Katten

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BROKER-DEALER

2021 Advisory Committee Overview and Engagement Notice

On March 26, the Financial Industry Regulatory Authority (FINRA) published a notice encouraging employees of member firms and other interested persons to apply for upcoming vacancies on FINRA's advisory and ad hoc committees. The Notice provides a general description of the responsibilities of each of FINRA's advisory committees and some of FINRA's ad hoc committees.

While the FINRA Board appoints advisory committee members and FINRA departments create the ad hoc committees, 50 percent of members of the Small Firm Advisory Committee (SFAC) are elected. The Notice advises interested persons to reference FINRA's forthcoming Election Notice, which will provide an overview of the annual election process.

FINRA Special Notice

FINRA Alerts Firms to Recent Increase in ACH "Instant Funds" Abuse

On March 25, the Financial Industry Regulatory Authority (FINRA) issued a notice warning member firms that there appears to be an increase in new customers opening online brokerage accounts and engaging in Automated Clearing House (ACH) "instant funds" abuse to effect securities trading. Some firms provide individuals opening a brokerage account online with instant access to funds, allowing those customers to trade in their online accounts as soon as they enable ACH transactions, without having to wait for the payment to settle. FINRA has observed that the increase in misuse of instant funds is correlated with the recent market volatility driven by social media interest in certain securities.

In light of the increase in instant funds abuse, FINRA has urged firms to evaluate and mitigate the potential financial risk they face. FINRA provides suggestions for how firms could mitigate their financial risk, including, (1) adjusting the amount of available "instant funds;" (2) delaying the ability to place orders with unsettled funds; or (3) enhancing firms account validation processes. In addition, FINRA reminds firms that have experienced instant funds abuse that this activity may trigger a Suspicious Activity Report (SAR) filing obligation, or require the firm to report the transaction to the Financial Crimes Enforcement Network using SARs.

Regulatory Notice 21-14

FINRA Announces Updates to the Interpretation on FINRA's Margin Rule for Day Trading

On March 24, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 21-13 (Notice) announcing updates to its interpretations regarding FINRA's Margin Rule 4210(f)(8)(B)(ii) (Rule). The Rule provides (1) the numerical determination of when a customer is classified as a "pattern trader;" and (2) that if a member knows or has reasonable basis to believe that a customer will engage in pattern day trading, then the pattern day trading margin requirements of the rule will apply.

FINRA announced that the new interpretations of the Rule will afford additional flexibility and guidance for firms by offering an alternative method to calculate the number of day trades when there are multiple purchases and sales of the same security on the same day. Under the new interpretations, instead of counting day trades based on the number of transactions a customer executes to establish or increase a position that is liquidated on the same day, firms may count day trades based on the number of times during the day that the day trading customer changes its trading direction, from buying a particular security to selling it, or from selling a particular security to buying it. In addition, under the new interpretations, a customer may terminate its pattern day trader designation based on the customer's good faith determination by (1) providing written certification that the customer understands the definition of pattern day trading and will not engage in future pattern day trading; or (2) finding that based on the member's application of technological restrictions on customer's trading activity, the customer is effectively prevented from engaging in pattern day trading.

Regulatory Notice 21-13

DERIVATIVES

See "CFTC Staff Issues Guidance Regarding Risk Assessment of Customer Accounts for Futures Commission Merchants" and "NFA Issues Notice Regarding Effective Date of NFA's Swap Dealer Capital Requirements" in the CFTC section.

CFTC

CFTC Staff Issues Guidance Regarding Risk Assessment of Customer Accounts for Futures Commission Merchants

On March 29, the Division of Clearing and Risk (DCR) of the Commodity Futures Trading Commission issued guidance regarding the implementation of revised Regulation 39.13(g)(8)(ii). Regulation 39.13(g)(8)(ii) provides that a derivatives clearing organization (DCO) must require its clearing members to collect from their customers initial margin at a level that is at least equal to the DCO's own initial margin requirements with respect to each product and portfolio and commensurate with the risk presented by each customer account. The regulation further requires that a DCO must set both (1) a baseline level of initial margin ("clearing initial margin"), which serves as the minimum amount its clearing members must in turn collect from their customers; and (2) an increased level of initial margin ("customer initial margin") for categories of customers determined by a clearing member to have a "heightened risk profile."

