Katten

Financial Markets Litigation and Enforcement

Katten's Annual Financial Markets Regulation Crystal Ball – A Look Back at 2020 and a Look Forward to 2021

February 2021

Introduction

The year 2020 was a uniquely challenging year, to say the least. Notwithstanding a global pandemic that forced the activation of business disruption plans and a remote work revolution, an economic recession that required unprecedented Congressional intervention, and significant political and social unrest, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC, and together with the CFTC, the Commissions) addressed these challenges by adopting several pivotal rulemakings, bringing record numbers of enforcement actions and issuing much needed relief to address the COVID-19 pandemic and a myriad of market-related crises.

With a new administration and Congress, 2021 will likely continue to be quite busy for both agencies. In short, the Commissions are expected to largely focus on: rule implementation for regulations, including derivatives regulatory reform under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank); environmental, social and corporate governance (ESG) issues (e.g., climate change); continued guidance involving cryptoassets; and investigations and enforcement actions to protect the integrity of markets and interests of consumers and investors.

The following summary provides both retrospective and prospective analyses of the Commissions' regulatory and enforcement agendas. The summary also highlights a number of regulatory and enforcement actions taken by the Commissions and other US regulators in the cryptoasset space in 2020.

CFTC and NFA

2020 – A Year in Review

1. COVID-19 Pandemic

In response to the COVID-19 pandemic, the CFTC took action through official rulemakings and temporary, targeted no-action relief to address anticipated compliance challenges because of the displacement of personnel. These efforts helped to facilitate orderly trading and liquidity in the US derivatives markets and allowed market participants to implement social distancing measures. In particular, CFTC staff issued temporary relief from various requirements for several types of CFTC registrants and registered entities, such as requirements to generate records of oral communications, recordkeeping requirements with respect to the date and time of transaction execution by time stamp or other timing devices, and timing requirements for swap execution facilities (SEFs) to submit annual compliance reports. As the pandemic continued throughout 2020, the CFTC granted further limited extensions and continuations of such relief.[1]

Notably, the CFTC granted no-action relief[2] until March 31, 2021, to any futures commission merchant (FCM) that encountered difficulties complying with conditions set forth in a separate advisory and no-action letter from 2019 concerning the treatment of separate accounts with the same beneficial owner. The 2019 guidance had

[1] *See* https://www.cftc.gov/coronavirus for more details on the CFTC's response to the pandemic.

[2] CFTC No-Action Letter No. 20-28 (Sept. 15, 2020).

confirmed that, consistent with CFTC Rule 1.56(b), FCM customer agreements must not "(i) preclude the FCM from calling the beneficial owner of an account for required margin; (ii) in the event the beneficial owner fails to meet the margin call, preclude the FCM from initiating a legal proceeding to recover any shortfall; or (iii) otherwise guarantee a beneficial owner against, or limit a beneficial owner's, loss."[3] The 2019 guidance also provided conditional relief that allowed FCMs subject to express conditions to treat separate accounts of a single customer as if they were accounts of separate entities under business as usual circumstances.[4]

2. Transition From LIBOR

The UK's Financial Conduct Authority (FCA), which is responsible for regulating the London Interbank Offered Rate (LIBOR), announced that the publication of LIBOR is not guaranteed beyond 2021. LIBOR has been used as a reference rate for more than $200 trillion of financial contracts in the cash and derivatives markets. For several years, the industry has been preparing for the permanent cessation of LIBOR and transition to different reference rates.

To assist market participants in connection with this effort, the CFTC issued a series of no-action letters in 2020 intended to assist swap dealers and market participants with the industry-wide transition from LIBOR and other interbank rates to alternative replacement rates.[5] Specifically, the CFTC provided time-limited relief to swap dealers from various eligibility requirements, the trade execution requirement and the swap clearing requirement.[6]

3. Climate Change

On the issue of climate change, the Climate-Related Market Risk Subcommittee — a subcommittee of the CFTC's Market Risk Advisory Committee (MRAC) — voted on September 9, 2020, to publish a report ("Report") warning of climate change's potential adverse effects on the stability of the US financial system.[7] The publication marked the first time a US financial regulator had ever supported the release of a report or statement highlighting the risks of climate change from a financial stability perspective. The Report explained the connection between the economy and climate change and embraced two fundamental conclusions: (1) US financial regulators must acknowledge, address, and accept that climate change poses risks to the US financial system; and (2) the financial community should be proactive and offer continuous involvement by proposing solutions to manage as well as mitigate climate risks using innovation.

4. Rulemakings Regarding Capital Requirements for Swap Dealers, Cross-Border Rules for Swaps, and Position Limits on Referenced Contracts

Of note in 2020, the CFTC adopted several final rules that completed its major Title VII Dodd-Frank rulemaking efforts. In particular, the CFTC adopted rules concerning: (1) minimum capital requirements for swap dealers (SDs) and major swap participants (MSPs); (2) the cross-border application of certain of its

[3] CFTC No-Action Letter No. 19-17 (July 10, 2019).

