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BROKER-DEALER

SEC Chairman Clayton and Trading and Markets Director Redfearn Call for a Reassessment of Regulation NMS

On March 8, US Securities and Exchange Commission chairman Jay Clayton and director, Division of Trading and Markets Brett Redfearn gave a speech entitled "Equity Market Structure 2019: Looking Back & Moving Forward." Chairman Clayton, who noted that their comments were their own and not necessarily those of the SEC or its staff, opined that a reassessment of Regulation NMS was needed. Regulation NMS was adopted in 2005 and has remained largely untouched since its adoption, despite substantial transformation of the US equity markets as the result of technology advances. Chairman Clayton stated his view of Regulation NMS as follows: "[T]here are many areas that the Commission got right, some that may have missed their mark, and some that were positive in 2005, but may no longer be so."

Chairman Clayton remarked that many market participants have raised concerns about the sufficiency of the consolidated public data feeds distributed pursuant to national market system plans operated by the exchanges and the Financial Industry Regulatory Authority (core data), as contrasted with the proprietary data products and access services available in the market place (which are typically faster, more content rich and costlier than core data). Chairman Clayton stated: "I believe we should explore whether core data needs to be upgraded to better meet the needs of investors and market participants in today's modern markets … Accordingly, I have asked staff in our Division of Trading and Markets to develop recommendations that would consider the concerns raised about core data and the potentially underlying causes that were highlighted" during public roundtables on this subject.

Director Redfearn indicated that staff intends to explore several key areas related to core data, including speed, content (odd lots), order protection/best execution, depth, governance, transparency, and fair and efficient access.

Another particular area of concern is the application of Regulation NMS to thinly traded securities. Regulation NMS mandates a single market structure for all exchange-listed stocks, regardless of whether they are actively or thinly traded. According to chairman Clayton, the lack of liquidity in the stocks of smaller companies negatively impacts investors and the issuers themselves. One potential initiative noted by chairman Clayton would be to "allow issuers of thinly traded securities to suspend unlisted trading privileges for non-listing exchanges, while continuing to allow off-exchange trading in these securities as a means to maintain competition among trading venues." Director Redfearn indicated that Division of Trading and Markets staff is considering whether to recommend that the SEC publish a policy statement regarding this issue and also whether exemptive relief from Regulation NMS is needed.

Chairman Clayton and director Redfearn also addressed regulatory approaches to combating retail fraud, including, potentially, amendments to Exchange Act Rule 15c2-11 (which governs the submission and publication of quotations by brokers and dealers for over the counter equity securities) and Exchange Act Rule 15g-9 (sales practice requirements relating to penny stocks).

The full text of the speech is available here.

SEC Examines Stock Exchange Pricing

The US Securities and Exchange Commission has begun looking into whether the current multi-tiered pricing system used by stock exchanges favors large brokers and traders at the expense of small ones. In an effort to increase the volume of trading on an exchange, certain exchange operators (including New York Stock Exchange-owner Intercontinental Exchange Inc., Nasdaq Inc. and CBOE Global Markets) provide large brokers, banks and traders with rebates based on the amount of business they bring to the stock exchanges.

Critics have stated that the pricing method poses a disadvantage for smaller brokers, as they end up bearing significant costs, which ultimately makes it harder to compete against the larger brokers.

No formal investigation has been announced at this time, but should the SEC determine the pricing structure is inequitable, exchanges could be forced to modify their pricing models.

A more detailed discussion in an article published by Reuters is available here.

FINRA Extends Deadline To Self-Report Violations Under 529 Plan Share Class Initiative

The Financial Industry Regulatory Authority has extended the deadline for member firms to self-report violations under the 529 Plan Share Class Initiative to April 30. The extension will allow firms to have more time to review their supervisory systems and procedures with respect to their 529 plan transactions.

A more detailed discussion of the Plan Share Class Initiative is available here.

FINRA recently issued a Frequently Asked Questions about the 529 Plan Share Class Initiative, which is available here.

FINRA Working Paper Concludes High Broker-Affiliated ATS Order Routing is Associated with Lower Fill Rates, Higher Transaction Costs

The Financial Industry Regulatory Authority's Office of the Chief Economist has released a working paper (Study), maintaining that institutional orders routed by brokers that send a high percentage of such orders through affiliated alternative trading systems (ATSs) tend to receive lower order fill rates and higher execution costs. The Study examined order-handling information over the life of 330 million orders, routed by 43 active institutional brokers for a sample of 273 stocks during October 2016.

