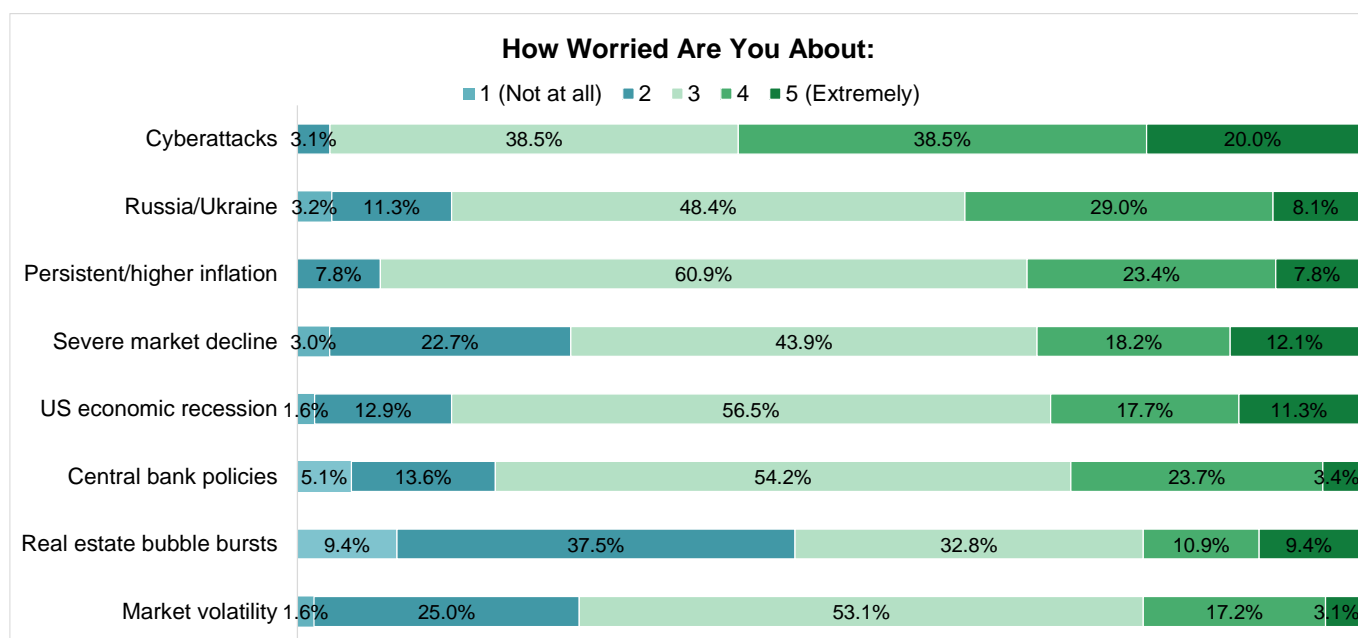
Other: Market trading issues, centralized KYC/AML, state requirements, SEC relief on hard dollars, and pace and breadth of SEC rulemaking, among others

Market Touchpoint: Macro Themes

Our pre-conference survey sought to gauge respondents' concerns around current geopolitical, economic, and market events and trends. We highlight the following in respondents' perspectives on key concerns, ranking responses by the aggregate level for #5 (extremely worried) and #4 (worried) responses:

- Cyberattacks ranked #1, with 58.5% of respondents either extremely worried or worried
- The Russia/Ukraine situation ranked #2, with 37.1% of respondents either extremely worried or worried
- Persistent/higher inflation remained a concern, with 60.9% of respondents ranking it a 3 out of 5
- Market volatility was one of the least concerning issues, 26.6% of respondents ranked it a 1 or 2

Survey Question: How worried are you about? (on a scale of 1-5 where 1 = not at all, 5 = extremely worried)



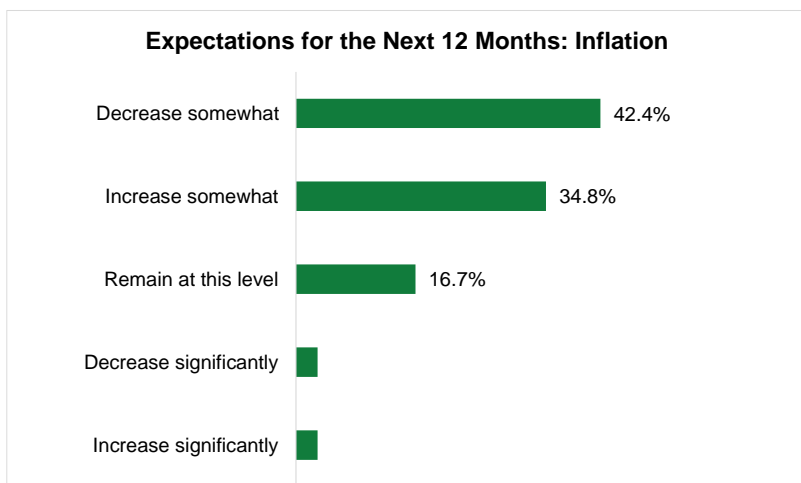
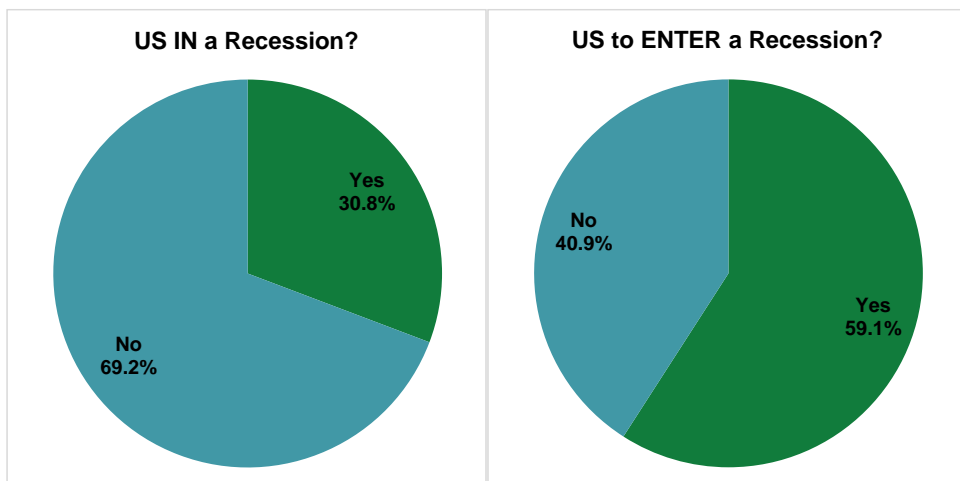
Source: SIFMA Insights pre-conference survey

Market Touchpoint: Economic Themes

Our pre-conference survey sought to gauge respondents' thoughts around the current economic environment. We highlight the following in respondents' perspectives on key concerns:

- Only 30.8% of respondents believe the U.S. is already in a recession
- 59.1% of respondents expect the U.S. to enter a recession
- As to inflation expectations for the next twelve months, 42.4% of respondents expect it to decrease somewhat versus 34.8% expect it to increase somewhat

Survey Questions: Do you expect the U.S. to enter a recession? Do you believe the U.S. is already in a recession? What are your inflation expectations for the next 12 months?



