Tech Xplore

Regulatory tech costs can have benefits, too

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RegTech might be one of the biggest new industries you've never heard of. The term most often refers to technology that helps companies comply with government regulations. In 2028, businesses are projected to spend $208 billion on RegTech, according to Juniper Research. That's up from $30 billion in 2020.

While they may view these costs as highly burdensome, new research from Zachary Kowaleski, assistant professor of accounting at Texas McCombs, finds that such investments can have significant operational benefits. Examining their impact on broker-dealers, who trade securities for themselves as well as for clients, Kowaleski says, RegTech is "not just a drain on the economy."

That's because the investments created new potential for company data, which they could use to improve customer relations and monitor employee behavior. Although they spent 24% more on information technology, they saw a 4% decline in:

- Overall customer complaints.
- Employee misconduct complaints.
- Incidents causing at least $5,000 in damages.

Having the technology in place paid off even more after the COVID-19 pandemic struck, and many employees worked from home. "Companies were better positioned to protect customers, even though supervisors couldn't monitor employees in person," Kowaleski says.

But RegTech didn't help everyone, the study found. Its benefits accrued mostly to large broker-dealers who compete on scale. Its costs weighed more heavily on small companies, where profits dropped the most. On average, budget increases were more than 10 times the apparent savings, Kowaleski says.

His study focused on a 2014 Securities and Exchange Commission regulation, enacted after a rash of Ponzi schemes, such as Bernard Madoff's swindling of $50 billion from his investors.

The new rule imposed stringent reporting and audit requirements on carrying broker-dealers—those, like Madoff, who hold assets for their

customers. They had to demonstrate, moment by moment, that they had adequate net capital and weren't commingling company assets with customer assets.

The new requirements were stricter than those for non-carrying broker-dealers, who don't hold their clients' money or securities.

With Ben Charoenwong of the National University of Singapore, Alan Kwan of Hong Kong University, and Andrew G. Sutherland of the Massachusetts Institute of Technology, Kowaleski looked at data reported to the SEC by 3,317 broker-dealers for three years before and after the rule. The companies were both carrying and non-carrying, allowing comparisons of the rule's effects.

Carrying broker-dealers, the study found, spent much more on RegTech than their counterparts.

- They were 16% more likely to invest in compliance software.
- Their IT-based compliance jobs grew by 10%.
- Smaller companies were hit the hardest, with budgets increasing 30% while profits fell 24%.

Although the paper doesn't look at the rule's central purpose of protecting customers, Kowaleski notes that it's important. SEC rules on capitalization and segregating customer assets could have saved investors by restraining the rampant fraud at FTX Trading, the now-bankrupt cryptocurrency exchange co-founded by Sam Bankman-Fried. However, because cryptocurrencies weren't considered securities, FTX was not subject to SEC oversight.

That's another reason that RegTech costs may appear massive and be costly to companies, Kowaleski says, "but they're not just waste."

The research is published in the *Journal of Financial Economics*.

More information: Ben Charoenwong et al, RegTech: Technology-driven compliance and its effects on profitability, operations, and market structure, *Journal of Financial Economics* (2024). DOI: 10.1016/j.jfineco.2024.103792

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