Broker-dealer financial regulatory reporting

Current landscape and challenges

EY

Building a better working world

Executive summary

This brief will focus on the daily challenges facing broker-dealers, highlighted on the right, and considerations for sustainable process improvement. We will summarize our industry observations based on past and ongoing engagements, industry surveys focusing on various aspects of the broker-dealer financial regulatory report production process as well as the latest areas of focus for FINRA examinations and related findings.

Financial regulatory reporting covers reporting requirements of broker-dealer financials and certain regulatory supplemental schedules such as those reported in the monthly breakout Financial and Operational Combined Uniform Single Reports (FOCUS) report in accordance with US GAAP and Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) standards and requirements. Broker-dealers have experienced increasing regulatory scrutiny of financial regulatory compliance and reporting in the past several years. Heightened regulatory expectations for specific documentation, data transparency and process consistency are now being applied to broker-dealer reports in many institutions.

Specifically, this brief will touch upon such topics as controls testing and compliance, data quality and governance, report automation, benefits of training and lessons learned from recent advancement in Federal Reserve Board (FRB) reporting.

We hope that our insights will add a valuable perspective on how to achieve a modernized, efficient and compliant report production process.

Reporting challenges

- Extensive manual processes with multiple spreadsheets and manual adjustments
- Lack of centralized "golden source" of data, resulting in need to aggregate data across multiple disparate systems
- Lack of automated industry solution for SEC Rule 15c3-3 customer reserves reporting is a heavy burden on personnel to turn computations around under tight deadlines
- Data quality issues from upstream systems
- Inadequate reconciliation of securities inventory to general ledger
- Continued challenges with possession or control information used for subjective areas or decisions
- Limited broker-dealer reporting training for upstream data providers
- Lack of confidence in real-time data, resulting in firms holding excess net capital buffer

Introduction

Given the direction of regulatory trends observed, broker-dealers have continued to face rising financial regulatory expectations from multiple parties. This includes sometimes ambiguous and changing rule interpretations around compliance with SEC Rule 15c3-3 customer protection, SEC Rule 15c3-1 net capital computations and related monthly reporting included in the FOCUS report. We have observed operations and regulatory reporting functions continuing to refine the control environment related to daily compliance with financial regulatory net capital computation, customer reserve computation, customer statements, quarterly security count and possession or control of customer-owned securities.

We understand that broker-dealers may expect to face continued scrutiny from regulators as well as external and internal auditors. Recent external examination findings have focused on the net capital and customer protection rules. Regulators such as FINRA continue to find broker-dealers facing challenges in complying with net capital rules, including insufficient documentation, incorrect inventory haircuts and inaccurate operational charges. External findings related to SEC Rule 15c3-3 highlight that broker-dealers are having difficulty complying with the appropriate segregation of client assets due to inconsistent check-forwarding processes, possession or control, and reserve formula calculations. As firms address these types of issues, in part by continuing to invest in new technologies and emphasizing data quality, they may focus on establishing a mature, holistic and controlled process that is maximized through end-to-end automation, increased accuracy and completeness of source data, inclusive of referential data, trained upstream data providers, and enhanced documentation that is transparent and provides comprehensive interpretative guidance.

Broker-dealer computations require cross-functional coordination with data providers and documentation of unique rule interpretations. Our clients have indicated that increased responsibilities and scrutiny have put pressure on specialized broker-dealer regulatory resources required to perform and monitor these, often underinvested in, home-grown and/or manual processes. We have found that broker-dealer executives, accountable for the compliance, accuracy and completeness of regulatory filings are increasingly looking to invest in automation to evidence compliance with the rules on a sustainable basis more efficiently through enhancing processes, data and control documentation.