Source: SIFMA Insights pre-conference survey

Outlook – Capital Markets

A theme that arose during the conference is change. Change is constant. Firms must therefore learn and adapt as the environment changes. Panelists indicated that the pace of change accelerates every year, noting that firms must make sure their culture keeps up. As culture may evolve – adapting to the hybrid work environment, working through mergers of two firms and therefore cultures – firms must keep their core values.

Speaking of change, the current pace of change in the regulatory environment is unprecedented. The number of regulations in the U.S. and across the globe creates many challenges for firms. This includes resource – budget, staffing – challenges when regulations come into place this fast. Panelists recommended maintaining flexibility and having a project management office to assess overlapping impacts of regulations. This includes having a clear risk escalation path for highlighting emerging risks.

There has certainly been significant change in the technology area (no, ChatGPT did not write this report). The industry finds itself awash in data, but how do we analyze and apply it? Technology provides the tools, and firms must work to continue to work to apply the tools. However, panelists noted that since regulations have not accelerated at the pace of technology growth, firms must ensure tools are applied in a regulatory compliant way.

While not new, the industry continues to see change – call it evolving change – in the post-COVID work environment. As speakers noted, hybrid work is here to stay. However, senior managers continue to work to find the natural fit for remote versus in office schedules. After all, different roles and groups across firms have different needs. Some staff need more collaboration, whereas other roles are more of the keep your head down and focus on your work type. As firms continue to seek out their natural fit, the focus is on return to people – working together, whether in person or through technology collaboration tools – rather than return to office – face time.

Given the fast moving, dynamic environment the industry is in, panelists stressed the importance of not becoming complacent. These compliance professionals noted the focus areas for firms:

- **People** – This discussion was not just about getting people with the right skills into the right roles but also about professional development to adapt to the changing environment. This segment also includes firm culture – creating an environment of doing the right thing for clients, your firm, and the industry as a whole.
- **Tools** – There are many new technologies out there to assist staff in doing their job. This ranges from the new tools to allow people to work together even if they are not physically together (Zoom, Teams), to the possibilities held by the future of technology, like artificial intelligence (AI), to enhance skillsets.
- **Process** – The industry is awash with data, but firms need to be able to use it in the right way. Panelists noted it is about connecting the dots – having processes in place to train the people to be able to use the technology tools in a compliant manner.

Outlook – Wealth Management

Continuing on the change theme, stock prices have certainly undergone change – in both directions – over the last week. Investors were already navigating the inflation environment and whether Fed policy moves would lead to a soft or hard landing for the economy – if, when, and how deep of a recession. Now markets are navigating the regional bank turmoil and potential contagion risks to markets more broadly or the economy. In general, the world keeps getting noisier and more complex.

On top of the macroeconomic and regional banking industry factors, retail investors are seeking to understand crypto as a new asset class alternative. One panelist when asked how their firm thinks about crypto replied “very carefully”. Firms remain optimistic on the underlying technology. As an asset class, firms struggle to identify the real fundamental drivers of crypto assets. Additionally, the lack of a regulatory framework makes it difficult for firms or investors to go all in on crypto. One panelist indicated that it is seeing its advisors experiment with their own money, i.e. testing the waters before investing their clients’ money. The interest is there, but the space remains very small versus traditional securities.

This environment reemphasizes the importance of financial advice. Speakers noted the increasing demand for advice, both prior to and especially with the recent regional bank turmoil. Financial advisors provide a safe harbor for their clients. As such, a speaker noted the level of their clients willing to pay for advice has grown to two-thirds from one-third.

Advisors assist clients with focusing on their long-term goals and objectives – not the noise – while managing assets through short term environmental factors. Advisors provide the IQ – wisdom, knowledge – and the EQ – understanding, empathy.¹ It is hard to get the EQ through technology and hard to get even the IQ if investors do it themselves. This is a reason wealth management firms are seeing more clients turn to advisors.

On the flip side, the growing demand for advice makes the greying of advisors concerning. According to Cerulli Associates’ research, within the next ten years 37% of financial advisors – collectively controlling \$10.4 trillion or 40% of total industry assets – are expected to retire. Yet, one in four advisors who are expected to transition their business within the next ten years are unsure of their succession plan. While some wealth management firms are looking for solutions to help advisors with their transition, this remains an area to monitor.

¹ IQ tests measure the ability to solve problems, use logic, and grasp or communicate complex ideas. EQ tests measure the ability to recognize emotion in oneself and others, and to use that awareness to guide decisions.

The Regulatory Landscape

The Industry View

In general, panelists noted that it is the most far-reaching set of proposals ever released from the SEC regarding equity market structure. It is much broader than Regulation National Market Structure (Reg NMS, 2005). It was acknowledged that some aspects of the four proposals could be beneficial to markets by improving transparency or increasing liquidity, such as certain aspects of the tick size proposal. While some of what was proposed is consistent with what the SEC has said in the past, some of it – if enacted as is – would actually erode what the SEC has already put in place. Panelists indicated this could harm markets and market participants, as well as negatively impact capital formation for small- and mid-cap stocks.

Additionally, four proposals overlap, yet were analyzed in isolation by the SEC. Panelists indicated that if the four proposals are enacted as written and at the same time, it will increase operational complexity to the system and therefore increase risk. The SEC has not laid out a success measure – how do they judge the impact on markets? The unintended consequence with an overall rulemaking of this magnitude is what happens when something goes wrong – none of this has been analyzed together.

Much like the SEC analyzed the four proposals in isolation, we recap panelist thoughts on each of the four proposals below. The SEC has claimed that its cost-benefit methodology is to consider each rule in isolation. However, we continue to believe that a more appropriate approach would be to perform an analysis of the four proposals together and consider how they impact each other and markets as a whole once all implemented.

- **Amendments to Rule 605** (order execution information): Panelists indicated there is a consensus to update 605. There are many statistics missing, such as size improvement (also odd lots, fractional shares, etc.). This area is very important for retail yet cannot be measured in the current 605. Additionally, panelists identified a contradiction across the proposals. This proposal implies 605 is broken and needs repaired. Yet other proposals rely on 605 data. So on one hand the SEC indicates that the 605 data is no good, yet on the other they rely on this same “bad” data in analyzing the other proposals.
- **Tick Size, Access Fees, Odd Lots and Round Lots:** Tick sizes determine how much liquidity is put into the system and therefore is available. Wider ticks bring more pooled liquidity but at higher costs. Narrow ticks mean lower costs but also less liquidity. This has been researched around the world but with no consensus. There are some stocks today “screaming” for a lower tick, as shown by the fact that they are stuck at a penny. These stocks have sufficient liquidity to handle ½ penny ticks according to market participants. Panelists found the proposal puzzling because it did not go to ½ penny. It went to 20 mils and 30 mils, splitting up liquidity. Panelists noted that this will damage the liquidity balance. Additionally, the current proposal sets both quoting and trading increments. The idea of a tick size for quoting and also for trading has been rejected by the SEC for many years, as well as rejected by academics. Panelists found its inclusion this time around perplexing.

- **Order Competition Rule** (retail order auctions): Panelists began by pointing out that what has been proposed is nothing like the opening or closing auctions currently used in equities – there are no analogies in today’s markets. The hallmark of Reg NMS is that the broker/dealer holds responsibility for the order. They can send it to a wholesaler or directly to an exchange to seek out midpoint liquidity, but they are still responsible. The SEC proposal removes this. Qualifying orders will be sent to an auction mechanism. That order will be announced to the market, and, presumably, the broker/dealer sending the order will be announced as well. What does that mean to the handling of the order.

