

## FINRA and CARDS

### Finding opportunity in a new compliance regime



The securities industry is reacting with a mixture of caution and indignation to the proposed transaction reporting system, the Comprehensive Automated Risk Data System (CARDS), which may go into effect in early 2015.<sup>1</sup>

While industry and regulator opinions may vary about the compliance cost CARDS is likely to impose—or about its potential redundancy with other rules already in effect—it appears certain that the final rule will give securities firms a significant to-do list, should it become regulation. Policies, data standardization, and information platforms themselves may have to change or be created as part of making the rule work.

At the same time, however, CARDS may also present hidden opportunities. The same steps that a firm will take to comply with the new rule can also generate a new standard of valuable data for internal use—data that will unlock analytical insights and help firms better understand their customers, financial advisors, and risks.

Firms that want to seize this opportunity shouldn't wait until implementation is well underway before they look beyond the compliance checklist. Instead, they should build the advantages into their CARDS strategies, right alongside the burdens.

#### What is CARDS?

On September 30, 2014, the Financial Industry Regulatory Authority, Inc. (FINRA) released the second iteration of the CARDS Rule Proposal, a new data reporting requirement that stands to affect 4,300 securities firms that are FINRA members, and requested industry feedback. As of this writing, CARDS would require those firms to collect, store, and report information at the transaction level from approximately 110 million retail brokerage accounts.

Under this mandate, FINRA member firms would be required to automate and standardize their collection of this data across markets and across product and asset classes. The collected information would include customer account information; customer account activity, including securities and account transactions; holdings; and security identification information. The mechanism of reporting has been clarified to include the option of providing the required information to FINRA pursuant to an agreement with a third party, but the relevant member firms would retain responsibility for ensuring the accuracy and completeness of the submitted information in such circumstances.

<sup>1</sup> FINRA, *Regulatory Notice 14-37: FINRA Requests Comment on a Rule Proposal to Implement the Comprehensive Automated Risk Data System*, <http://www.finra.org/Industry/Regulation/Notices/2014/P600952>, accessed December 1, 2014.

The September 30, 2014, proposal contained several updates, which address some of the concerns raised by effected member firms and industry watch groups. Updates over the earlier CARDS concept proposal include:

- The amount and level of personally identifiable information (PII) collected for customers, including the exclusion of data containing account name, account address, and tax identification number to reduce privacy concerns.
- Data collection frequency at a monthly versus a daily basis. However, the provision of daily data granularity remains in effect.
- A phased approach to data collection:
  - Phase I applies to carrying or clearing firms and requires the submittal of securities and account transactions, holdings, securities reference data, and account profiles, but limits account profile data to select elements.
  - Phase II applies to fully disclosed introducing firms related to the firms' introduced securities accounts and requires the submittal of the additional account profile data that was scoped out of Phase I.
- Allowance for select exceptions to data standards, i.e., free format text fields in select data elements, such as suitability information and security descriptions, to allow firm flexibility within their records.

FINRA's rationale for proposing CARDS is to "protect the investing public" by analyzing data from actual transactions to identify "red flags" in sales practices and business conduct. FINRA would leverage this data to perform a more risk-based approach to its examinations through the identification of suspicious activities and high-risk areas. CARDS would also provide FINRA the opportunity to move its surveillance process to a more real-time and continuous basis. FINRA believes the automated nature of the process would lower regulatory costs for its members by reducing the number of examination-related requests that FINRA makes of them. Finally, FINRA believes this program would allow firms to better monitor and manage their own compliance, as it plans to make its analyses of this data available to member firms.

### The data opportunity

The burden of CARDS on affected firms would be the need to collect and standardize large quantities of transaction data. The proposed changes that would assist FINRA in its oversight efforts, however, could also benefit the firms themselves—because for many of them, CARDS would produce broader, "cleaner," more cohesive data than their existing fragmented systems ever have before. The same information a firm reports to FINRA could generate new value in-house, when analytics is leveraged to discern trends and patterns that were once deemed invisible.