Insights gained from informal client discussions and the broker-dealer survey supplement to the EY Federal Reserve regulatory reporting survey conducted in 2018 (Survey)[1] suggest that FOCUS reporting processes are heavily manual, requiring input from multiple functional groups to obtain the correct level of information. Firms vary greatly in the number of resources required to complete FOCUS reporting and other broker-dealer reporting tasks. Lack of industry-wide, consistent leading practices for sustainable processes and comprehensive turnkey automation supporting unique regulatory reporting requirements and diverse practices in governance and accountability for FOCUS reporting and SEC Rule 17a-5 controls compliance perpetuate current state inefficiencies and challenges.

Recent FINRA examination focus areas and select findings[2, 3]

FINRA regulates more than 3,700 firms and 630,000 individual brokers and regularly examines every firm for compliance with FINRA rules. Recent FINRA examination focus areas and select findings include the following:

Accuracy of net capital calculations and credit risk assessments

- Insufficient documentation substantiating or defining a methodology for expense-sharing agreements
- Improper application of haircuts under SEC no-action letter and for open contractual commitments
- Challenges with calculating operational changes due to human error and limited spreadsheet controls
- Inadequate policies and procedures for assessing and monitoring creditworthiness
- Inappropriate application of thresholds to determine securities with minimal credit risk, and therefore, lower haircut
- Inappropriate use of internal or external credit risk assessments
- Deficient pre-trade financial controls and inadequate substantiation of credit and capital thresholds for clients

Segregation of client assets

- Challenging customer and non-customer designation process
- Concerns around static data for customer protection
- Need to verify that SEC Rule 17a-5 controls around customer protection are in place and operating effectively
- Challenges with implementing consistent processes for check forwarding
- Inaccurate reserve formula calculation due to errors in coding

Confirmation review process, systems and vendors

- Failure to enter information into the firm's order entry systems, resulting in omitted or inaccurate markups or markdowns
- Missing customer disclosures due to incorrect designation of institutional accounts
- Vendor challenges, resulting in improper identification prevailing market price using lower levels of the "waterfall" instead of firm's own concurrent trades

[1] The Survey respondent panel consisted of 47 participating firms, including 18 clearing broker-dealers
EY 2018 Federal Reserve regulatory reporting survey

[2] Report on FINRA Examination Findings, December 2018

[3] Report on FINRA Examination Findings, December 2017

17a-5 control certification, governance and compliance

As part of SEC Rule 17a-5, broker-dealers are required to assert annually to the effectiveness of controls over net capital, customer reserve computation, customer statements and quarterly security firms' count and possession or control over customer-owned securities. Management's assertion is tested, and results are reported by the external auditors. The external audit and attestation standards and expectations are driven by the Public Company Accounting Oversight Board.

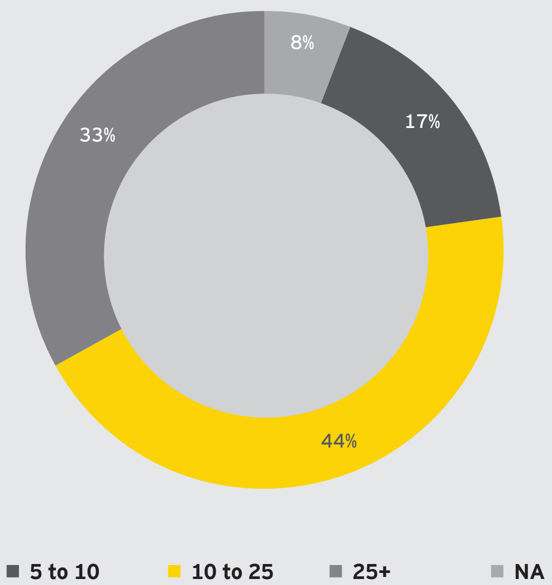
The main concern of broker-dealer stakeholders while performing SEC Rule 17a-5 control testing using information produced by the entity (IPE)[4] is to confirm that IPE will not cause an internal control breakdown such as a material weakness that would be required to be disclosed in management's SEC Rule 17a-5 annual report and to regulators through the SEC Rule 17a-5 reporting rules. In this case, a material weakness[5] is identified when there is a reasonable possibility that noncompliance with SEC Rule 15c3-1 or SEC Rule 15c3-3 or noncompliance to a material extent will not be prevented or detected on a timely basis. Examples of material weaknesses identified by broker-dealers or their external auditors include insufficient documentation of review controls, controls implemented midyear that insufficiently cover the full year, and incomplete documentation related to customer reserve computation.