[4] *Id.*

[5] *See* CFTC No-Action Letter No. 20-23; 20-24; 20-25 (Aug. 31, 2020).

[6] *See id*.

[7] CFTC Market Risk Advisory Committee, Climate-Related Market Risk Subcommittee, *Managing Climate Risk in the U.S. Financial System* (2020). *See also* Katten's advisory on this topic, "A Call to Internalize Greenhouse Gas Cost Externalities: CFTC Subcommittee Publishes First-of-Its-Kind Report Regarding Climate Change's Impact on Financial Markets.".

swap regulations; and (3) federal position limits for 25 core futures contracts (as well as any derivatives contracts referencing those 25 core futures contacts).[8]

Capital Rules for SDs. The CFTC's final capital rules, effective November 16, 2020, imposed minimum capital requirements and financial reporting requirements on SDs that are not subject to a prudential regulator's oversight.[9] Specifically, the final capital rule allows SDs that are not registered FCMs to elect one of three alternatives in order to be in compliance with the CFTC's capital rules: (1) the net liquid assets capital approach; (2) the bank-based capital approach; or (3) the tangible net worth approach. The tangible net worth approach is specifically available as a capital alternative to SDs that are predominantly engaged in non-financial activities. In addition, the final capital rule amended existing capital requirements for FCMs to provide specific capital deductions for market risk and credit risk for swap and security-based swap (SBS) transactions entered into by an FCM.

Final Cross-Border Swaps Rules. The CFTC adopted final rules that, among other things, clarified the cross-border application of the SD registration thresholds and compliance requirements for non-US-domiciled SDs.[10] In essence, the final rules supersede parts of the CFTC's existing interpretive guidance and policy statement on this subject. The vote on the final rule was relatively contentious, resulting in a party-line split of three CFTC commissioners (including former CFTC Chairman Heath Tarbert) in favor and two commissioners opposed. The final rule's supporters emphasized the need for a measured and territorial approach to swaps regulation, which protects principles of international comity in light of developments abroad that have led to the adoption of comparable swaps regulatory regimes in other major countries. Critics of the final rule argued that it represents a dangerous retreat from the CFTC's 2013 cross-border interpretive guidance. While the final rule became effective on November 13, 2020, compliance with several provisions in the final rule is not required under September 14, 2021.

Among other regulatory amendments, the rule also addressed: (1) the handling of non-US SD transactions with other non-US persons that are arranged, negotiated or executed by personnel or agents located in the United States (so-called "ANE transactions"); (2) the "US Person" definition and the definitions of other key terms; (3) the CFTC's revised approach towards determining whether collective investment vehicles are US Persons; (4) the narrower treatment of guarantees in determining the scope of US persons; (5) changes to the methodology for determining which swaps count towards the SD registration *de minimis* threshold; and (6) the re-categorization and application of swap requirements to cross-border swap transactions.

Position Limits. Ending almost a decade-long saga, the CFTC adopted its final position limits rule on October 15, 2020. The final rule imposes federal speculative position limits for 25 core futures contracts and

[8] While we have chosen to highlight these three rulemakings, the CFTC released a number of other proposed and final rules, including with respect to swap reporting (see relevant Katten advisory, "Time for a Change: The CFTC Adopts Extensive Amendments to Swap Reporting Regulations to Improve Data Quality") and commodity broker bankruptcies (see relevant Katten advisory, "The CFTC Adopts Comprehensive Amendments to Its Bankruptcy Rules").

[9] 85 Fed. Reg. 57,562. *See also* Katten's *Corporate & Financial Weekly Digest* summary on this topic, "CFTC Adopts Final Capital Requirements for Swap Dealers." The CFTC's final capital rules also apply to MSPs not subject to a prudential regulator's oversight; however, to date, there are no registered MSPs.

[10] 85 Fed. Reg. 56,924. *See also* Katten's advisory on this topic, "A Promise Made, a Promise Kept: CFTC Adopts Final Cross-Border Swaps Rules Largely as Proposed." The final cross-border swaps rule also establishes registration thresholds and compliance requirements for MSPs; however, as noted above, to date, there are no registered MSPs.

for any futures contracts and options on futures contracts that are linked to those contracts, including "economically equivalent swaps."[11] The 25 core futures contracts include nine legacy agricultural contracts that are already subject to federal position limits[12] and 16 additional non-legacy contracts.[13] The nine legacy contracts are subject to federal position limits that apply in the spot month, any single non-spot month and all months combined, while the 16 non-legacy contracts are now subject to federal spot month limits only. The limits on these nine legacy contracts become effective on the effective date of the final rule, which is March 15, 2021.

Of note, the new rules also change the bona fide hedge exemption to the limits by, among other things, expanding the list of enumerated bona fide hedges. An enumerated bona fide hedge exemption is "self-effectuating" for federal position limit purposes and a market participant that qualifies for an enumerated bona fide hedge would not be required to request prior approval from the CFTC in order to hold a hedge position in excess of a federal position limit. However, the practical benefit of this "self-effectuating" exemption is limited given that market participants may still need to request an exemption from the relevant exchange for any limits set by the exchange.

