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SEC/CORPORATE

DC Circuit Court Rejects States' Challenge of Blue Sky Preemption Under Regulation A+

On June 14, the Federal Court of Appeals for the District of Columbia (the DC Circuit) rejected challenges from the State of Montana and the Commonwealth of Massachusetts to Regulation A+'s preemption of state securities "blue sky" registration and qualification requirements in Tier-2 offerings under Regulation A+. As previously reported in the June 5, 2015 edition of *Corporate & Financial Weekly Digest*, the Commonwealth of Massachusetts and the State of Montana, had filed lawsuits with the DC Circuit (which lawsuits were combined by the DC Circuit), which sought to enjoin the effectiveness of Regulation A+ on the basis that Regulation A+ exceeded the SEC's congressional mandate by pre-empting state "blue sky" review of Tier 2 offerings under Regulation A+. This preemption is fundamental to the utility of Regulation A+.

The complete text of the decision is available here.

BROKER-DEALER

FINRA Files Proposed Amendment to Margin Requirements for Credit Default Swaps Rule

On June 15, the Financial Industry Regulatory Authority filed with the Securities and Exchange Commission a proposed amendment to FINRA Rule 4240 (Margin Requirements for Credit Default Swaps). FINRA Rule 4240 implements a pilot program that imposes margin requirements for certain credit default swaps that are also security-based swaps. The proposed amendment would allow for the extension of this pilot program until July 18, 2017. The comment period will be open for 21 days following the publication of the proposed rule amendment in the *Federal Register*.

The proposed rule amendment is available here.

SEC Approves Revised FINRA Margin Requirements Rule

On June 15, the Securities and Exchange Commission approved on an accelerated basis proposed amendments to FINRA Rule 4210 to establish margin requirements for TBA transactions, Specified Pool Transactions and certain forward transactions involving collateralized mortgage obligations (collectively, Covered Agency Transactions).

Pursuant to the amended rule, FINRA members that engage in Covered Agency Transactions must establish risk limits for these transactions in accordance with the member's written risk policies and procedures. In addition, for transactions with non-exempt accounts, members must collect maintenance margin from counterparties in an amount equal to 2 percent of the contract value of the counterparty's net long or net short position plus any net mark to market loss. Any deficiency that is not satisfied by the close of business on the next business day must be deducted from the member's net capital until the deficiency is satisfied. If the deficiency is not satisfied within five business days, the member must promptly liquidate positions to satisfy the deficiency unless FINRA has specifically granted the member additional time.

Maintenance margin will not be required for transactions where the original contractual settlement is in the same month as the trade date or in the following month if the customer regularly settles its Covered Agency Transactions on a delivery verses payment basis or for "cash"—provided, however, that such exception does not apply to customers that engage in dollar rolls, "round robin" trades, or that use other financing techniques for its Covered Agency Transactions.

No maintenance margin will be required to be collected for transactions with exempt accounts. However, those transactions must be marked to the market daily and the member must collect any net mark to market loss. If this loss is not satisfied by the close of business on the next business day, the member must take the same net capital deductions and liquidation actions noted above.

All requirements to collect any deficiency or mark to market loss from a single counterparty is subject to a $250,000 minimum transfer amount. The rule will exempt from the foregoing margin requirements: (1) transactions with central banks and multilateral development banks; (2) transactions that are cleared through a registered clearing agency, and (3) subject to certain other requirements, short-dated transactions between a member and a counterparty where the dollar amount of the counterparty's gross open positions in Covered Agency Transactions with the member are equal to or less than $10 million.

It is worth noting that FINRA amended the proposed amendments three times prior to receiving SEC approval. Among other things, the last amendment clarified the written risk limit requirements that will become effective six months after SEC approval. The actual margin requirements imposed under Rule 4210 will become effective in December 2017.

The text of the adopting release is available here.

DERIVATIVES

See "FINRA Files Proposed Amendment to Margin Requirements for Credit Default Swaps Rule" in the Broker-Dealer section, "CFTC Extends No-Action Relief for DCMs and SEFs Pertaining to Clerical and Operation Errors in Swaps Trades" and "CFTC Approves Rules Amending Cleared Swaps Data Reporting and Recordkeeping Requirements" in the CFTC section, and "European Commission Updates List of Recognized Third-Country CCPs" and "European Commission adopts MiFID II and MiFIR Delegated Regulations" in the EU Developments section.

CFTC

CFTC Seeks Comment With Respect to ICE Futures US Rule Amendment Certification

On June 14, the Commodity Futures Trading Commission (CFTC) announced that it had advised ICE Futures US (IFUS) that IFUS's amendment to its Block Trade FAQ, which IFUS had previously self-certified to the CFTC pursuant to CFTC Regulation 40.6, would be stayed for a period of 90 days pending further review. The CFTC had determined that the amendment presented novel and complex issues that require additional time to review and may be inconsistent with the Commodity Exchange Act (Act) and CFTC Regulations.