- Reporting firms could use sourced transaction-level data along with associated customer account numbers (at both the security master and product levels) to run predictive analytics models. Using those models, they could identify the need for new products, prioritize resources, and design products that meet their customers' needs more directly while maintaining suitability requirements.
- A unified view of client transaction data could also enhance data quality standards, facilitate improved information sharing models between organizational functions or channels, and develop better customer reporting.
- Firms could also use this data to enhance compliance-monitoring routines, including the monitoring of potential sales practice misconduct. That means firms could refine their own "red flags" to protect customer interests—possibly before FINRA does so with the same information.
- Firms could potentially use customer investment data to understand on a holistic or enterprise-wide level where there are opportunities to realign portfolios so that they better meet customers' investment goals.

In effect, firms could treat CARDS as an external mandate to build an internal tool with large potential benefits. This could be advantageous for the firms whose present data collection systems are most in need of refinement. For the current leaders in customer and transaction data, however, CARDS is a mandate for everyone else to start catching up.

### The compliance task

More than 140 FINRA member firms and other entities submitted reactions to the CARDS concept proposal during a formal comment period that originally expired on February 21, 2014, and was extended to March 21, 2014. The updated proposal is in the early stage of its comment period.

Many of the initial comments questioned the need for the system, warned of privacy concerns associated with its use, and said it will likely impose a costly burden on firms required to comply with it. Outside the formal commentary, some legislators, such as Congressman Scott Garrett, chairman of the Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises, and media voices have expressed similar views.<sup>2</sup>

The contrary view supported by regulators—that CARDS may bear a silver lining in the form of enhanced market intelligence—has been less prevalent, but it is beginning to be advanced as many in the marketplace see the adoption of CARDS as inevitable.

CARDS presents itself as a technology challenge, and the firms that excel in adapting to this coming change would be the ones that have already begun to address it on those terms. However, for the moment, CARDS is also a regulatory and legal uncertainty. Following the FINRA process that will take the proposed rule over the final few steps to implementation is critical for anyone who would have to live under the resulting requirements.

To implement CARDS, should the rule become regulation, firms may have to develop new technology infrastructures to collect and transmit the required data from their own accounts and on behalf of other FINRA member firms they are responsible for clearing. In some instances, these data investments will be unique. In others, they may resemble or duplicate structures that some firms have or will put in place to comply with the Securities and Exchange Commission's (SEC) Consolidated Audit Trail (CAT) requirement for broker-dealers or with the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) requirement for firms affiliated with large bank holding companies. It is possible that firms would be able to consolidate their compliance with more than one of these rules using the same systems, but tailored to the individual rule requirements.

The challenges of CARDS implementation would be broad and they would include, but not be limited to:

- Data standardization.
- Creation of cohesive systems to transmit authentic data within introducing and clearing brokers.
- The cost of new infrastructure and staff.

Firms active in the securities market already have tailored processes and technology infrastructure for maintaining and reporting customer data (e.g., National Association of Security Dealers' (NASD) Order Audit Trail System (OATS) reporting, FINRA's Electronic Blue Sheets). Under CARDS, they would have to standardize those processes and platforms according to FINRA specifications. They would also need to consolidate detailed transaction data from multiple systems and functions, including the collection of additional customer information from introducing firms, although the account information data required to be reported by carrying or clearing firms would be more limited under the updated proposal. This is one basis for some industry commenters' concerns about customer data confidentiality.

Firms that would be required to comply with both CARDS and CAT may need to assess the apparent overlap between the two requirements, and then consider whether they can consolidate or integrate the production of these new data sets.

### Distinguishing CARDS from similar requirements

CARDS bears some functional similarity to another securities regulation adopted in 2012: the SEC's Rule 613, which requires the creation of a CAT. In published comments, some industry leaders have questioned whether both rules are necessary.

CAT requires FINRA and the national securities exchanges to develop a system that will collect and identify transactions that involve an exchange-listed security in a US market. The rule implementation process is currently at the stage of identifying a contractor to build the necessary information technology system to serve as the centralized CAT processor. Six entities are finalists, including FINRA itself.

Assuming CARDS will go into effect, it will be important for industry decision-makers to understand similarities and differences between both CARDS and CAT. Figure 1 summarizes some of those differences and similarities.