When it was originally adopted in 2011, Regulation 39.13(g)(8)(ii) required clearing members to collect customer initial margin for "non-hedge," i.e., speculative positions. In 2012, DCR issued guidance clarifying that while DCOs generally set customer risk profiles as "hedge" or "non-hedge," a DCO could choose to use a different set of risk-based criteria. In 2020, the CFTC replaced the term "non-hedge" with "heightened risk profile," raising concerns among market participants that FCMs could apply the term narrowly to offer lower margin requirements to customers, ultimately resulting in a market-wide reduction in customer margin.

In Letter No. 21-08, DCR clarified that, although the terminology may change, it did not expect to see significant changes in margining practices as a result of the 2020 amendment to the rule. DCR explained that, in order to comply with a DCO's rules, a clearing member must analyze the risk profile of each customer to determine if the customer presents a heightened risk profile (HRP). DCR added that an FCM can only categorize an account as "non-HRP" that was previously categorized as a "non-hedge" account if it can demonstrate that it is warranted based on the risk profile of the customer. DCR also emphasized that an FCM could assess whether a customer account a customer account presents a "heightened risk profile" based on whether the account is a hedging or speculative account, provided that the FCM maintains policies and procedures that demonstrate that is the risk analysis the FCM uses to determine whether to collect additional initial margin from a customer.

CFTC Letter No. 21-08

NFA Issues Notice Regarding Effective Date of NFA's Swap Dealer Capital Requirements

On March 31, the National Futures Association (NFA) issued Notice I-21-14 advising member firms that are registered with the Commodity Futures Trading Commission as swap dealers (SDs), that NFA rules adopting minimum capital and financial reporting requirements will become effective October 6.

NFA's Financial Requirements Section 18 requires SDs that are not subject to the rules of a prudential regulator (Covered SDs) to: (1) meet the applicable capital requirements in CFTC Regulation 23.101(a); (2) use internal models to calculate market and credit risk exposure; (3) submit an application to NFA and obtain NFA's written approval prior to using the models; and (4) submit regular financial reports to NFA and to file notices with NFA in accordance with CFTC Regulations. Section 18 also permits Covered SD members to use internal models approved by certain regulators specified in CFTC Regulation 23.102 prior to NFA's approval.

In addition, NFA developed two new financial reports (FR-CSE-NLA and FR-CSE-BHC) to standardize regular financial reports. Covered SD members are required to file regular financial reports using one of the standardized forms, although Covered SD members that are Securities and Exchange Commission registered broker-dealers or security-based SDs may use the FOCUS report. Further, Section 18 allows non-SEC registered Covered SD members to use subordinated debt to meet capital requirements, provided the Covered SD obtains pre-approval of the subordinated loan agreement from NFA. The agreement must be submitted for review at least 30 days prior to the agreement's execution date.

NFA separately set forth minimum capital and internal model requirements for Covered SD members that also are registered as futures commission merchants (FCM), specified that NFA will review a new SD's compliance with minimum capital requirements during registration, and imposed a $1,000 per business day late fee for financial reports required to be filed under Section 18.

Notice I-21-14

BREXIT/UK DEVELOPMENTS

AML: HM Treasury Updates Advisory Notice on Money Laundering and Terrorist Financing Controls in Higher-Risk Jurisdictions

On March 24, HM Treasury revised its advisory notice on money laundering and terrorist financing controls in overseas jurisdictions (AML/CTF). This replaces all previous notices issued by HM Treasury on this subject. The updated notice follows two statements published by the Financial Action Task Force on February 25, identifying jurisdictions with strategic deficiencies in their AML/CTF regimes.

The Democratic People's Republic of Korea and Iran are identified in the notice as being higher-risk jurisdictions for which enhanced due diligence and appropriate countermeasures should be conducted to meet the risks presented to the global financial system.

The advisory notice sets out Albania, Barbados, Botswana, Burkina Faso, Cambodia, Cayman Islands, Ghana, Jamaica, Mauritius, Morocco, Myanmar, Nicaragua, Pakistan, Panama, Senegal, Syria, Uganda, Yemen and Zimbabwe as countries for which appropriate actions should be taken to minimize the associated risks. This may include enhanced due diligence in high-risk situations.