The CFTC also approved an expedited regime for market participants to exceed federal position limits for a non-enumerated bona fide hedging transaction or position. Under this regime, a market participant may choose whether to apply directly to the CFTC or, alternatively, apply indirectly to the CFTC through the applicable exchange. If any exchange approves the non-enumerated hedge exemption, the CFTC will generally have 10 days to reject the exchange's determination, after which the hedge exemption would be valid for both exchange and CFTC purposes.[14]

Finally, the final position limits rule enhances the roles played by exchanges. In particular, under the final rules, in addition to setting limits and granting exemptions (as noted above), exchanges must begin collecting significantly more data from market participants that claim exemptions since the final rule eliminates the CFTC's collection of information using Form 204 (State of Cash Positions in Grains) and portions of Form 304 (State of Cash Positions in Cotton).

5. CFTC Enforcement Activity in 2020

Despite the COVID-19 pandemic, the CFTC filed the most enforcement actions in a single year in its history in 2020, as it initiated 113 investigations and ordered monetary relief exceeding $1.3 billion. Nearly half of the enforcement actions involved retail fraud; 24 involved protection of customer funds, supervision and

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[11] 86 Fed. Reg. 3236. *See also* Katten's advisory on this topic, "CFTC Adopts New Rules on Position Limits for Derivatives."

[12] The nine legacy agricultural contracts are: CBOT Corn (and Mini-Corn) (C), CBOT Oats (O), CBOT Soybeans (and Mini-Soybeans) (S), CBOT Wheat (and Mini-Wheat) (W), CBOT Soybean Oil, (SO), CBOT Soybean Meal (SM), MGEX Hard Red Spring Wheat (MWE), CBOT KC Hard Red Winter Wheat (KW), and ICE Cotton No. 2 (CT). *See* 17 CFR 150.2.

[13] The 16 non-legacy contracts are: CBOT Rough Rice (RR), ICE Cocoa (CC), ICE Coffee C (KC), ICE FCOJ-A (OJ), ICE Sugar No. 11 (SB), ICE Sugar No. 16 (SF), CME Live Cattle (LC), COMEX Gold (GC), COMEX Silver (SI), COMEX Copper (HG), NYMEX Platinum (PL), NYMEX Palladium (PA), NYMEX Henry Hub Natural Gas (NG), NYMEX Light Sweet Crude Oil (CL), NYMEX New York Harbor ULSD Heating Oil (HO), NYMEX New York Harbor RBOB Gasoline (RB). *See* 86 Fed. Reg. 3236.

[14] In the interim, once an exchange approves a non-enumerated hedge exemption, a market participant could exceed the federal position limits during the CFTC's 10 business-day review period. If the CFTC subsequently denies the exemption, the market participant would have to liquidate positions in excess of the speculative position limit within a commercially reasonable amount of time.

financial integrity; and 16 involved manipulative conduct and spoofing. A few case enforcement actions of note are described below.

***In the Matter of J.P. Morgan Securities LLC*.** Most notably, the CFTC settled an action with JPMorgan Chase & Co. (JPMorgan) relating to alleged spoofing and manipulative conduct, pursuant to which JPMorgan agreed to pay a total of $920 million in monetary relief (including restitution, disgorgement and a civil penalty) — "the largest amount of monetary relief ever imposed by the CFTC."[15] The CFTC claimed that, over a period of eight years, JPMorgan traders in the precious metals futures market and in the US Treasury futures market placed hundreds of thousands of orders to buy and sell futures contracts with the intent to cancel them before execution. As alleged, the traders intentionally sent false signals of supply or demand designed to deceive market participants.

***In the Matter of The Bank of Nova Scotia*.** In two separate enforcement actions, the CFTC filed and settled charges against the Bank of Nova Scotia (BNS) "for [purported] spoofing and making false statements … as well for swap dealer compliance and supervision violations and additional false statements," imposing $127.4 million in fines and equitable relief.[16] The CFTC claimed that BNS precious metals traders placed orders to buy or sell certain gold and silver futures contracts traded on the Commodity Exchange, Inc. with the intent to cancel the orders before execution and that the traders acted with the intent to manipulate market prices.

***U.S. Commodity Futures Trading Commission v. Monex Credit Company*.** The CFTC charged Monex Deposit Company and its affiliates (Monex) on September 6, 2017, for allegedly "defrauding thousands of retail customers out of hundreds of millions of dollars, while executing thousands of illegal, off-exchange leveraged commodity transactions."[17] After the US Court of Appeals for the Ninth Circuit ruled in 2019 that the CFTC's charges of fraud and illegal off-exchange commodity trading could proceed, the US Supreme Court denied a petition for a writ of certiorari by Monex on June 29, 2020, refusing to block the $290 million civil enforcement. The denial of certiorari all but confirmed the CFTC's claimed sweeping authority to use Commodity Exchange Act Section 6(c)(1), which prohibits "any manipulative or deceptive device of contrivance,"[18] as a catch-all prohibitionfor both fraud and manipulation.