Take an example of a retail investor who wants to buy 500 shares of a midcap stock that only trades every ten minutes and there are only 200 shares at the quote. In today’s markets, the retail investor gets the 500 shares at the price they see on screen because the broker dealer gets it done, even if only 200 shares were shown at the quote. Under the SEC proposal, the order must sit at the auction for 300 milliseconds – an eternity in today’s markets. Now every market participant sees this order, and someone can take the 200 shares and sell them back. This will move markets from a world where the retail investor gets the price they see on screen to a world where that investor will see \$25 on screen but get executed at \$25.01 for some shares, \$25.03 for others, etc. The retail investor will not know what happened and no one will be responsible, whereas the broker-dealer is today. This scenario led panelists to ask what problem are we trying to solve for and why are we trying to break a system that works?

- **Regulation Best Execution** (best ex): There were many concerns around this proposal, not the least of which is that it is not in line with FINRA’s rule. Additionally, best ex under the proposal is being determined as best price, but better price does not always mean lower costs to investors. The interplay between the four proposals permeates the best ex proposal – going to the auction undermines efforts to get best ex. The rule as written is so prescriptive that panelists expect unintended consequences. Will there be a strict liability standard and therefore the broker gets penalized if they see the “best price” but do not get it? The rule in certain respects is very narrow, focused on retail, internalization, and PFOF. The SEC does not say how brokers would resolve conflicted transactions – whereas FINRA has guidance for brokers – rather it just tells brokers to go and consider immaterial liquidity. However, these instructions seem to only apply if the broker takes PFOF. Panelists found it strange that there are rules for heightened execution standards only if brokers take PFOF.

Finally, it was unclear to panelists why the SEC has to do all four proposals at one time. If the SEC adopts the best ex rule exactly as is and adopts the auction rule as is, then a broker-dealer has to violate one of them. Best ex makes brokers hunt for all liquidity, but the auction rule says the broker has to go to the auction. Is the broker supposed to or prohibited from doing something?

Instead of going through with all four proposals as is, panelists indicated the responsible course of action would be to start with revising Rule 605 reports on order execution information. They can study that data collected under the updated rule and then go from there.

The SEC View

On the Equity Market Structure Proposals

The SEC indicated the overarching theme for their equity market structure proposals is to get best execution for retail investors, where best ex is in terms of “better” prices. Then each individual proposal has its own objectives:

- **Amendments to Rule 605:** The SEC believes it has “widespread consensus” to update the statistics on order execution information. This includes adding fractional shares, aggregate odd lots, and a new time code. It would also provide more useful statistics on price improvement and add size improvement.
- **Tick Size, Access Fees, Odd Lots and Round Lots:** The SEC believes they have “a lot of consensus” to revisit tick sizes, albeit that consensus is to go to a half cent (not what they proposed). The SEC stated that their data analysis implies that going from tick constrained to multiple ticks in between the spread improves market quality, similar to Europe where they found “the sweet spot of spreads”. The SEC acknowledged that its proposal is more extensive than the consensus view, i.e. greater than one tick in between the spread. On access fees, the SEC believes they have “consensus” to take the cap down from 30 mils. They also believe it is important for market participants to know the access fee in advance.
- **Order Competition Rule (retail order auctions):** The SEC noted that the “issue” they identified is retail marketable order flow is segregated from the rest of the market, i.e. from institutional flow. The SEC stated that their data analysis compared “realized” spreads from wholesalers to those on exchanges, implying that despite already receiving price improvement there would be “greater” price improvement with “competition”, i.e. if retail orders were not separated. This proposed rule is designed to “level the playing field for all auction responders”.
- **Regulation Best Execution:** The SEC noted that this proposal was “designed to be consistent with FINRA”, yet “more robust”. It would require more considerations for brokers to address in connection with routing orders and require brokers to explain the thought process on how it routed orders. How did they make the judgement? What market data did they look at? How did they balance time/speed versus finding the “best” price. The proposed rule would also address conflicted orders (affiliates, internalization, PFOF/rebates) and require more due diligence before sending orders to “the same old people”. The SEC noted that the proposed rule was designed to be “a flexible principles-based rule”.

And In General

SEC Director Gurbir Grewal carried on with the trust theme mentioned above, noting a role of the SEC is to maintain and enhance public trust. For the SEC, a way they reinforce trust is through robust enforcement and the urgency to act on cases, viewing that large fines do have a deterrent effect. For market participants to enhance public trust, he noted the importance of not just having policies on paper but also implementing them rigorously. Compliance should be updated with training – particularly as new regulations come into play – and instilled in the firm’s culture. He also urged firms to value self-reporting, noting the importance of escalating risk issues up the chain in their firms and to regulators when relevant.

He also discussed the need for regulators to work together, leveraging the different authorities and resources agencies bring to the table. Regulators should engage together and with market participants. As to market participants, firms should engage across business lines. By continuing to educate themselves – not just on new regulations but also new technologies which could bring new risks or conflicts with existing regulations – in order to be appropriately addressing risks in the dynamic environment in which capital markets operates.

A few specific market and technology areas the SEC is monitoring or capitalizing on include:

- **Crypto** – Grewal noted that traditional firms “do not and cannot” play in this space – national securities exchanges do not list these assets because they are not traditional securities. Broker-dealers are wary of this space given compliance concerns around it. He noted that SEC oversight and examinations are not there because crypto players are not registered entities. Until the compliance is there, it is hard for traditional financial service firms to enter the space with meaning, Grewal commented. However, the interest is there. As such, the SEC is doubling the size of its Crypto Assets and Cyber Unit (formerly known as the Cyber Unit). The agency views investors as getting harmed in this space, and, accordingly, has brought over 100 enforcement actions in this space. Grewal also noted that he views crypto assets as securities (more to come on this in the digital assets section).
- **Artificial Intelligence (AI), Big Data** – The SEC is using AI in enforcement, analyzing large data sets like CAT as well as others. This enables them to identify unusual trading patterns, which could signal escalation to an investigation. An example is the SEC’s EPS (earnings per share) initiative. They utilize AI to identify when public companies are manipulating earnings data to meet their stated guidance to markets, or “gimmicky accounting” as the SEC calls it.

Finally, as to its more overarching priorities, the SEC is focused on: robust enforcement, developing its people, and being proactive.

The FINRA View

FINRA staff noted the value of intelligence and information, including how important it is to have two-way flow between the regulators and market participants. They continue to combine this intelligence gathering with their risk monitoring focus. As to priorities, much like market participants are dealing with a wide variety of topics, so too is FINRA.