The Study divided brokers into three groups based on affiliated order routing, while noting that not all brokers demonstrated a preference for routing institutional client orders to affiliated ATSs. The Study found that the group with the most routes to an affiliated ATS filled 16.9 percent of orders on average, significantly lower than the 29.8 percent and 43.5 percent fill rates for the middle group and the group least likely to route orders to an affiliated ATS, respectively. The Study found that the institutional orders experiencing lower fill rates are associated with higher trading costs and increased opportunity costs resulting from unfilled orders.

Order routing, execution success and quality, and the potential for conflicts of employing affiliated ATSs has been the subject of continued focus for FINRA for several years. Sweep examinations were conducted in these areas in 2014, 2015 and 2017. The Study highlights the value of better disclosure on order routing practices and increased scrutiny where brokers demonstrate a preference to route orders to affiliated channels.

A full copy of the Study is available here.

DERIVATIVES

See "NFA Proposes Amendments to Bylaw 301, Compliance Rule 2-24 and Related Interpretive Notice" in the CFTC section and "ESMA Statement on Application of MiFID II, MiFIR and BMR Provisions in No-Deal Brexit" in the EU/Brexit Developments section.

BCBS/IOSCO Provide Guidance on Uncleared Swap Margin Rule Implementation

On March 5, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) issued guidance on two issues that have been identified in connection with the implementation of the framework for margin requirements for non-centrally cleared derivatives previously adopted by the two groups that initially went into effect in 2016. This framework is embodied in the margin rules for uncleared swaps that were adopted in the United States by the banking regulators for swap dealers subject to prudential regulation and by the Commodity Futures Trading Commission for other swap dealers.

The first issue arises because the margin rules apply to any swap executed before the effective date of the margin rules (a legacy swap), if the legacy swap is amended in a material way after the effective date. As a result of that principle, market participants have been concerned that all legacy swaps would become subject to margin because of amendments that will be necessary to reflect the replacement of current benchmark interest rates like LIBOR. The guidance on this issue is that "[a]mendments to legacy derivative contracts pursued solely for the purpose of addressing interest rate benchmark reforms do not require the application of the margin requirements for the purposes of the BCBS/IOSCO framework."

The second issue arises because of the fact that the phase-in level for initial margin drops to zero in 2020. That change is likely to bring numerous new small market participants into scope for initial margin, and all of those new parties will be faced with putting in place new initial margin documentation and custodial relationships even though initial margin will not actually be posted until the swap exposure of the party exceeds $50 million. The guidance on this issue is that compliant documentation and related arrangements are not needed "if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold." However, the guidance goes on to make the related point that parties must "act diligently when their exposures approach the threshold to ensure that the relevant arrangements are in place if the threshold is exceeded."

Since the guidance takes the form of a press release, it does not have the force of law or regulation, but national regulators are expected to adopt rules that are consistent with these recommendations.

The text of the press release is available here.

ISDA Proposes Amendments To Counter "Manufactured" Credit Derivative Defaults

On March 6, the International Swaps and Derivatives Association (ISDA) published for public comment some proposed amendments to the 2014 ISDA Credit Derivatives Definitions to address the issue of "narrowly tailored" or "manufactured" credit events. This type of credit event came under scrutiny by ISDA because of a few situations in which a company was apparently induced to default on some of its debt in return for advantageous financing, thus creating a credit event for purposes of credit derivatives referencing the company even though the company was not in actual economic distress.

The primary solution proposed by the ISDA working group that examined the issue is the inclusion of a "Credit Deterioration Requirement" in the "Failure to Pay" credit event. If the amendments are adopted, a non-payment will not be a credit event unless, directly or indirectly, it results from, or results in, a deterioration in the creditworthiness or financial condition of the relevant entity.

Feedback on the proposals is requested by March 27.

The text of the proposal is available here.