2021 Futures and Derivatives Regulatory and Enforcement Forecast

1. New CFTC Leadership and Its Regulatory Agenda

With the change in administration, the CFTC is now led by Acting Chairman Rostin Benham, who has served as a commissioner at the agency since 2017. Given the leadership role he has played as head of the MRAC and sponsor of the MRAC subcommittee's Report (as discussed above), climate change and other ESG issues will likely be front and center in the CFTC's regulatory agenda in 2021. This focus will continue once the Biden Administration nominates a new chair.

[15] CFTC Press Release No. 8260-20 (Sept. 29, 2020).

[16] CFTC Press Release No. 8220-20 (Aug. 19, 2020).

[17] CFTC Press Release No. 8192-20 (June 30, 2020).

[18] 7 U.S.C. § 9(1).

Additionally, it is expected that the agency will spend much of 2021 and beyond providing interpretive guidance and other relief to market participants in an effort to smooth out the implementation of those final 2020 rulemakings. Further, the CFTC will likely continue to coordinate and work with its sister agency, the SEC, as the SEC implements its security-based swaps regime (as discussed below). The Commissions will likely continue their efforts to further harmonize the swaps and security-based swaps regimes.

2. Enforcement Trends

The CFTC's Division of Enforcement (DOE) released its annual report for fiscal year 2020. In the report, the DOE noted that, moving forward, it will focus its enforcement efforts on the following priorities: "(1) preserving market integrity; (2) protecting customers; (3) promoting individual accountability; and (4) coordinating with other regulators and criminal authorities on parallel matters."[19] In particular, the DOE stressed its focus on detecting fraud, manipulation, spoofing and disruptive trading. In 2021, the CFTC has continued, and likely will continue, to maintain its more recent aggressive posture towards investigating and penalizing alleged misconduct in its markets.

3. National Futures Association (NFA) Initiatives

NFA's 2021 initiatives appear largely focused on implementation by SDs of compliance rules adopted or amended in 2019 and 2020 that have or will take effect in 2021.

Compliance Rule 2-9(d). The NFA adopted an interpretive notice to NFA Compliance Rule 2-9(d) in November 2020 concerning SDs' supervision of the use of marketing materials.[20] In general, Rule 2-9(d) places a continuing obligation on each SD to supervise diligently its employees and agents in the conduct of their swap activities. This notice, effective May 31, 2021, requires each SD member to "implement and enforce a written supervisory program that is designed to reasonably ensure that marketing materials comply with all applicable and NFA and CFTC requirements."[21] To ensure compliance and to prevent fraudulent or deceptive practices, each SD member must maintain a supervisory program outlining procedures for training, recordkeeping and review as well as approval of marketing materials.

Swaps Proficiency Exam. On March 25, 2019, NFA amended NFA Bylaw 301 and NFA Compliance Rule 2-24 and adopted a new interpretive notice, which require all individuals registered as associated persons (APs) at FCMs, IBs, commodity pool operators and commodity trading advisors who engage in swaps activity subject to the CFTC's jurisdiction, as well as individuals acting as APs at SDs, to successfully complete a swaps proficiency requirements.[22] The compliance date for successful completion of the requirements was January 31, 2021.

Individuals who did not satisfy the requirements by the compliance date are now unable to engage in swaps activities until they have done so. To the extent any individual newly seeks to engage in swaps activity, he or

[19] CFTC Press Release No. 8323-20 (Dec. 1, 2020).

[20] *See* NFA, Notice I-20-48 (Dec. 22, 2020). This rule also applies to MSPs; however, to date, there are no registered MSPs.

[21] *Id*.

[22] NFA, Notice I-19-09 (March 25, 2019).

she must first satisfy NFA's swaps proficiency requirements prior to being approved as a swap AP at an NFA Member FCM, IB, CPO or CTA or acting as an AP at an SD.

SEC and FINRA

2020 – A Year in Review

1. Rules on Advertising, Mutual Fund Use of Derivatives Valuations and ETFs

The SEC amended the Investment Advisers Act of 1940 (Advisers Act) in December 2020 to modify the rules that govern investment adviser marketing and advertising. The new rule updates the long-standing advertising and solicitation regimes applicable to investment advisers, which had not been amended for decades. Notably, the new marketing rule "will require advisers to standardize certain parts of a performance presentation to help investors evaluate and compare investment opportunities," and advertisements that include third-party ratings "will be required to include specific disclosures to prevent them from being misleading."[23] In addition, the amended rule will permit the use of testimonials and endorsement subject to certain conditions.

In another regulatory update, the SEC amended the Investment Company Act of 1940 (Investment Company Act) and streamlined the framework for derivatives use by registered investment companies, including mutual funds, exchange-traded funds (ETF) and closed-end funds as well as development companies (collectively, "funds").[24] In general, the Investment Company Act restricts the ability of registered entities "to engage in transactions that involve potential future payments obligations, including obligations under derivatives such as forwards, futures, swaps and written options."[25] However, the new rule allows funds to enter into the aforementioned transactions, provided that they comply with certain conditions designed to protect customers.