Challenges with IPE include substantiating the reports from thirdparty service providers for outsourced back-office functions; controlling manual update and creation of multiple spreadsheets, haircut and other intricate computations performed by third-party service providers; and validating the maintenance margin requirement calculation. To further complicate the issue, many broker-dealers rely on a diverse set of stakeholders to capture and calculate the correct data, often retaining only an email or other manual record. This requires management to perform considerable amount of work communicating between front- and back-office functions to determine how to substantiate the data during the year-end external audit. To minimize the possibility of a material weakness, broker-dealers should enhance the control environment around key systems reports supporting in-scope controls, create an IPE rationalization policy that explains how each key report or query is substantiated (e.g., through a reconciliation, through a manual control, through IT application controls) and seek to reduce manual data manipulation by investing in automated solutions. Broker-dealers relying on reporting created by a third-party service provider may request that these reports be included by name in the service provider's System and Organization Controls (SOC1) report.

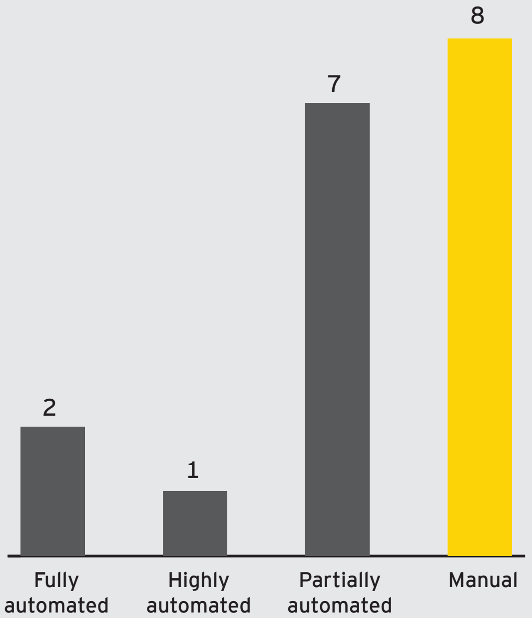
[4] IPE is defined as information created by information technology (IT) applications, end user computing tools or other means.

[5] A material weakness is defined as a deficiency, or combination of deficiencies, in the broker-dealer's internal control over compliance such that there is a reasonable possibility that noncompliance with SEC Rule 15c3-1 or paragraph (e) of SEC Rule 15c3-3 will not be prevented or detected on a timely basis, or that noncompliance to a material extent with SEC Rule 15c3-3, except for paragraph (e), SEC Rule 17a-13 or any Account Statement Rule will not be prevented or detected on a timely basis.

Q: For manual reports, how many spreadsheets are used?



Q: What level of automation is in place for Broker-dealer financial and nonfinancial reporting?



Data quality challenges, remediation and reporting automation

Similar to FRB reporters, many broker-dealers face data-related challenges from manually driven processes and reliance on multiple systems to comply with the regulations and complete their broker-dealer reports. Data quality concerns range from data availability, accuracy and conformance affecting ongoing report production to more strategic areas such as overall data governance, lineage and architecture. In the Survey, 80% of firms indicated that the main challenges faced for the SEC Rule 15c3-1 net capital calculation are data quality received from upstream data providers, including important reference data such as customer and non-customer classification and manual processing issues. Other broker-dealers have noted similar reporting challenges, including pulling data from many different data sources, performing a high number of manual adjustments, and experiencing challenges in gathering timely and accurate information from upstream data providers. Based on the Survey conducted for the 18 participating clearing broker-dealers, only 16% reported as "highly" or "fully" automated, and 44% of firms reporting as manual yet controlled.