CFTC

CFTC Issues Advisory on Violations of the CEA Involving Foreign Corrupt Practices

On March 6, the Commodity Futures Trading Commission's Division of Enforcement issued an Enforcement Advisory regarding self-reporting and cooperation for violations of the Commodity Exchange Act (CEA) involving foreign corrupt practices. Providing further guidance regarding the Enforcement Division's cooperation and self-reporting program, the Advisory notes that the Enforcement Division will apply a presumption that it will recommend to the CFTC a resolution with no civil monetary penalty, absent aggravating circumstances, in the event of a timely and voluntary disclosure of violations of the CEA involving foreign corrupt practices. In evaluating potentially aggravating circumstances, the Enforcement Division will consider a variety of factors, including, but not limited to, the pervasiveness of the conduct. Even if the Enforcement Division does not recommend a civil penalty pursuant to the Advisory, the Advisory notes that the Enforcement Division would still require the disgorgement, forfeiture and/or payment of restitution resulting from such misconduct.

A copy of the Advisory is available here.

NFA Proposes Amendments to Bylaw 301, Compliance Rule 2-24 and Related Interpretive Notice

On March 5, the National Futures Association (NFA) submitted with the Commodity Futures Trading Commission proposed amendments to NFA Bylaw 301 and Compliance Rule 2-24. The proposed changes to NFA Bylaw 301(l) are intended to specify that any individual applying for approval as a futures commission merchant (FCM), introducing broker (IB), commodity pool operator (CPO) or commodity trading advisor (CTA) member swap firm or swap associated person of an FCM, IB, CPO or CTA must take and pass the NFA's Swap Proficiency Requirements to be granted approval as a swap firm or swap associated person (AP). In connection with this change, the NFA also proposed amendments to Compliance Rule 2-24 which, among other changes, would prohibit an FCM, IB, CPO or CTA member from having associated with it an individual engaged in CFTC regulated swap activities, unless such individual has satisfied the aforementioned requirements.

In addition to the proposed amendments to NFA Bylaw 301 and Compliance Rule 2-24, the NFA issued a proposed interpretive notice entitled NFA Bylaw 301 and Compliance Rule 2-24: Proficiency Requirements for Swap APs (Interpretive Notice), which provides more detailed information regarding certain considerations related to such proficiency requirements. For example, the Interpretive Notice establishes two proficiency tracks (i.e., a Long Track and a Short Track). The track applicable to an individual will be based on the type of swaps activity performed by such individual, and whether such individual works as a swap dealer or an intermediary. The Interpretive Notice also describes a series of related requirements, which includes a new obligation for swap dealers (SDs) to maintain records demonstrating that covered individuals have satisfied the applicable proficiency requirements. Individuals acting as APs at SDs located outside the United States, including non-US branch offices of a US SD (Non-US APs), who solely solicit or accept swaps with counterparties that are non-US persons and/or non-US branch offices of US SDs, are excluded from these requirements. The compliance date to complete the proficiency requirements is January 31, 2021.

The NFA filed the proposed amendments and the Interpretive Notice with the CFTC pursuant to Section 17(j) of the Commodity Exchange Act, which authorizes the NFA to make such amendments and the Interpretive Notice effective 10 days after receipt by the CFTC, unless the CFTC notifies the NFA that it intends to review the proposal for approval.

The text of the proposed amendments and the Interpretive Notice are available here.

BANKING

CFPB Releases Advanced Notice of Proposed Rulemaking Regarding Residential Property Assessed Clean Energy Financing

On March 4, the Consumer Financial Protection Bureau (CFPB) released an Advanced Notice of Proposed Rulemaking (ANPR) to seek information from the public about certain issues related to Property Assessed Clean Energy (PACE) financing. In particular, the CFPB issued the ANPR to obtain more information (1) about the relationship between an assessment of a consumer's "ability to repay" and the terms of a PACE financing agreement, and (2) related to the extension of Truth In Lending Act (TILA) general civil liability to PACE transactions.

The ANPR requests information related to the following five categories: (1) written materials associated with PACE financing transactions; (2) descriptions of current standards and practices in the PACE financing origination process; (3) information relating to civil liability under TILA for violations of the ability to repay requirements in connection with PACE financing; (4) information about what features of PACE financing make it unique and how the CFPB should address these features; and (5) views concerning the potential implications of regulating PACE financing under TILA. The CFPB seeks information from a variety of stakeholders, including contractors, consumers and law firms.

Comments will be due 60 days after publication in the *Federal Register*. More information is available here.

ANTITRUST

FTC Releases Revised Hart-Scott-Rodino Filing Thresholds for 2019

The Federal Trade Commission (FTC) recently announced new filing thresholds that will apply to mergers and acquisitions under the Hart-Scott-Rodino (HSR) Antitrust Improvements Act of 1976, as amended. These new thresholds will go into effect on April 3.