We highlight a few areas of interest discussed at the conference:

- **Crypto:** This was identified as an area of interest as a potential area of risk. As to whether or not the industry will see enforcement – from the FINRA perspective – the short answer was yes but the long answer was it depends on what you mean in this area. This is a very broad topic, and FINRA indicated it is looking at matters in this space that are adjacent to traditional broker-dealer activities.
- **FinFluencers:** Note, do not take investment advice from a sock puppet on TikTok. All kidding aside, influencers and social media in general are areas FINRA is monitoring, with the focus on investor protection. It was highlighted as a priority, to ensure compliance teams are looking at social media platforms.
- **Regulation Best Execution:** As to the SEC’s proposed best execution proposal for equities, FINRA noted that they have long-standing rules in place and will continue to enforce them as they have in the past. This is the beginning of the process, not the end of the process. FINRA recognizes that there needs to be more specificity about the final rule before moving forward. Before they issue any rulemaking, there will be a regulatory notice and opportunity to comment on it.
- **Regulation Best Interest (Reg BI):** FINRA indicated they have come to see this as a mature rule. Panelists noted that it affects vast swaths of organizations, and the focus should be on integration, making sure it is baked into a whole set of policies and procedures with appropriate supervision. For example, does the firm have a mechanism for tracing, monitoring, and surveilling complex products? Panelists commented on the need for adequate – and innovative – training. They also noted that the industry could see enforcement tick up, as cases under the old suitability rule will now be under Reg BI.
- **Regulatory duplication:** Panelists noted that regulatory duplication is not good for anyone, including the regulators. And historically “it has not happened that often, maybe around a couple dozen times”. FINRA representatives indicated that the communication with other regulators, particularly the SEC, has never been better and that they are traditionally able to deconflict, or come to a reasonable conclusion, before regulatory duplication occurs. After all, panelists noted, there is not an advantage for multiple regulators to be in the same space at the same time.
- **Remote inspections:** We should know soon whether the SEC will weigh in on FINRA’s proposed remote branch inspection pilot and personal residence exemption for supervisors. The balance is to preserve investor protection while allowing for a certain degree of flexibility. After all, if FINRA does not give a framework, they are essentially saying that all work must be done in the office. FINRA President and CEO Robert Cook made it clear that is not their intention.

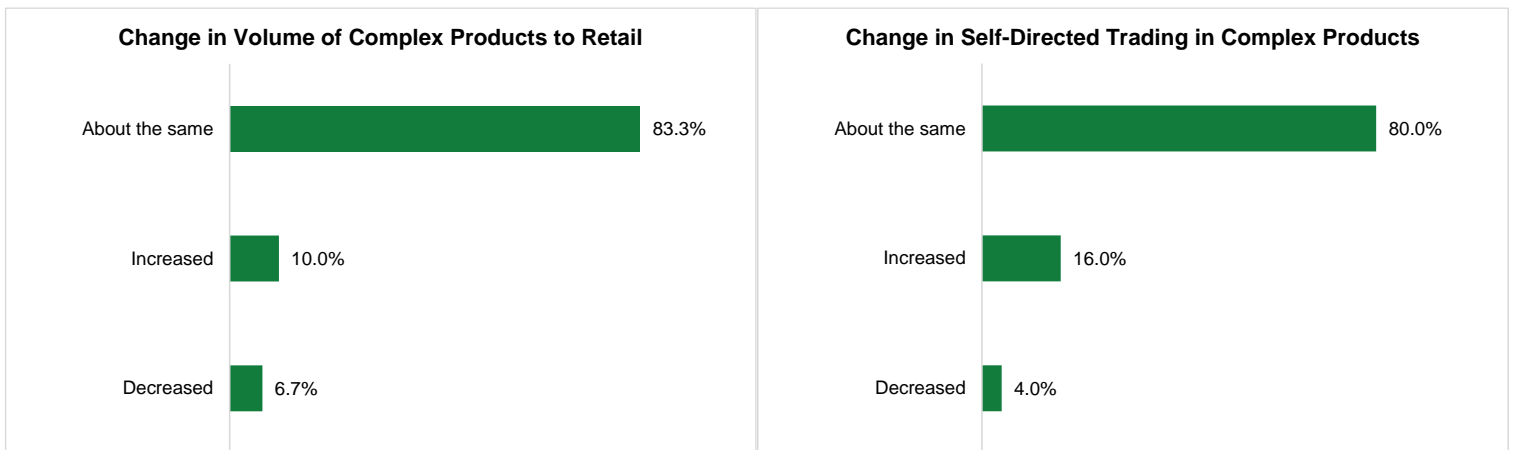
- Complex products:** Panelists indicated that an area of focus is on options, where the rules have not changed since 1978 when investors had to trade with a broker. They have seen a significant increase in retail participation – estimated at around 40% – and the level continues to increase. Regulators are not clear that these investors have the proper tools, such as education. They noted that in a FINRA capabilities study, of investors who have traded options only one-fourth could answer one out of five questions accurately. Whether or not options continue to be complex products will continue to be a focus.

Market Touchpoint: Complex Products

We used our pre-conference survey to gauge respondent’s views on trends in complex product offerings to retail investors. We highlight the following:

- There looks to be essentially no change the volume of recommendations of complex products to retail investors, 83.3% of respondents
- The same was said about the change in the volume of self-directed trading in complex products, 80.0% responded the level was about the same

Survey Questions: Since the effective date of Reg BI in June 2020, how has the volume of recommendations of complex products to retail investors at your firm changed? As your firm develops and expands its digital engagement practices (online, mobile app, etc.) with retail investors, how has the volume of self-directed trading in complex products at your firm changed?



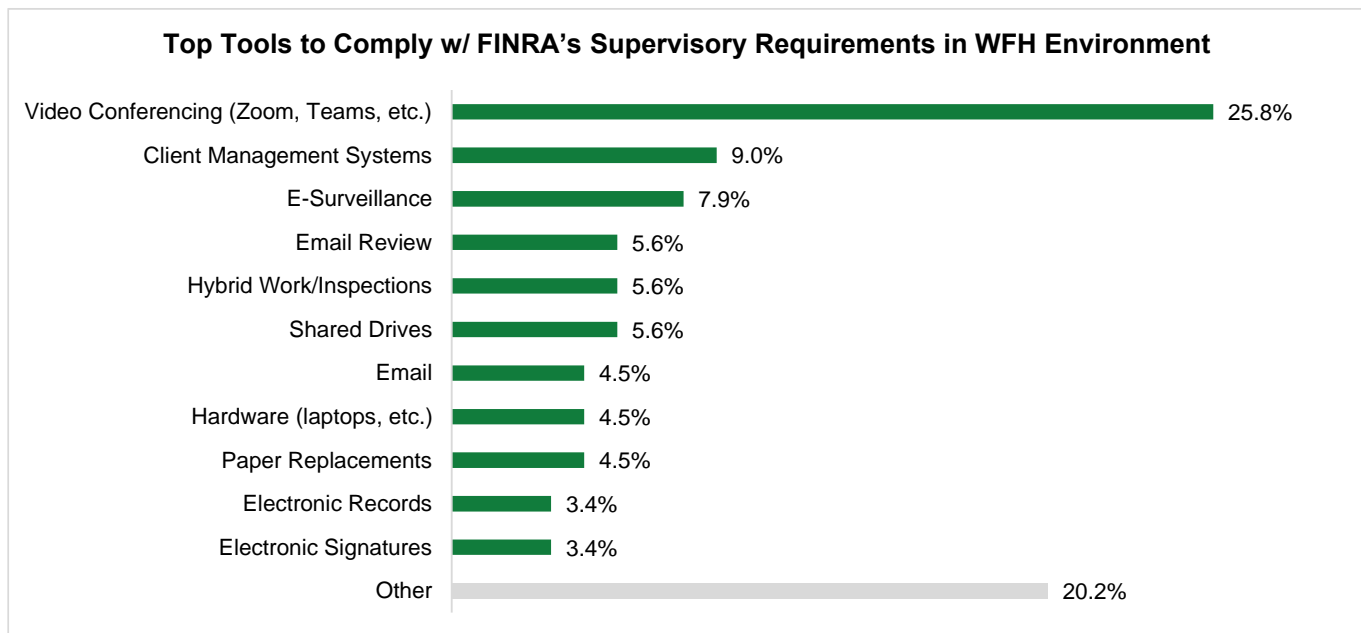
Source: SIFMA Insights pre-conference survey