The SEC also adopted a new rule in 2019 to modernize the regulation of ETFs by "establishing a clear and consistent framework for the vast majority of ETFs operating today."[26] The rule became effective as of December 23, 2019 and the SEC set a compliance date of December 23, 2020. The rule permits ETFs that satisfy certain transparency, policies and procedures, and disclosure requirements to operate within the scope of the Advisers Act and "come directly to market without the cost and delay of obtaining an exemptive order."[27]

2. 529 Plan Share Class Initiative

The Financial Industry Regulatory Authority (FINRA) launched its 529 Plan Class Initiative (529 Initiative) in 2019 to promote firms' compliance with the rules governing 529 saving plan share class recommendations and promptly compensate all harmed customers.[28] The 529 Initiative encouraged firms to review their supervisory systems regarding such recommendations, self-report violations, create or demonstrate all past or future corrective action plans, and provide FINRA with intended remedial plans for harmed customers.

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[23] SEC Release No. 2020-334 (Dec. 22, 2020).

[24] SEC Release No. 2020-269 (Oct. 28, 2020).

[25] *Id*.

[26] SEC Release No. 2019-190 (Sept. 26, 2019).

[27] 84 Fed. Reg. 57162.

[28] "FINRA Launches New Initiative for Member Firms to Self-Report 529 Savings Plan Violations" FINRA News Release (Dec. 30, 2020), https://www.finra.org/media-center/newsreleases/2020/finra-announces-interim-progress-voluntary-529-plan-share-class.

In an interim progress update on December 30, 2020, FINRA said its 529 Initiative has resulted in more than $2.7 million in restitution, largely arising from settlements with Morgan Stanley Smith Barney LLC (MSSB) and B. Riley Wealth Management Inc. (BRWM).[29] MSSB agreed to pay approximately $1.7 million in restitution to customers who FINRA claimed incurred excess fees in their 529 plan accounts, after a FINRA finding that the firm violated Municipal Securities Rulemaking Rule G-27 regarding supervision. BRWM agreed to pay approximately $250,000 in restitution after purportedly failing to have a reasonable 529 plan supervisory system.

3. Enforcement

The SEC recorded a significant year in terms of enforcement despite having to initiate and file investigations in a telework environment for much of the year. The SEC filed a total of 715 enforcement actions, which included 405 stand-alone enforcement actions, 180 follow-on proceedings and 130 proceedings to deregister public companies. Specifically, the SEC recorded a record-breaking number of monetary remedies in 2020, resulting in $3.589 billion in disgorgement — an increase from the $3.248 billion in disgorgement in 2019.[30]

The SEC's efforts in seeking disgorgement in 2020 were partly buoyed by the National Defense Authorization Act (NDAA). The NDAA, signed into law on January 1, 2020, granted the SEC the statutory authority to seek disgorgement in federal enforcement actions and set a 10-year statute of limitations (doubling the prior statute of limitations period) on SEC disgorgement actions for insider trading, fraud and any other provision of securities laws for which scienter must be established.[31] However, on June 22, 2020, the Supreme Court in *Liu v. SEC* limited disgorgement in a significant way. In *Liu*, the Court ruled that a disgorgement award is permissible equitable relief only if the award does not exceed a wrongdoer's net profits.[32]

In the Matter of Bluecrest Capital Management Limited. The SEC settled an action with Bluecrest Capital Management (Bluecrest) relating to purported inadequate disclosures, material misstatements and misleading omissions, pursuant to which Bluecrest agreed to pay a total of $170 million in monetary relief (including disgorgement, prejudgment interest and civil penalty). The SEC claimed that Bluecrest moved its top traders from its flagship client fund to a proprietary fund and replaced those traders with an underperforming algorithm. Bluecrest then failed adequately to disclose, and made misstatements and omitted to state facts concerning the proprietary fund's existence, the movement of traders, the algorithm and related conflicts of interest, to clients and prospective clients.[33]

In the Matter of Gilder Gagnon Howe & Co. LLC. The SEC settled an action with Gilder Gagnon Howe and Co. LLC (GGHC), a dually registered investment adviser and broker-dealer, for $1.7 million. The SEC

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[29] "FINRA Announces Interim Progress of Voluntary 529 Plan Share Class Initiative" FINRA News Release (Jan. 28, 2019), https://www.finra.org/media-center/newsreleases/2020/finra-announces-interim-progress-voluntary-529-plan-share-class.

[30] *SEC Division of Enforcement: 2020 Annual Report* (Nov. 2, 2020), https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

[31] National Defense Authorization Act, H.R. 6395 (Jan. 1, 2021).

[32] 140 S. Ct. 1936 (2020).