<sup>2</sup>Scott Garrett, Garrett: *FINRA CARDS Proposal Short of a Full Deck*, <http://garrett.house.gov/media-center/press-releases/garrett-finra-cards-proposal-short-of-a-full-deck>, accessed October 14, 2014.

CARDS vs. CAT	Regulatory focus	Information collected	Considerations for both
<p><b>CARDS</b></p> <p>Source: FINRA Regulatory Notices 13-42 and 14-37</p>	<ul style="list-style-type: none"> <li>Retail customer and sales practice oriented with a focus on business conduct</li> <li>Enhances FINRA's abilities to identify excessive commissions, churning, markups, and mutual fund switching</li> </ul>	<ul style="list-style-type: none"> <li>All purchase and sales information in retail account across all products, including:               <ul style="list-style-type: none"> <li>Account profile information (excluding PII)</li> <li>Account activity &amp; holdings</li> <li>Account balances</li> <li>Security reference information</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Data security and privacy</li> <li>Resource commitments and financial costs to develop, implement, and maintain</li> <li>Increased regulatory scrutiny of activity</li> <li>Emphasize need for robust infrastructure for data retention and flexible trade data repositories</li> <li>Regulators and broker-dealers will be able to utilize information to be preventive and proactive</li> </ul>
<p><b>Consolidated Audit Trail</b></p> <p>Source: SEC Rule 613</p>	<ul style="list-style-type: none"> <li>Market place conduct and trading oriented</li> <li>Enhances regulators' abilities to monitor and analyze trading data to identify prohibited activities, such as insider trading and market manipulation</li> </ul>	<ul style="list-style-type: none"> <li>For all exchange-listed equities and equity options in all US markets, every:               <ul style="list-style-type: none"> <li>Order</li> <li>Order cancellation</li> <li>Order modification</li> <li>Trade execution</li> <li>Associated customer with each order</li> </ul> </li> </ul>	

Although many technology planners have considered these similarities as “overlap” between the two data regimes, other strategic leaders have called this “synergy,” as these data sets support a holistic view of broker-dealer activities. CAT focuses on the order lifecycle (to help regulators determine overall market structure) and CARDS focuses on executed trades (with the stated goal of enhancing investor protection) with some data attribute overlap between them. As such, there does appear to be some potential for efficiency in considering the two rules as part of a unified strategy. If a future phase of CAT expands beyond secondary market transactions in National Market System (NMS) stocks and options to focus on OTC securities as well, this overlap may become larger.

**The CARDS timeline**

Since its initial release as a proposed rule, CARDS has changed in both form and timing. Plans for a pilot rollout in early 2015 have been postponed. The most recent comment period for the rule proposal closed on December 1, 2014, and FINRA often revises rule proposals based on the comments received. FINRA's estimated timeline, once a final proposed rule has been submitted to the SEC for approval, anticipates that Phase 1 would be implemented nine months post SEC approval and Phase 2 would be implemented 15 months post SEC approval.

FINRA is engaged in an analysis of the impact CARDS would have on the securities industry from an economic point of view. As such, FINRA staff is continuing to collect and assess information about the costs, benefits, and other economic impacts of CARDS from a variety of sources, including the 6 pilot and 11 sounding board firms, commenters, and FINRA internal sources. The initial economic impact assessment indicated the following:

- The preliminary estimates of cost to develop CARDS systems and procedures range from approximately \$390,000 to \$8.33 million.<sup>3</sup>
- The annual cost to maintain these systems ranges from approximately \$76,000 to \$2.44 million.<sup>4</sup>
- The median estimates of cost to develop and annual cost to maintain CARDS systems and procedures are approximately \$1.68 million and \$400,000, respectively.<sup>5</sup>

**How Deloitte can help**

Deloitte recognizes that our basic responsibility is to help clients protect their value by effectively complying with these new regulatory requirements. But our foremost responsibility is to help our clients build value and create competitive advantage. By working together to identify opportunities for predictive capabilities and enhanced real-time monitoring, we can help turn the “big data” gathered to comply with CARDS into improved performance and enhanced compliance.

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<sup>3</sup> Financial Industry Regulatory Authority (FINRA), Regulatory Notice 14-37: *Comprehensive Automated Risk Data System*, September 2014, page 19.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

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