Under the revised notification thresholds, transactions valued above $90 million will require HSR notification when they satisfy other requirements of the Act. This threshold is an increase from the current threshold of $84.4 million. The FTC adjusted the filing thresholds for larger transactions, as well. The current $168.8 million threshold will be increased to $180 million, and the current $843.9 million threshold will be increased to $899.8 million. Under the new thresholds, the filing fee for notifiable transactions valued: (1) above $90 million, but less than $180 million, remains at $45,000; (2) above $180 million, but less than $899.8 million, remains at $125,000; and (3) above $899.8 million remains at $280,000.

Transactions valued between $90 million and $359.9 million also must satisfy the “size of person” test in addition to the “size of transaction” test for a filing to be required. The FTC also announced new size of person thresholds. Under the new thresholds, one party to the transaction must have net sales or total assets of at least $18 million, and another party to the transaction must have net sales or total assets of at least $180 million. Transactions valued greater than $359.9 million under the HSR rules will require a filing regardless of the size of the persons involved.

The FTC’s announcement on the revised thresholds is available here.

UK/BREXIT DEVELOPMENTS

PRIIPs Regulations Made in Preparation for Brexit

On February 28, the Packaged Retail and Insurance-based Investment Products (PRIIPs) (Amendment) (EU Exit) Regulations 2019 (UK Regulations) were published together with a draft explanatory memorandum.

The UK Regulations were laid before Parliament on January 9, as reported in the January 11 edition of *Corporate & Financial Weekly Digest*. There do not appear to be any substantive changes.

The purpose of the UK Regulations, which were made on February 27, is to ensure that the regime established under the Regulation on Key Information Documents for PRIIPs (PRIIPs Regulation) continues to operate effectively after the United Kingdom’s withdrawal from the European Union (Brexit).

The UK Regulations amend the PRIIPs Regulations 2017 and the retained versions of the PRIIPs Regulation and Commission Delegated Regulation on product intervention powers.

The UK Regulations will become effective when the United Kingdom exits the European Union on March 29.

The UK Regulations are available here and the related draft explanatory memorandum is available here.

FCA Publishes Statement on Operation of UK MiFIR Transparency Following No-Deal Brexit

On March 4, the United Kingdom Financial Conduct Authority (FCA) published a document containing statements of policy on how it intends to operate the transparency regime under the retained UK version of the European Union's Markets in Financial Instruments Regulation (UK MiFIR), if the United Kingdom leaves the European Union without an implementation period.

The FCA states on a webpage related to the statements of policy that they outline how it will use its decision-making powers relating to the transparency regime in these circumstances. The FCA also notes that it will have a degree of flexibility during a four-year transitional period to allow it to build the systems needed as currently operated by the European Securities and Markets Authority and to change the regime if necessary to reflect a move from an EU-wide trading data set to one that is solely related to the United Kingdom.

The statements of policy cover the FCA's approach to:

1. Suspending the use of pre-trade transparency waivers for trading venues for the purposes of the double volume cap;

2. Withdrawing a pre-trade transparency waiver granted for a trading venue in respect of non-equity financial instruments;

3. Suspending the pre-trade transparency obligations for trading venues with respect to non-equity financial instruments and suspending the post-trade transparency obligations for trading venues with respect to non-equities;

4. Determining the standard market size of equity instruments for the purposes of the pre-trade transparency regime for systematic internalizers;

5. Suspending the post-trade transparency obligations for non-equity transactions taking place outside a trading venue; and

6. Directing that an equity instrument is to be treated as not having a liquid market.

The statements of policy are available here and their related website is available here.

EU/BREXIT DEVELOPMENTS

ESMA Statement on Application of MiFID II, MiFIR and BMR Provisions in No-Deal Brexit

On March 7, the European Securities and Markets Authority (ESMA) published a statement outlining its approach to the application of key provisions of the revised Markets in Financial Instruments Directive (MiFID II), Markets in Financial Instruments Regulation (MiFIR) and the Benchmarks Regulation (BMR), in the event that the United Kingdom leaves the European Union without a withdrawal agreement (no-deal Brexit).

The statement covers MiFID II and MiFIR provisions relating to the following:

- **MiFID II C(6) carve-out**: ESMA identifies that derivative contracts based on electricity or natural gas produced, traded or delivered in the UK may no longer be eligible for the carve-out in C(6) of Annex I of MiFID II, as they will not fall within the "wholesale energy product" definition. Such contracts could therefore be considered "financial instruments" for the purposes of MiFID II and MiFIR.