Market Touchpoint: Supervision in a WFH Environment

We used our pre-conference survey to gain a sense of how compliance and legal departments are managing the remote working environment. The top tools in the work from home environment to comply with FINRA’s supervisory requirements included:

- Video Conferencing – Zoom/Teams/Skype/general video conferencing
- Client Management Systems – Slack, general communication tools, Hearsay, Salesforce, e-Surveillance, tools for social media/text review, archiving capabilities
- Email Review – general review capabilities, Global Relay, Smarsh
- Hybrid Work/Inspections – hybrid environment/inspections/working standards, remote access/examinations
- Shared Drives – network drives with secure file access, SharePoint, VPN
- Email – secure capabilities
- Hardware – laptops/docking stations, good headset/microphone, good Wi-Fi
- Paper Replacements – Adobe PDF, any program that replaces paper processes/Red Oak/ComplySci/FINRA Reg Element, no paper at home, no printers permitted
- Electronic Records – electronic books and records storage, electronic record keeping,
- Electronic Signatures – general capabilities, DocuSign

Survey Question: What are the top tools you’ve found most useful in the work from home environment to comply with FINRA’s supervisory requirements?



Source: SIFMA Insights pre-conference survey

Other: Clearing firm records, compliant e-communications systems/platforms, data from tech teams, digital logs, and direct discussions/phone calls, among others

The Digital Assets Perspective

When Are They Securities? And Who Oversees Them?

Speakers reminded us that our industry is built on trust. It is the foundation of our business. Unfortunately, in today’s environment, not all people trust large institutions – not specific to financial firms – or government agencies. We were reminded of the importance of working together to maintain and enhance public trust.

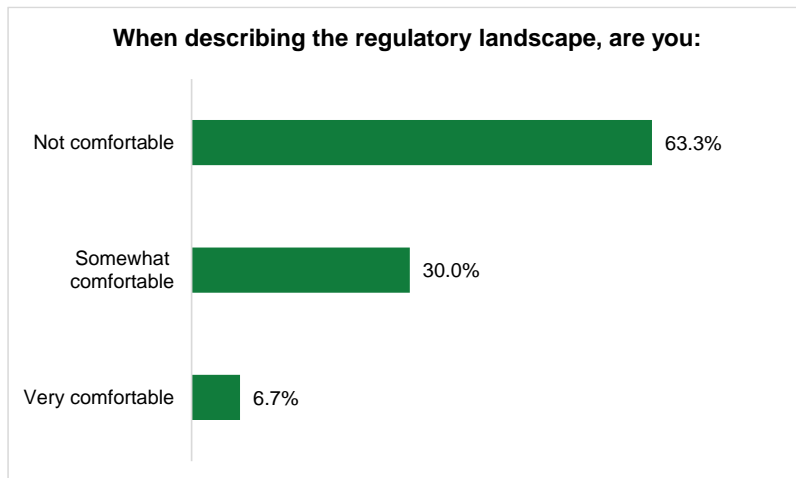
Bringing trust into practice, speakers spoke about the role disclosures can play in building – or rebuilding – trust. Regulators see investors getting harmed around some crypto assets and stated that they will continue to work to protect them. Disclosures can bring transparency. Compliance can supply protection via segregation of assets. This can build trust.

For their part in building trust, the SEC doubled the size of its Crypto Assets and Cyber Unit (formerly known as the Cyber Unit). The agency took actions on three lending platforms. It also underwent its first crypto insider trading case on listing of new crypto tokens on a crypto exchange. In general, panelists indicated that disclosure and control issues continue to be the major focus of the SEC.

Seeking Regulatory Clarity

One panel polled the audience to gauge how comfortable people were in explaining the digital assets regulatory landscape. Almost two-thirds of the audience responded not comfortable at all. This is not surprising, as it has long been discussed by market participants that more regulatory clarity is needed in this space.

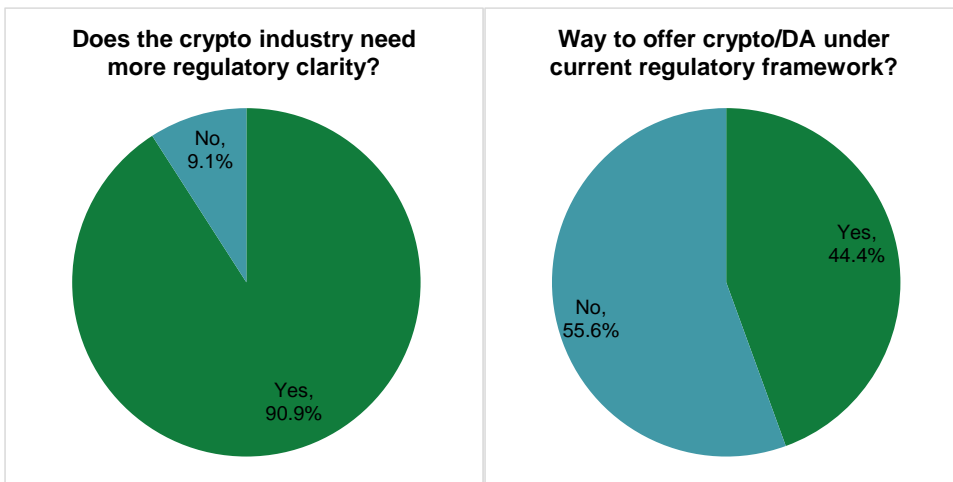
Question: When it comes to advising your business colleagues about the regulatory landscape of digital assets or related products or services, are you?



Source: Audience polling

During one panel, almost 100% of the audience responses were that the industry needs more regulatory clarity. Of note, panelists were surprised that 9% responded no. What was a bit more surprising was that, despite the regulatory uncertainty, over 40% of the audience responses were that firms were finding ways to offer crypto/digital assets to clients.

Questions: Do you think the crypto industry needs more regulatory clarity? Is there a way to offer crypto/digital asset securities under the current regulatory framework?



Some firms are offering products to meet client demand. However, digital assets have still not been adopted in scale across the industry. Many firms are not willing to take on the regulatory risk – regulations could be implemented in the future that end up being in opposition to the strategy they implemented – in this space.

What is the issue? First, we note that not all digital assets are crypto. The terminology actually incorporates a wide swath of products. Since this is a new asset class covering many products, panelists noted that regulators are not in agreement on which one should take the lead. The SEC has the Howey and Reeves tests to determine if a product is a security and therefore under their purview. Panelists summarized this test as an investment of money in: a common enterprise; with a reasonable expectation of profits; to be derived from the efforts of others. Panelists throughout the seminar commented that SEC Chair Gary Gensler believes all digital assets are securities under this test (although he has also been known to say that Bitcoin is not a security, everything else is).

As to the CFTC, this agency regulates and holds anti-fraud jurisdiction over derivatives (swaps, futures, actual delivery longer than 28 days, etc.). However – and many people often forget this – this regulator can undertake anti-fraud authority over spot markets of derivative products. And derivative products already exist in the digital assets space.