HM Treasury Advisory Notice

AML: UK Government Publishes Money Laundering and Terrorist Financing (Amendment) (High-Risk Countries) Regulations 2021

On March 25, the UK Government published the Money Laundering and Terrorist Financing (Amendment) (High-Risk Countries) Regulations 2021 (SI 2021/392) on its website together with an explanatory memorandum (the Regulations).

The Regulations amend regulation 33(3)(a) of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692) (MLRs 2017).

Schedule 3ZA, which sets out a list of high-risk third countries, will be inserted into the MLRs 2017. The Regulations will change the definition of a “high-risk third country” from a country that was defined by a European Commission delegated act to a country specified in the new Schedule 3ZA, and they make a subsequent amendment to regulation 39(4).

The Regulations also repeal the retained EU law version of Commission Delegated Regulation (EU) 2016/1675, which provides a list of high-risk third countries recognized by the European Commission. This list will be superseded by the new list in Schedule 3ZA.

The Regulations go into effect on March 26.

Amendment Regulations

Explanatory Memorandum

UK Treasury Announces Technical Discussions on MoU on UK-EU Regulatory Cooperation in Financial Services

On March 26, HM Treasury published a press release announcing it had concluded technical discussions on the text of the Memorandum of Understanding (MoU) for UK-EU regulatory cooperation in financial services (the Press Release).

HM Treasury states that formal steps are required from both the UK and the EU before the MoU can be signed, which is expected promptly.

The MoU intends to create the framework for voluntary regulatory cooperation in financial services between the UK and the EU. It will establish the Joint UK-EU Financial Regulatory Forum, which will act as a platform to facilitate discussion on financial services issues.

HM Treasury Press Release

EU DEVELOPMENTS

ESAs Opinion on Jurisdictional Scope of the Securitisation Regulation

On March 26, the European Supervisory Authorities (ESAs) published an opinion to the European Commission on the jurisdictional scope of the Securitisation Regulation ((EU) 2017/2402).

In the Securitisation Regulation, the definition of "securitization" does not set out its jurisdictional scope and does not stop entities located in a third country (for example, the UK) from being party to a securitization. Securitizations with a third-country party can lead to difficulties when interpreting Articles 5 to 7 and 9 of the Securitisation Regulation and obstruct the effective functioning of the market. The following scenarios are specifically highlighted:

- securitizations where some of the sell-side parties are located in a third country;
- securitizations where all sell-side parties are located in a third country and EU investors invest in them;
- investments in securitizations by subsidiaries of EU regulated groups, where those subsidiaries are located in a third country; and
- securitizations where one of the parties is a third-country investment fund manager.

Hence, the ESAs' view is the Commission should publish a statement to provide interpretative guidance on application points.

The opinion suggests:

- the Commission should use the future review of the securitization framework to propose amendments to the Securitisation Regulation;
- amending Article 14 of the Capital Requirements Regulation (*575/2013*) (CRR) to enable an EU parent undertaking to ring-fence a third-country subsidiary investing in a securitization from the EU group;
- amendments to Article 42 of the Alternative Investment Fund Managers Directive (*2011/61/EU*) (AIFMD) to clarify how rules apply to non-EU AIFMs; and
- amendments to drafting in the Securitisation Regulation to avoid conflicts with delegation regimes in the AIFMD and UCITS Directive (*2009/65/EC*).

ESA Opinion

Joint Committee of ESAs Q&As on Securitisation Regulation

On March 26, the Joint Committee of the European Supervisory Authorities (ESAs) published a set of Q&As on the Securitisation Regulation (EU) 2017/2402, covering questions that fall outside the scope of any of the three ESAs.

The Q&As aim to help market participants comply with their obligations, especially in relation to:

- the content and format of the information that should be disclosed by the originator, sponsor and SSPE;
- the transaction documents in a simple, transparent and standardized (STS) securitization that should be made publicly available; and
- the type of STS certification services that can be provided by third-party verifiers to the securitization parties.

The Q&As also aim to promote common supervisory practices in the application of the Securitisation Regulation and encourage cross-sectoral consistency at an EU level.

ESA Q&As

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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FINANCIAL MARKETS AND FUNDS

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BREXIT/UK/EU DEVELOPMENTS

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