In an effort to reduce data quality errors that result from manual interventions, firms are beginning to invest in shoring up technology or data architecture to alleviate data-related concerns, including rationalizing data sources and centralizing data into a single data source. Other broker-dealers have begun small and medium-sized projects to perform tactical remediation of identified manual processes and are exploring the use of outside vendors to assist with sub-components of the report production process.

High data quality

There are established data quality rules and control standards that are reviewed periodically, a well-defined data governance structure and ongoing testing continuously validate quality.

Medium data quality

There are established data quality rules and control standards in place for some regulatory reports, along with data management roles and responsibilities and periodic testing to validate quality.

Low data quality

There are limited data quality rules and controls, governance or testing in place specifically for regulatory reporting.

Data quality requirements and challenges faced by regulatory reporting broker-dealer teams

SEC Rule 15c3-1 net capital calculation

Data to support the SEC Rule 15c3-1 net capital calculation and reporting requirements is typically dispersed across multiple systems and internal processes. Although firms are trying to automate their net capital reporting process, there is a lack of available technology vendors that provide a comprehensive, turnkey and end-to-end broker-dealer reporting solution. Instead, current technology vendors provide niche computations that contribute to sub-components of the reporting process with a workflow overlay that bolts into other systems such as reconciliation engines, etc.

Firms leverage internally developed solutions coupled with vendor tools (e.g., Dash Financial Technologies, Broadridge Financial Solutions, AxiomSL) to support reporting requirements. However, heavy reliance is placed on the broker-dealer reporting teams to manually aggregate the data using internal and vendor solutions supplemented by spreadsheets to support the remainder of the reporting process. Regulators continue to find suboptimal processes and controls that have led to inaccurate suspense or aged fail charge calculations due to human error and limited spreadsheet controls.

Due to the manual nature of the net capital reporting process across institutions and lack of an automated solution for sourcing data from a single golden source, complete real-time data is unrealistic. Therefore, firms tend to hold excess net capital buffer based on historic trends. In addition, firms are obtaining intraday data for transactions that could cause material fluctuations based on specified thresholds to maintain moment-to-moment net capital requirements.

SEC Rule 15c3-3 customer reserve calculations

The Survey revealed that all of the firms interviewed reported that they continue to have challenges with data quality related to the SEC Rule 15c3-3 customer reserve calculations. Similar to the SEC Rule 15c3-1 net capital calculation, the customer reserve calculations require multiple data sources (with some firms reporting using up to 50 spreadsheets) and manual processing to fully support the reporting requirements. The customer reserve calculation has a limited turnaround time, and the manual aggregation process creates a significant time burden on brokerdealer reporting resources, leaving limited time to perform thorough root cause analysis on identified issues. In addition, regulators have observed that several firms had inaccurate customer reserve formula calculations due to errors in coding, challenges with spreadsheet controls, inefficient coordination among various internal departments and performance of reconciliation calculations.