But this is not the last of the regulatory soup. On the federal level, the Bank Secrecy Act (BSA²) applies to issuers and exchangers of crypto assets, which seems to be a blanket rule. The state level adds additional complexity for certain products and activities, as the applicability of state money transmission law depends on specific activities. And do not forget that federal bank regulators continue to play an increased role in digital assets supervision. There is also individual state supervision of trust companies – and state laws vary state by state.

Why is regulatory clarity so elusive? Take the SEC. It regulates securities markets, including digital assets/crypto that are securities. As such, issuers – those offering and selling – of digital asset securities are subject to SEC registration requirements. Intermediaries – those transacting in digital asset securities – are also required to register with the SEC. As if defining a security is not challenging enough, the rules for issuers and intermediaries registering follow suit.

Additionally, for market participants, a main concern continues to be around custody of digital assets. The concerns in this area were highlighted by the FTX scandal. Statements from the SEC have created major challenges for firms wishing to custody digital assets, such as the capital implications of Staff Accounting Bulletin 121 and the operational and business model limitations of the safe harbor for digital asset securities the SEC provided through its special purpose broker dealer model. The end result is that custody models have not developed, creating a major hurdle for broader adoption of digital assets. Panelists described it like this. The SEC – really, the Chair – says all but Bitcoin are securities. This means firms would need to custody essentially all digital assets. However, the SEC Chair has said firms cannot custody these assets since they are not registered. How can a firm be a qualified custodian and hold these assets?

While the landscape is muddy now, what was clear to panelists is that more regulations are coming, although the fundamentals of future regulations is unknown. This leads firms with no guidance on which to affirmatively advise clients. As one panelist put it to firms offering or wanting to offer digital assets/crypto to clients, “buckle up and bring a parachute”. The lack of regulatory clarity in the U.S. is therefore forcing market participants to go abroad.

Inflection Point?

For substantial institutional take up in the digital assets space, it was clear to panelists that more regulatory clarity is needed. Is an inflection point coming? Panelists believe we are nearing a head on the SEC taking control, giving the Chair’s comments that essentially all digital assets are securities. However, panelists were not optimistic on registrations forthcoming. As such, they believe the SEC will continue to – and increase the scale of – regulation by enforcement.

In addition to regulatory uncertainty, panelists believe legislation is “dead in the water because it is a third rail for some legislators”. If firms enter this space now, they must either: (a) accept that certain digital assets are currently not securities; (b) work with established firms in this space; or (c) wait and see. If a firm is global, it is most likely already exposed to digital assets. They would have already identified an appropriate customer base and set compliance policies and procedures which could eventually be replicated in the U.S. For venture capital firms, it still

² BSA requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering

makes no sense to invest in U.S.-based projects, when other regions across the globe have more well defined regulatory frameworks (and money is fluid).

A panelist commented that they believe a U.S. central bank digital currency (CBDC) is coming. Therefore, the regulators do not want growth in stablecoins because they do not want competition to the eventual CBDC. Panelists noted that they are waiting for the “shoe to drop” in the stablecoin space and expect enforcement here. Until there is regulatory clarity, the expectation is for enforcement across the digital asset space. And while a year ago, many market participants expected the CFTC to take the lead, that is less clear today given the SEC Chair’s commentary.

Finally, panelists commented on current events and the impact on the digital asset space. They noted challenges and disruptions to the operations of two of the institutions which were major providers of liquidity for certain parts of the digital asset market: Silvergate Bank and Signature Bank. Of course, other parts of the digital asset ecosystem, particularly as they relate to registered products and services using distributed ledger technology (DLT) platforms, continue to be developed by financial institutions, infrastructure venues, and technology providers.

Panelists indicated that long term there are many smart developers working on new projects and use cases for the technology. However, the space overall will see lots of turbulence in between. There will be winners and losers. Historically, the losers in new spaces like this are those who thought they were savvy and then took on excessive regulatory risk. The winners were bucketed by those who entered the space early but built strong compliance programs or those late comers who let the regulatory dust settle first.

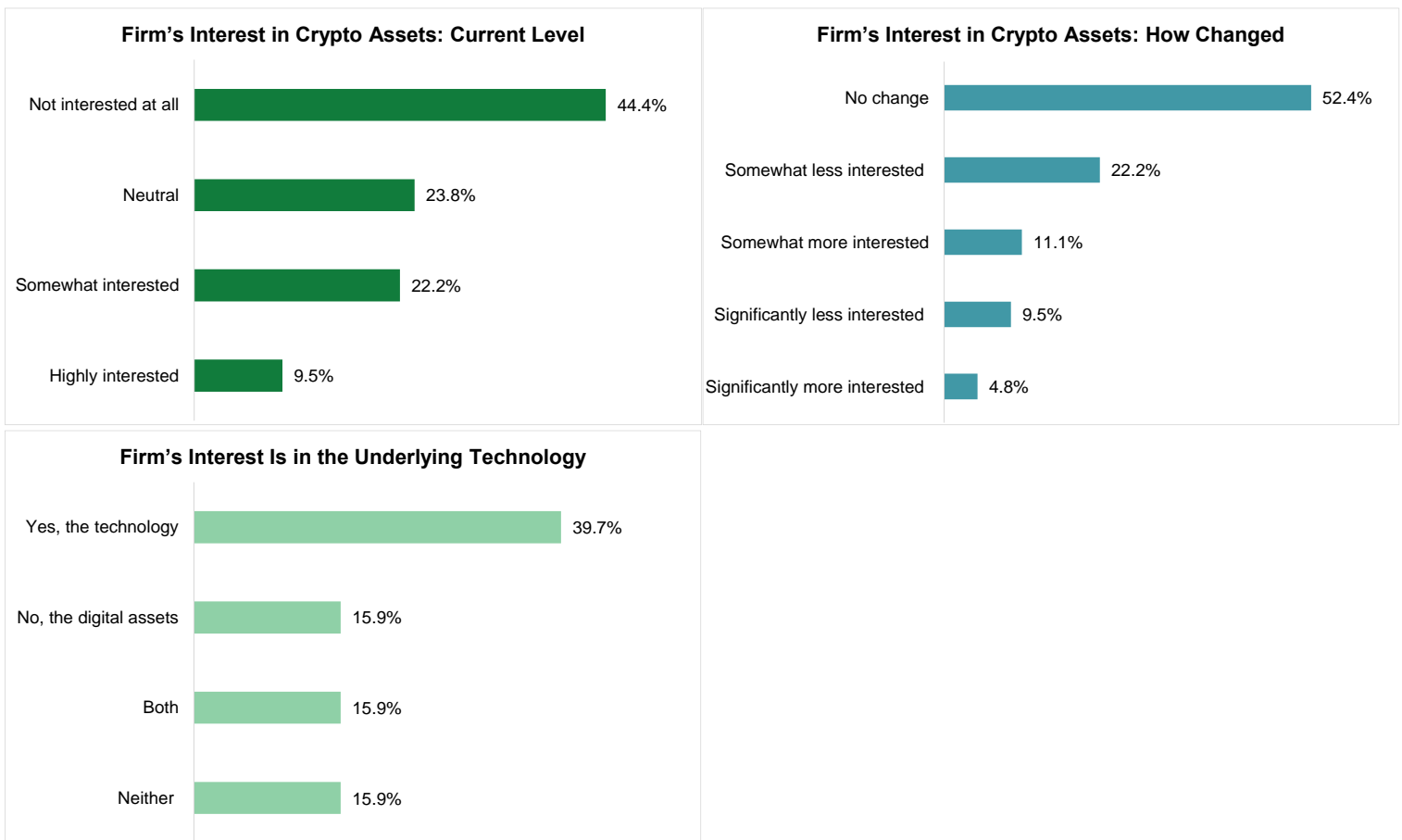
A panelist looked back to when the equities markets went electronic. Innovators survived. Those who did not innovate did not survive. And, importantly, those who complied survived.