The amendment to IFUS's Block Trade FAQ would confirm that, except for an intermediary that enters into a block trade opposite a customer, the parties to a block trade may participate in pre-hedging or anticipatory hedging with respect to positions they believe in good faith will result from the consummation of a block trade. An intermediary that takes the opposite side of its customer's order may not, prior to the consummation of the block trade, offset the position established by the block trade in any account (1) which is owned or controlled by the intermediary, (2) in which an ownership interest is held by the intermediary, or (3) that is considered a proprietary account of the employer of such intermediary.

Pursuant to CFTC Regulation 40.6(c), the IFUS amendment will become effective upon the expiration of the 90-day review period, unless the CFTC notifies IFUS that the CFTC: (1) has determined to withdraw the stay prior to the end of the 90-day review period; or (2) objects to the proposed certification on the grounds that it is inconsistent with the Act or the CFTC's regulations.

Public comment on the IFUS amendment must be filed with the CFTC on or before July 14, 2016.

The submission to the CFTC by ICE Futures US is available here.

The CFTC's notice is available here.

CFTC Extends No-Action Relief for DCMs and SEFs Pertaining to Clerical and Operation Errors in Swaps Trades

On June 10, the Commodity Futures Trading Commission's Division of Market Oversight and Division of Clearing and Risk issued No-Action Letter No. 16-58 granting designated contract markets (DCMs) and swap execution facilities (SEFs) relief from relevant provisions of CFTC regulations that would otherwise prohibit the DCM or SEF from facilitating transactions entered into to correct clerical or operational errors that cause a swap to be rejected for clearing and become void or that are discovered after clearing. The No-Action letter extends relief previously granted in No-Action Letter No. 15-24, which was to expire on June 15, 2016. Specifically, a DCM or SEF will be able to permit parties to correct clerical or operational errors that cause a swap to be rejected for clearing within one hour of such rejection by allowing a new and pre-arranged trade that retains the terms and conditions of the original trade but for any error and the time of execution. Similarly, a DCM or SEF will be able to permit parties to correct clerical or operational errors discovered after clearing by allowing (1) the original parties to engage in a new, prearranged trade to offset swaps carried on the derivatives clearing organization's (DCOs) books, or (2) the original or intended parties to engage in a pre-arranged trade reflecting the correct terms to which the parties agreed. In both instances, the CFTC will not recommend any action against a DCM or SEF for failure to comply with CFTC Regulations 37.9(a)(2) and 38.500, which pertain to required methods of execution, and CFTC Regulations 37.203 and 38.152, which prohibit pre-arranged trading. Relief extends until the earlier of June 15, 2017 or the effective date of revised CFTC regulations that lay out a formal solution to clerical and operational errors.

The CFTC's No-Action letter is available here.

CFTC Approves Rules Amending Cleared Swaps Data Reporting and Recordkeeping Requirements

On June 14, 2016, the Commodity Futures Trading Commission announced the approval of amendments to Part 45 of the CFTC's regulations, which pertain to the reporting and recordkeeping obligations involved in cleared swaps transactions. The amendments seek to clarify certain aspects of the existing Part 45 rules, including the roles of registered entities and swap counterparties, and streamline data collection and maintenance. Specifically, the amended regulations:

- clarify that a derivatives clearing organization (DCO) is the reporting counterparty for swaps transactions cleared pursuant to its rules, and in which the DCO is a counterparty and clarify creation data reporting and the use of unique swap identifiers with respect to such transactions;
- clarify which entity has the obligation to choose the swap data repository to which creation data will be reported;
- remove certain reporting requirements with respect to swaps intended to be submitted to a DCO for clearing at the time of execution;
- clarify ongoing reporting requirements, including termination reporting and data provided in order to link swaps; and
- clarify that all swap data with respect to certain transactions must be reported to a single swap data repository.

The majority of the rules will become effective 180 days following their publication in the *Federal Register*. One element of the rules, the codification of No-Action letters that eliminate daily valuation reporting by swap dealers and major swap participant counterparties, is effective immediately upon *Federal Register* publication.

The CFTC's announcement is available here.

BANKING

Financial Accounting Standards Board Issues New Loan Loss Rule

On June 16, the Financial Accounting Standards Board (FASB) issued its new and long-expected loan loss accounting framework, also known as the current expected credit loss model (CECL). Bank regulators have described CECL as the "biggest change to bank accounting ever," a sentiment which has been echoed by accountants, bank securities lawyers and industry trade groups.

According to the American Bankers Association (ABA), "CECL effectively requires bankers to record, at the time of origination, credit losses expected throughout the life of the asset portfolio on loans and held-to-maturity securities. This is in contrast to today's 'incurred loss' accounting, under which losses are recorded when it is probable that a loss event has occurred." The new standard "is expected to increase the allowance for loan and leases losses throughout the industry," and "will require significant operational changes at all banks, including collecting and analyzing the type of data that supports the modeling of the life-of-loan loss expectation, as well as forecasting and quantifying losses in the future."