[33] SEC Press Release No. 2020-308 (Dec. 8, 2020).

alleged that GGHC failed to conduct reviews of its accounts for excessive commissions and trading as required by its policies and procedures. The reviews were designed to monitor the firm's trading strategy.[34]

***In the Matter of Ares Management LLC*.** The SEC settled an action with Ares Management LLC (Ares), a Los Angeles-based private equity firm and registered investment adviser, relating to Ares' purported "failure, during 2016, to implement and enforce certain of its written policies and procedures reasonably designed … to prevent the misuse of potentially material nonpublic information … that it had obtained."[35] The SEC charged that Ares' compliance policies "failed to account for the special circumstances presented by having an employee serve on the portfolio company's board while that employee continued to participate in trading decisions regarding the portfolio company."[36]

4. Regulation Best Interest (Reg BI)

By adopting Reg BI, the SEC has imposed a new general standard of conduct on broker-dealers, providing enhanced protections for retail customers by requiring broker-dealers and their associated persons to act in the best interest of the retail customer when recommending an investment strategy or securities transaction.[37] Reg BI imposes specific obligations on broker-dealers across four areas of focus: (1) disclosure; (2) care; (3) conflict of interest; and (4) compliance. The SEC set June 30, 2020 as the date for compliance.[38]

In general, under the disclosure obligation, a broker-dealer must disclose all material facts related to the scope and terms of the relationship with the retail customer. This includes information concerning: (1) the capacity of the financial entity providing services; (2) the material fees and costs that apply to the retail customer's transactions; and (3) the type and scope of services provided to the retail customer.

Under the care obligation, a broker-dealer must exercise reasonable care when making a recommendation to a retail customer. While this new care obligation retains the FINRA Rule 2111 suitability requirement that a recommendation must be founded upon a reasonable basis, which considers customer specific and quantitative factors, it imposes additional obligations that include that the recommendation be in the best interest of the retail customer.

The conflict of interest obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to: (1) identify all conflicts; (2) disclose material conflicts; (3) mitigate conflicts that can be adequately disclosed; and (4) eliminate conflicts that cannot be mitigated.

Further, the compliance obligation mandates that a broker-dealer establish, maintain and enforce written policies designed to achieve compliance with Reg BI as a whole.

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[34] *In the Matter of Gilder Gagnon Howe & Co. LLC* (Sept. 17, 2020), https://www.sec.gov/litigation/admin/2020/ia-5582.pdf.

[35] *In the Matter of Ares Management LLC* (May 26, 2020), https://www.sec.gov/litigation/admin/2020/ia-5510.pdf.

[36] SEC Press Release No. 2020-123 (May 26, 2020).

[37] *See* Katten partner Susan Light's article on Reg BI for more information on this development: "Regulation Best Interest: A New Standard of Conduct for Broker-Dealers in Recommendations to Retail Customers," Journal of Financial Compliance, vol. 3, no. 4 (Feb. 21, 2020).

[38] Chairman Jay Clayton, Statement on June 30 Compliance Date for Reg BI (June 15, 2020), https://www.sec.gov/news/public-statement/clayton-compliance-date-regulation-best-interest-form-crs.

On December 21, 2020, the SEC Division of Examinations (formerly the Office of Compliance Inspections and Examinations) announced that beginning in January 2021, its staff "will examine whether broker-dealers have written policies and procedures and systems in place to achieve compliance with [Reg BI]."[39] The exams will focus on firms' compliance with Reg BI's specific requirements, "including those that go beyond suitability standards and require broker-dealers to have a reasonable basis to believe that recommendations are in retail customers' best interests."[40] As such, Reg BI is expected to be an enforcement focus for the SEC and FINRA in 2021.

5. Cybersecurity

Due to the challenges posed by the COVID-19 pandemic, the SEC's Division of Trading and Markets issued temporary relief for broker-dealers on March 16, 2020, from consolidated audit trail (CAT) reporting requirements until May 20, 2020.[41] The SEC also issued a parallel no-action order, granting self-regulatory organizations conditional relief until May 20, 2020, from reporting of certain customer data, including (1) individual social security numbers; (2) dates of birth; and (3) account numbers. In addition, the SEC established a phased CAT reporting timeline for broker-dealers on April 20, 2020, that would allow for equity and options reporting in phases.[42] Critics of CAT remain concerned about the cybersecurity risks it poses, as a single repository of sensitive customer information may put the data at greater risk of being targeted or breached.

The Division of Examinations issued examination observations on January 27, 2020, related to cybersecurity and operational resiliency practices taken by market participants. The observations highlighted examples of best practices and controls that market participants have implemented to safeguard against breaches and respond to future incidents relating to governance and risk management, access rights and controls, data loss prevention, and other high-risk areas.[43] The Division encouraged organizations to reflect on their own cybersecurity practices.

2021 Outlook

1. New Leadership at the SEC and Its Regulatory Agenda

Similar to the CFTC, we expect new leadership at the SEC will result in the agency taking a much different regulatory approach than under the prior administration. On January 21, 2021, President Joseph R. Biden, Jr. designated Allison Herren Lee as Acting Chair of the SEC. Prior to her designation, Acting Chair Lee was one of the agency's Democratic commissioners whose term commenced on July 8, 2019. It is widely anticipated that she will stay in her role as Acting Chair until Gary Gensler is confirmed by the Senate and

[39] Division of Examinations, Statements on Recent and Upcoming Regulation Best Interest Examinations (Dec. 21, 2020), https://www.sec.gov/news/public-statement/examinations-regulation-best-interest-2020-12-21.