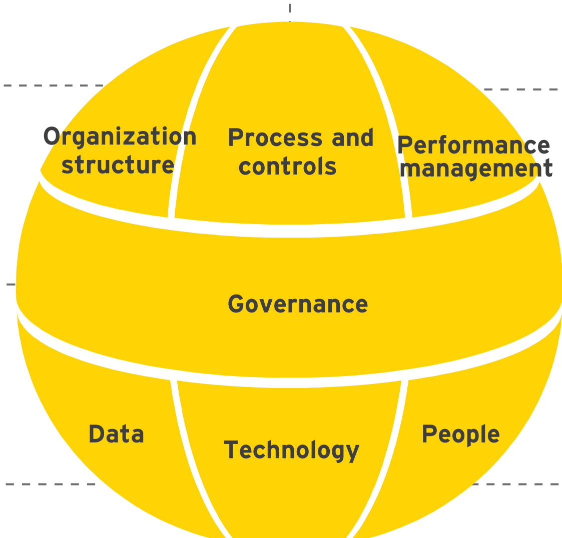
Training

In addition to data quality remediation efforts, firms are just beginning to explore broker-dealer-specific training programs to improve accuracy and efficiency, including a focus on data quality and data governance. The Survey found that 72% of firms do not have a formalized broker-dealer regulatory reporting training program in place. Instead, firms have been relying on industry seminars, external classes and series 27 licensure. However, broker-dealers continue to indicate that data quality issues exist in data from upstream data providers due to their lack of understanding of the reporting requirements. Firms with more developed training programs and guidance reported more timely escalation of issues to subject-matter resources.

Although availability of general awareness and specialized regulatory broker-dealer reporting training might not directly translate into data quality improvements, it will serve to facilitate enforcement of accountability from data providers, build overall understanding of compliance requirements and aid in the appropriate discharge of professional responsibility.

Broker-dealer operating model — Survey snapshot

- Broker-dealer filings are highly manual with significant amount of time spent on report preparation vs. analysis (e.g., 80% vs. 20%).
- 33% of firms surveyed indicated use of more than 25 spreadsheets for FOCUS reporting.



- There is significant variability in the size of broker-dealer teams, ranging from 1-2 FTEs to 10-20 FTEs.

- There are a limited policies and procedures documentation for 17a-5 compliance.
- Establishment of data governance and effective first line of defense structure is still in progress.

- 66% of firms surveyed indicated medium or low data quality available for broker-dealer reporting.
- Only 26% of firms are currently conducting data remediation efforts.

- There is limited usage of key metrics and dashboards covering accuracy of regulatory reporting data and reports

- Some firms are focused on improving, controlling and certifying source data for FOCUS reporting and 17a-5-related control compliance.

- 72% of firms surveyed indicated that they do not have a formalized broker-dealer training program in place.
- Hiring and maintaining teams of qualified professionals to handle the nature, volume and frequency of reporting is a challenge.

- Only 3 of 18 firms surveyed indicated "high" or "full" report automation.
- The majority of firms use homegrown solutions with a combination of vendor tools.