CECL will be effective in 2020 for Securities and Exchange Commission (SEC) registrants (i.e., holding companies and banks with a class of securities registered with the SEC) and 2021 for all others. The ABA's brief introductory video is available here. The ABA also has provided other educational resources, available here. Bankers are urged to become familiar with CECL before it goes into effect.

EU DEVELOPMENTS

European Commission Updates List of Recognized Third-Country CCPs

On June 14, the European Securities and Markets Authority (ESMA) published an update to its list of third-country central counterparties (List of Third-Country CCPs) that are recognized under the European Market Infrastructure Regulation (EMIR) to offer services and activities in the European Union. The update includes the Chicago Mercantile Exchange, Inc. (CME), which was recognized as of June 13, 2016. Table 2 in the List of Third-Country CCPs sets out the classes of financial instruments covered under each CCP's recognition. CME's recognition covers: (1) equity derivatives (over-the-counter (OTC) third-country exchange); (2) interest rate derivatives (OTC bilateral and OTC third-country exchange); (3) credit derivatives (OTC bilateral); (4) currency derivatives (OTC bilateral and OTC third-country exchange); (5) commodity derivatives (OTC bilateral and OTC third-country exchange); (6) emissions (OTC third-country exchange); and (7) freight derivatives (OTC third-country exchange).

A copy of the updated List of Third-Country CCPs is available here, and ESMA's accompanying press release is available here.

European Commission Adopts MiFID II and MiFIR Delegated Regulations

On June 13, the European Commission (Commission) adopted three delegated acts in relation to the amended and restated Markets in Financial Instruments Directive (MiFID II) and Markets in Financial Instruments Regulation (MiFIR). The delegated acts each take the form of a directly applicable regulation (together, Delegated Regulations). They cover: (1) the direct, substantial and foreseeable effect of derivative contracts in the European Union and the prevention of the evasion of rules and obligations (Derivatives Delegated Regulation); (2) requirements on market making agreements and schemes (Market Making Delegated Regulation); and (3) the volume cap mechanism and the provision of information for the purposes of transparency and other calculations (Volume Cap Delegated Regulation).

- **Derivatives Delegated Regulation**

  MiFIR introduces a "trading obligation," which broadly requires certain counterparties, as in the European Market Infrastructure Regulation, to only trade on regulated markets, multilateral trading facilities, organized trading facilities and/or third-country trading venues deemed equivalent. Under MiFIR, the trading obligation applies to transactions between in-scope EU entities and third-country entities (TCEs), where those TCEs would be caught by clearing obligations were they to be established in the European Union. The Derivatives Delegated Regulation extends the application of the "trading obligation" to transactions between TCEs and other TCEs, where those TCE's would be caught by clearing obligations were they established in the European Union and where those contracts have a "direct, substantial and foreseeable effect in the EU" or where the obligation is necessary to prevent evasion of the rules and obligations. The Derivatives Delegated Regulation confirms that an over-the-counter (OTC) derivative contract will have a direct, substantial and foreseeable effect in the European Union where at least one TCE is guaranteed by an EU financial counterparty for an aggregate value of EUR 8 billion and where that guarantee is at least 5 percent of current total exposures in OTC derivative contracts of the EU financial counterparty issuing the guarantee.

- **Market Making Delegated Regulation**

  The Market Making Delegated Regulation is made under MiFID II, and specifies requirements for firms conducting algorithmic trading as part of market making strategies (in addition to associated requirements for trading venues). The Market Making Delegated Regulation confirms when a market making agreement should be executed and its contents. It also sets out the exceptional circumstances where investment firms are not required to provide liquidity on a regular and predictable basis (including, for example, in situations of extreme volatility, war or industrial action, or disorderly trading conditions on a trading venue from delays or interruptions). It further specifies the requirement for trading venues to publish details of the market making schemes, names of the firms that it has entered into market making agreements with and the financial instruments covered, on their websites (among other things).

- **Volume Cap Delegated Regulation**

  The Volume Cap Delegated Regulation is made under MiFIR and specifies requirements in relation to data requests from competent authorities to trading venues, approved publication arrangements (APAs) and consolidated tape providers (CTPs). This is to further allow competent authorities to make accurate calculations for pre- and post-trade transparency requirements, including, for example, to determine if certain classes of derivatives are "sufficiently liquid" for the trading obligation, and to identify firms as systematic internalisers. The Volume Cap Delegated Regulation specifies that trading venues, APAs and CTPs are required to respond to an "ad hoc" data request within four weeks of receipt (among other things).

As mentioned in previous updates, the European Council and European Parliament will consider the Delegated Regulations and, once formally approved, the Delegated Regulations will go into effect 20 days following their publication in the *Official Journal of the European Union*.

For more information, see the *Corporate & Financial Weekly Digest* editions of June 10, May 27, May 20, April 29 and April 15.

A copy of the Derivatives Delegated Regulation is available here.

A copy of the Market Making Delegated Regulation is available here.

A copy of the Volume Cap Delegated Regulation is available here, and its Annex is here.

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

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