Market Touchpoint: Crypto

We used our pre-conference survey to gauge respondents' interest for crypto asset investing. We highlight the following:

- 44.4% responded that they have no interest at all in crypto asset investing, with 23.8% neutral to the idea
- This has not changed since last year, as per 52.4% of the respondents
- However, 39.7% of survey respondents are interested in the underlying technology, with 15.9% interested in both the technology and the assets themselves

Survey Question: How do you rate your firm's current interest in crypto asset investing? How has your firm's interest in crypto asset investing changed since last year? My firm's interest is in the underlying technology rather than the assets themselves.



Source: SIFMA Insights pre-conference survey

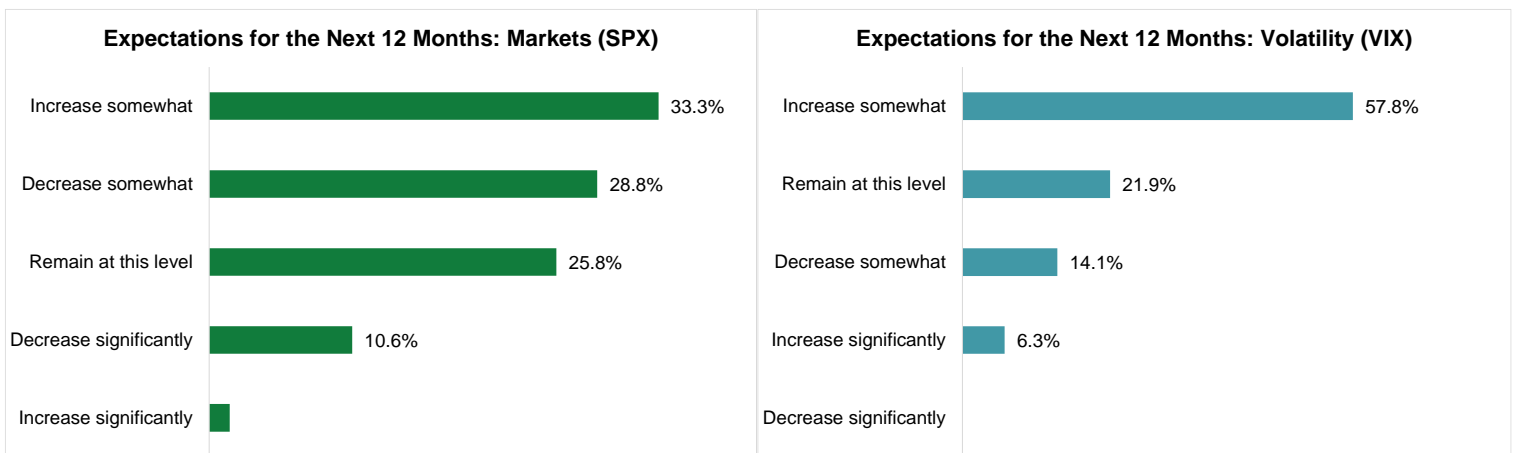
More on Market Themes

Market Touchpoint: Market Themes

Our pre-conference survey sought to gauge respondents' thoughts around market performance (S&P 500 index price) and volatility (VIX index) trends. We highlight the following in respondents' perspectives on key concerns:

- **Markets** – The spread of the results – 1/3 increase, >1/4 decrease, 1/4 remain the same – showed how unclear the path is for the S&P 500 over the next year given the many moving pieces impacting markets (the Fed, inflation, current regional bank turmoil)
- **Volatility** – In light of those factors, 57.8% of respondents expect volatility to increase over the year versus 21.9% remain at this level (we note that the survey closed prior to the regional bank turmoil when volatility was lower than at writing of this note)

Survey Questions: Over the next 12 months, do you expect markets – in terms of the price of the S&P 500 index – to? Over the next 12 months, do you expect market volatility – in terms of the price of the VIX index – to?



Source: SIFMA Insights pre-conference survey

Digital Engagement Practices

The SEC has broadly defined digital engagement practices (DEP) to include behavioral prompts, differential marketing, game-like features (referred to as gamification), and other design elements or features for engaging with retail investors on digital platforms (websites, portals, and applications or apps). This includes the following examples:

- Social networking tools
- Games, streaks, and other contests with prizes
- Points, badges, and leaderboards
- (Push) notifications
- Celebrations for trading
- Visual cues
- Ideas presented at order placement
- Subscription and membership tiers
- Chatbots

Panelists noted that the SEC's focus on labeling is missing the point. There is not necessarily anything positive or negative about these tools. It is not the tools, rather the use of the tools that firms should monitor. These tools were not created in a vacuum. They were designed because this is the world we live in, a world where, for some people, everything is done from their iPhone.

The financial advisor world used to be very high touch. However, as more young investors come into the market it is increasingly utilizing technology tools. This can range from tools to assist advisors in staying in touch with their clients to app-based trading platforms. We are seeing an intersection with retail investors, retirement assets, and technology.

Panelists further indicated that customers have asked for this, particularly the younger generations of investors. This is how they engage with finance, similar to how they do all commerce. Panelists also discussed a few case studies on DEPs used for good or neutral applications, including:

- Notifications on the interest earned on cash held in the investor's account
- Alerts that an investor is about to buy a leveraged product prior to completing the transaction (includes a link to information on leveraged products)
- Investment ideas everyone sees and investors can choose from, akin to a Netflix recommendations list
- In general, notifications can always be turned off

A final recommendation from panelists was that firms need to have designed-in disclosures, rather than adopt a band aid approach. This approach has the technologists work with the disclosures staff in early stages. Firms educate the engineers – even though not in the compliance department – on the regulatory framework for the industry. They also educate the marketing teams on regulations, including doing role playing exercises on case studies with legal and compliance representatives.

Cybersecurity

Cybersecurity cannot be a check-the-box exercise. Ensuring the security of systems and markets requires vigilance. When a significant breach occurs, regulators acknowledged that many firms can feel that they were impacted twice: first by the breach and second by the enforcement actions that follow. However, regulators encouraged industry members to report significant breaches as soon they occur and warned that, if not, enforcement will surely follow.

As noted above, the SEC doubled the size of its Crypto Assets and Cyber Unit (formerly known as the Cyber Unit). Regulators' goal is to find the attackers. They are interested in the breach, the how. Firms should have policies and procedures in place and make sure they are implemented. A best practice suggested by panelists was to take a holistic approach rather than siloed. Create teams or working procedures which include both the technical advisors and the people on the disclosures side. Additionally, panelists indicated it is important for Boards to get real time updates when an issue has been identified.