[40] *Id*.

[41] SEC No-Action Letter, Consolidated Audit Trail Reporting (Mar. 16, 2020), https://www.sec.gov/divisions/marketreg/mr-noaction/2020/consolidated-audit-trail-reporting-031620.pdf.

[42] SEC Press Release No.2020-92 (Apr. 20, 2020).

[43] OCIE Cybersecurity and Resiliency Observations (Jan. 27, 2020), https://www.sec.gov/files/OCIE Cybersecurity and Resiliency Observations.pdf.

sworn in by the President as the next SEC Chair.[44] The Senate Committee on Banking, Housing and Urban Affairs is scheduled hold a confirmation hearing on Mr. Gensler on March 2.[45]

Mr. Gensler is familiar to many in financial markets as he has previously held roles in government, the private sector and academia. The one role for which he is arguably most known is his role as the former CFTC Chairman under President Barack Obama from 2009 to 2014. While in that role, Mr. Gensler helped the CFTC adopt a record number of rulemakings promulgated under Title VII of Dodd-Frank, which essentially established the first regulatory regime in the world for the oversight of the over-the-counter derivatives market.

Under Acting Chair Lee and anticipated Chair Gensler, the SEC is expected to take a much more pro-investor and consumer posture.[46] In addition, the agency's regulatory agenda will change materially. Already, the SEC has expanded delegations of power to the SEC's divisions to enter into formal orders and ended coordination of settlement requests with requests for waivers of automatic disqualifications. Looking ahead, we anticipate that the agency will focus on: (1) prioritizing climate and other sustainability issues including the expected appointment of an ESG officer; (2) finishing any outstanding Dodd-Frank rulemakings; and (3) taking actions recommended in SEC studies relating to the 2020 financial crisis.

In the sections that follow, we highlight an additional expected SEC focus area in 2021, along with FINRA's 2021 initiatives.

2. Go-Live for Security-Based Swap Regulations

In December 2019, the SEC adopted a package of rule amendments, guidance and a related order to expand and improve the framework for regulating cross-border SBSs, including single-name credit default swaps. As a result of those actions, the compliance date for SEC's SBS regulatory regime is set to occur in October 2021. As a result, SBS entities will be required to register with the SEC and the implementation period for previously adopted SEC SBS rules under Title VII of Dodd-Frank will begin, including regulations relating to uncleared margin requirements for uncleared SBS, capital requirements for large SBS entities, segregation requirements for collateral relating to uncleared SBSs, recordkeeping and reporting requirements, and various business conduct requirements.

Key 2021 compliance dates for security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs) include:

- **August 6, 2021:** "Counting date" for determining the applicability of thresholds in SBS entity definitions.
- **October 6, 2021:** Compliance date for certain rules applicable to SBS entities.
- **November 1, 2021:** Registration applications due from SBSDs that are subject to a registration obligation as of the counting date.

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[44] "Biden is Expected to Name Gary Gensler for SEC Chairman," *The Wall Street Journal* (Jan. 12, 2021), https://www.wsj.com/articles/biden-is-expected-to-name-gary-gensler-for-sec-chairman-11610487023.
[45] Nomination Hearing, US Senate Committee on Banking, Housing, and Urban Affairs, (Feb. 22, 2021), https://www.banking.senate.gov/hearings/02/22/2021/nomination-hearing.
[46] *See id*.

- **December 1, 2021:** Registration applications due from MSBSPs that incur a registration obligation as a result of SBS activities in the quarter ending September 30, 2021.[47]

3. FINRA Initiatives

FINRA released its 2021 Report on FINRA's Examination and Risk Monitoring Program on February 1, highlighting its focus on evaluating member firms for compliance with various FINRA rules.[48] Each year, FINRA releases similar reports on selected regulatory obligations identifying specific considerations for member firm compliance programs, summarizing noteworthy findings from recent examinations and outlining effective practices that FINRA observed during its oversight. This year's FINRA report touched on several key regulatory topics, including, (1) firm operations; (2) financial management; (3) communications and sales with the public; and (4) market integrity. Below, we highlight a couple of points relating to the last two topics.

Communications and Sales with the Public. FINRA adopted Rule 2210 with the specific aim to monitor "communications relating to certain new products. This rule also addressed how member firms must supervise, comply with recordkeeping obligations and address risks relating to new digital communication channels."[49] In general, FINRA Rule 2210 includes "principles-based content standards that are designed to apply to ongoing developments in communications technology and practices."[50] FINRA Rule 2210 requires, among other things, that all communications be based on principles of fair dealing and good faith, be fair and balanced, provide a sound basis for evaluating the facts, and include all material facts or qualifications necessary to ensure that such communications are not misleading.[51]

Best Execution. FINRA Rule 5310 (Best Execution and Interpositioning) has routinely been an area of focus for FINRA during its review of member firms compliance. In particular, FINRA has continued to focus on potential conflicts of interest in order-routing decisions, requiring member firms to develop appropriate policies and procedures for different order and security types. Relatedly, FINRA has increasingly focused on the sufficiency of member firms' reviews of execution quality. In 2020, FINRA conducted a targeted review of member firms that did not charge commissions for customer transactions (i.e., "zero commission" trading) to evaluate the impact that not charging commissions has or will have on member firms' order-routing practices and decisions, and other aspects of member firms' business.