- **Trading obligation for derivatives**: Post-Brexit, trading venues established in the UK will be considered to be third-country trading venues for EU purposes. While noting that the large majority of trading in derivatives subject to the trading obligation (Article 28 of MiFIR) is concluded on UK trading venues, ESMA states that it has no evidence that market participants will be unable to continue complying with such obligation in the event of a no-deal Brexit and in the absence of an equivalence decision by the Commission covering UK trading venues. Nevertheless, ESMA will continue to closely monitor how liquidity develops post-Brexit.

- **ESMA opinions on third-country trading venues for the purpose of post-trade transparency and the position limits regime**: ESMA has not yet assessed any UK trading venue against the criteria set out in the opinions it gave in 2017 for the purposes of post-trade transparency and the position limits regime (for further information, see the January 5 edition of *Corporate & Financial Weekly Digest*), but will do so on the request of EU market participants.

- **Post-trade transparency for OTC transactions**: ESMA considers the obligations under Article 20 and 21 of MiFIR in the context that investment firms established in the UK post-Brexit will no longer be EU investment firms, but will fall within the category of counterparties established in a third country. EU investment firms will therefore be required to make transactions concluded over the counter with UK counterparties public in the EU.

The statement also covers the removal of UK administrators from ESMA's register of administrators and third-country benchmarks under the BMR and the application of the BMR transitional period defined in Article 51.

Given the uncertainty surrounding Brexit, ESMA states that it may adjust its approach if the timing and conditions of Brexit change, and will announce any changes to its approach as soon as possible.

ESMA's statement is available here.

Council of EU Invites COREPER To Approve Final Compromise Text of EMIR Refit Regulation

On March 1, the Council of the European Union published an "I" item note with an accompanying addendum, setting out the final compromise text of the proposed Regulation to amend the European Market Infrastructure Regulation (EMIR Refit Regulation).

In the "I" item note, the general secretariat council invites its Permanent Representatives Committee (COREPER) to approve the final compromise text of the EMIR Refit Regulation with a view to reaching an agreement at first reading with the European Parliament.

The Council of the European Union and the European Parliament previously reached political agreement on the proposals in February (for further information, see the February 8 edition of *Corporate & Financial Weekly Digest*).

The "I" item note and addendum are available here and here.

ESMA Delays Publication of Annual Calculations of LIS and SSTI Thresholds for 2019/20 Bonds

On March 1, the European Securities and Markets Authority (ESMA) published a press release relating to the annual calculation of the large in scale (LIS) and size specific to the instruments (SSTI) thresholds for bonds.

In its press release, ESMA has announced that it will postpone publishing the results of the annual calculations because its IT systems require more time than anticipated to complete them. The publication was originally planned for March 1, in advance of the April 30 deadline set out in Commission Delegated Regulation (EU) 2017/583, but ESMA will now aim to ensure that publication will take place later in March.

The transparency requirements based on the results of the annual calculations are expected to be published by April 30, and will apply from June 1 until May 31, 2020. The results of the next annual LIS and SSTI thresholds for bonds calculations will be published by April 30, 2020, and will become applicable from June 1, 2020.

ESMA's press release is available here.

ESMA Publishes Annual Transparency Calculations for 2019/20 Equity and Equity-Like Instruments

On March 1, the European Securities and Markets Authority (ESMA) published a press release announcing that it has made available the results of the annual transparency calculations for equity and equity-like instruments.

There are currently 1,344 liquid shares and 389 liquid equity-like instruments other than shares, subject to calculations relating to the transparency requirements in the revised Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR). ESMA's annual transparency calculations are based on the data provided to the ESMA financial instruments transparency system (FITRS) by trading venues and arranged publication arrangements in relation to the 2018 calendar year.

The full list of assessed equity and equity-like instruments is available through the FITRS in the XML files that have the publication date from March 1, and through the register web interface.

The transparency requirements based on the results of the annual transparency calculations published from March 1 will apply from April 1 until March 31, 2020. The next annual transparency calculations for equity and equity-like instruments will be published by March 1, 2020, and will become applicable from April 1, 2020.

It is likely that EMSA will have to update the results after March 29, because of late data submissions by some reporting entities and adaptations needed in the event of the United Kingdom exiting the European Union without a withdrawal agreement.

ESMA's press release is available here.

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

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