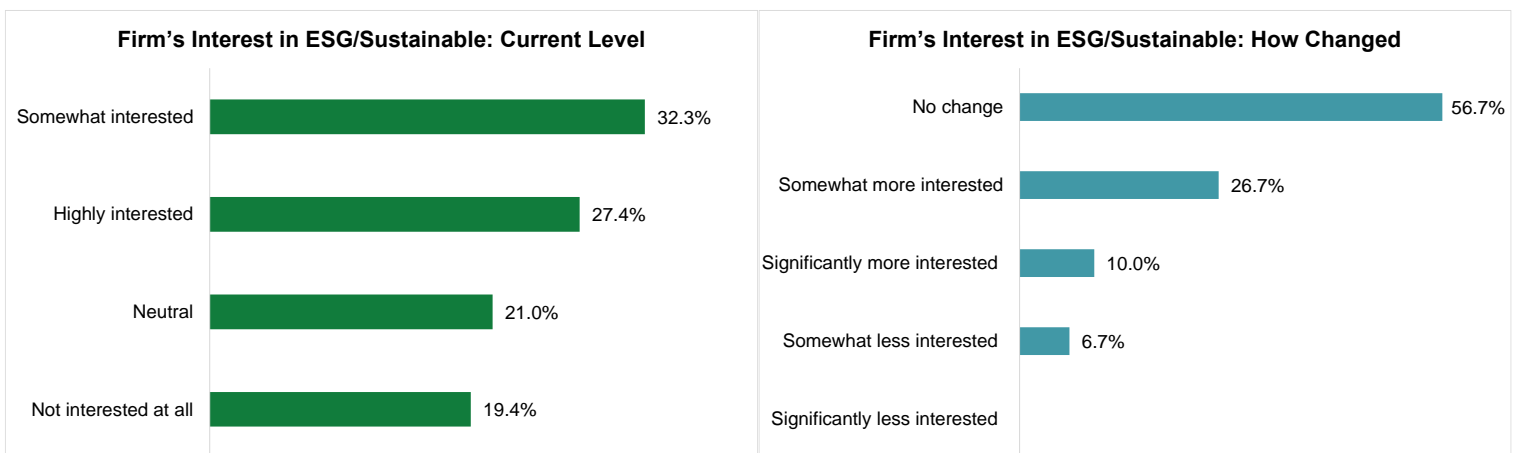
Cybersecurity incidents will happen. The key is preparation and reporting. Compliance teams should monitor who has access to system. Controls should be in place for who can access systems, what parts of the systems individual employees can access, as well as password controls. Firms should monitor and have controls in place for remote technologies used to get into systems. Additionally, compliance should undergo periodic risk assessments in addition to annual reviews, not just wait for after an incident occurs to review policies and procedures. After all, threats to operational resiliency can create long-term reputational risk in addition to the initial monetary amounts associated with any given incident.

Market Touchpoint: ESG

We used our pre-conference survey to survey respondents on their firm’s interest for ESG and sustainability services and product offerings. We highlight the following:

- 59.7% of respondents replied their firm is interested in ESG and sustainability services and product offerings, 32.3% somewhat interested and 27.4% highly interested
- As to how this view has changed over the last year, 56.7% replied no change and 26.7% somewhat more interested

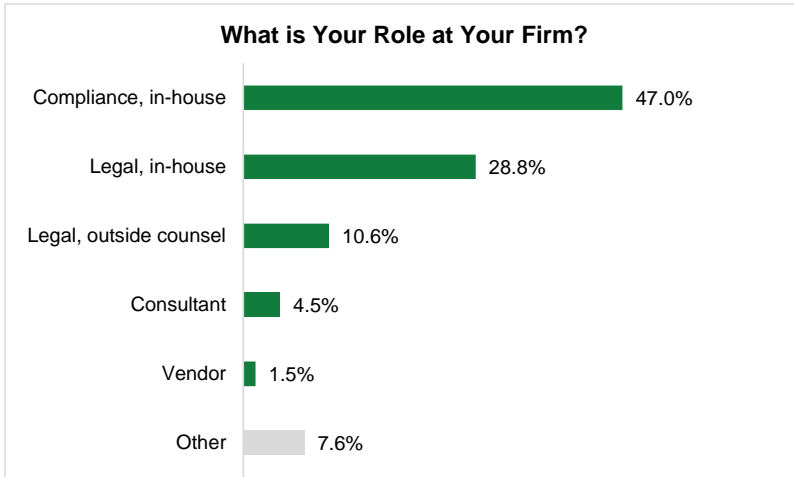
Survey Question: How do you rate your firm's current interest in providing ESG/sustainable products/underwriting? How has your firm's interest in providing ESG/sustainable products/underwriting changed since last year?



Source: SIFMA Insights pre-conference survey

Appendix: Pre-Conference Survey Methodology

This survey was sent out prior to the start of the conference, populated between February 22 to March 9. We had 66 respondents, broken out across the following roles:



Source: SIFMA Insights pre-conference survey

Other: Director of Supervision, executive, front line regulatory supervision, records management, CCO

Appendix: SIFMA Insights Research Reports

Monthly Market Metrics and Trends: www.sifma.org/insights-market-metrics-and-trends

- Statistics on volatility and equity and listed options volumes
- Also highlights an interesting market trend

SIFMA Insights Market Structure Primers: www.sifma.org/primers

- Capital Markets Primer Part I: Global Markets & Financial Institutions
- Capital Markets Primer Part II: Primary, Secondary & Post-Trade Markets
- Global Equity Markets Primer
- Electronic Trading
- US Capital Formation & Listings Exchanges
- US Equity
- US Multi-Listed Options
- US ETF
- US Fixed Income
- SOFR: The Transition from LIBOR
- The Evolution of the Fintech Narrative

SIFMA Insights Equity Market Structure Analysis Series:

- Analyzing the Meaning Behind the Level of Off-Exchange Trading
- Analyzing the Meaning Behind the Level of Off-Exchange Trading Part II
- Why Market Structure and Liquidity Matter

Conference Debriefs

- Insights from market participants into top-of-mind topics

SIFMA Insights: www.sifma.org/insights

- Market Structure Compendium (recapping FY22)
- Pre-Conference Survey Comparison (2022)
- Market Structure Thoughts
- Market Structure Compendium (recapping FY21)
- Inflation 101
- Market Structure Survey (2021): Volatility, Volumes, Market Levels & Retail Investor Participation
- SPACs versus IPOs
- A Look Back at 2020 Market Structure Themes
- US Capital Formation's 2020 Journey
- Market Structure Download: Post-Election Update
- Market Performance Around US Presidential Elections

- Market Volatility Around US Presidential Elections
- Market Structure Download
- A Deeper Look at US Listed Options Volumes
- The Cboe Trading Floor Reopened – Revisiting Volume Data
- NYSE Goes All Electronic – What Does It Mean?
- The NYSE Trading Floor Reopened – Revisiting Market Share Data
- COVID-19 Related Market Turmoil Recap: Part I (Equities, ETFs, Listed Options & Capital Formation)
- COVID-19 Related Market Turmoil Recap: Part II (Fixed Income and Structured Products)
- 2020, the Year of the SPAC
- The 2020 Market Madness
- The VIX's Wild Ride
- The 10th Anniversary of the Flash Crash
- DTCC's Important Role in US Capital Markets

Author

SIFMA Insights

Katie Kolchin, CFA

Managing Director, Head of Research

kkolchin@sifma.org

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