Cryptoassets

1. Regulatory Guidance

There was a flurry of activity in 2020 from US financial regulators with respect to cryptoassets. Of particular importance, in December 2020, the SEC announced that, for a five-year period, it will not take enforcement

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[47] "Key Dates For Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants" (Feb.13, 2020), https://www.sec.gov/page/key-dates-registration-security-based-swap-dealers-and-major-security-based-swap-participants.
[48] FINRA, Report on FINRA's Risk Monitoring and Examination Activities (Feb. 1, 2021), https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf.
[49] *Id*.
[50] *Id*.
[51] *See* FINRA Rule 2210 (Aug. 16, 2019), https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210.

action against a special purpose broker-dealer (SPBD) on the basis that the SPBD "deems itself to have obtained and maintained physical possession or control of customers' fully paid for digital asset securities," subject to certain enumerated conditions and observations.[52]

Further, the CFTC issued an advisory on October 21, 2020, clarifying that FCMs are permitted to accept and hold virtual currency as customer funds subject to certain conditions.[53] The advisory provides guidance to FCMs on how to hold and report certain deposited virtual currency from customers in connection with physically delivered futures contracts or swaps, taking into consideration that "virtual currencies present a higher degree of custodian risk than is beyond what is currently present with depositories."[54]

In another development, the Office of the Comptroller of the Currency announced in an interpretive letter on January 4, 2021, that national banks and federal savings associations may validate, store and record payment transactions on independent node verification networks, such as blockchains, and use stablecoins to engage in payment activities and other bank-approved activities.[55]

2. Enforcement Actions

US financial regulators also brought numerous enforcement actions against both individuals and business entities involved in the offering or transacting of cryptoassets, highlighting the intensifying regulatory scrutiny in cryptoasset activities in recent months.

Most recently, the Department of Treasury's Office of Foreign Assets Control (OFAC) announced it had entered into a settlement with BitGo, Inc. (BitGo) related to 183 alleged violations of multiple sanction programs by BitGo from approximately March 10, 2015, through December 11, 2019, in connection with its processing of digital currency transactions.[56] In the OFAC settlement, BitGo agreed to pay a fine of $98,830 to resolve its potential civil liability on December 30, 2020.

As one of a growing number of enforcement actions against cryptoasset entities for purported securities registration violations, the SEC filed a civil complaint against Ripple Labs, Inc. (Ripple) on December 22, 2020, claiming that the firm and related individual defendants engaged in the unregistered sales of Ripple's XRP digital asset token, which did not qualify for any exemption from registration requirements.[57] Specifically, the SEC claims the defendants sold over 14.6 billion units of XRP since 2013 in exchange for cash or other consideration valued over $1.38 billion.

In a similar action, the SEC obtained a final judgment from a federal district court on October 21, 2020, permanently enjoining Kik from violating the registration provisions of the Securities Act of 1933.[58] The SEC claimed in its complaint that Kik had conducted an unregistered offering of its own digital asset securities

[52] SEC Press Release No.2020-340 (Dec. 23, 2020). This relief is effective 60 days after publication in the *Federal Register*.
[53] CFTC No-Action Letter No. 20-34 (Oct. 21, 2020).
[54] *Id*.
[55] OCIE Interpretive Letter No. 1174 (Jan.2021).
[56] OFAC Enforcement Release (Dec. 30, 2020), https://home.treasury.gov/system/files/126/20201230_bitgo.pdf.
[57] SEC Release No. 2020-338 (Dec. 22, 2020).
[58] SEC Release No. 2020-262 (Oct. 21, 2020).

called “Kin,” which also did not qualify for any exemption from registration requirements. The court found that Kik’s sales of Kin tokens were sales of investment contracts and therefore of securities.

Further, the CFTC announced the filing of a civil complaint on October 1, 2020, in a federal court in the Southern District of New York against five entities, including HDR Trading Limited, and three individuals that own and operate the BitMEX trading platform.[59] The CFTC charged that BitMEX failed to register as a designated contact market, SEF, or FCM, and failed to implement various anti-money laundering procedures as required under the Bank Secrecy Act.

Conclusion

Looking into the 2021 crystal ball, the Commissions are expected to increase their focus on, among other things, issues related to ESG (including the growing impact of climate change on the stability of financial markets), as well as the oversight of cryptoassets and related emerging technologies. Further, the Commissions will likely continue to prioritize their enforcement efforts to protect both the integrity of the markets and consumers. Despite the disruptions caused by the COVID-19 pandemic, 2020 was a busy year, and 2021 is shaping up to be just as busy.

[59] CFTC Release No. 8270-20 (Oct. 1, 2020).

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