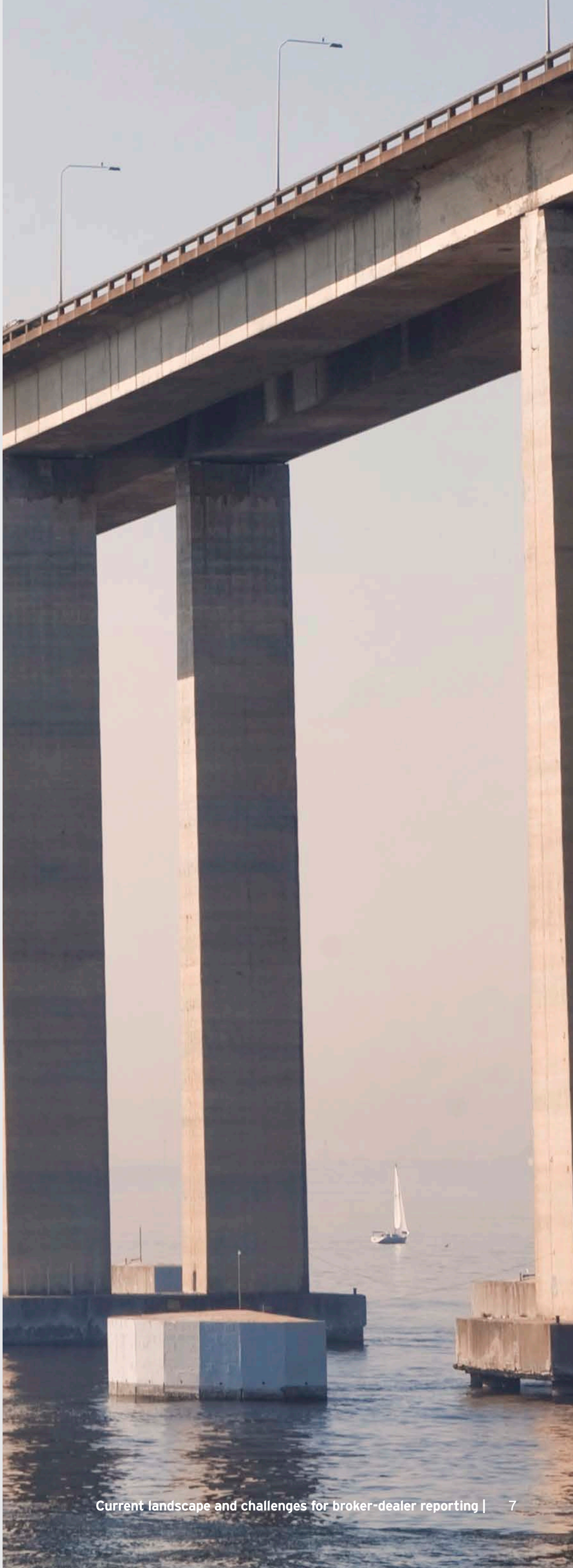
Lessons learned from FRB reporting

In the past several years, large bank holding companies (BHCs) and foreign banking organizations (FBOs) have made significant investments in establishing enterprise-wide data governance organizations, quality assurance disciplines and forward-looking technology solutions to support regulatory reporting. Ongoing data remediation efforts and comprehensive training programs engaging upstream and downstream stakeholders have proved effective in addressing regulators' concerns about data quality, overall governance and process efficiency.

Transforming regulatory processes and emerging technologies from manual to semi- or fully automated is a growing trend. The practices range from employing robotics on a subset of activities to implementing an end-to-end regulatory reporting platform. Increased automation allows more effective utilization of resources between production and other higher-value activities such as analytics, governance and controls.

As regulatory reporting expectations continue to evolve, broker-dealers should consider implementing or enhancing infrastructure and data governance to establish a sustainable process for broker-dealer reporting. The enhancements in the regulatory reporting space implemented by BHCs and intermediate holding companies such as data quality control frameworks that establish standards across regulatory reporting controls, data governance, accountability and training, automation and infrastructural enhancements can be leveraged for broker-dealer reporting.

For further information on related regulatory reporting enhancements, please visit the
EY Insights on regulatory reporting website.



EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

SCORE No. 05691-191US
1812-2975438
ED None.

ey.com

Contacts

Ann Cheeseman
Partner, Ernst & Young LLP
+1 312 879 3084
ann.cheeseman@ey.com

Steven Thiakodemitris
Partner, Ernst & Young LLP
+1 212 773 0903
steven.thiakodemitris@ey.com

Vadim Tovshteyn
Principal, Ernst & Young LLP
+1 212 773 3801
+1 917 375 1488
vadim.tovshteyn@ey.com

Michael J.Quinn
Executive Director, Ernst & Young LLP
+1 917 763 0594
michael.quinn1@ey.com

Alberto Rosello
Executive Director, Ernst & Young LLP
+1 212 773 7714
alberto.rosello@ey.com

Stephen Verrone
Executive Director, Ernst & Young LLP
+1 212 773 0168
stephen.verrone@ey.com

Jenny Chan
Senior Manager, Ernst & Young LLP
+1 212 773 4673
jenny.chan@ey.com

Stella Grinberg
Senior Manager, Ernst & Young LLP
+1 212 773 9535
stella.grinberg@ey.com

Elizabeth Kettler
Senior Manager, Ernst & Young LLP
+1 612 371 6385
elizabeth.kettler@ey.com

Chris Cardwell
Manager, Ernst & Young LLP
+1 212 773 9867
chris.cardwell@ey.com

Emily Zhou
Manager, Ernst & Young LLP
+1 212 773 7077
emily.zhou1@ey.com