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BROKER-DEALER

FINRA Issues Investor Alert Regarding IRS Phone Scam

The Financial Industry Regulatory Authority issued an Investor Alert warning investors about a phone scam involving phone calls allegedly coming from the Internal Revenue Service. Since 2013, more than 700,000 investors have received scam phone calls demanding that they immediately pay a tax obligation or face serious consequences, such as the possibility of arrest. FINRA notes that these scams have been successful because the impersonators have become increasingly sophisticated in building credibility through altered caller ID numbers and official-looking documents.

To avoid this scam, FINRA recommends that investors become aware of the procedures the IRS uses when engaging taxpayers. For example, FINRA warns investors that the IRS will never call taxpayers and demand the immediate payment of a tax obligation. FINRA recommends reporting these incidents to the IRS and the Treasury Inspector General.

The press release discussing the Investor Alert is available here.

The Investor Alert is available here.

FINRA Issues Notice on the Mandatory Participation of Member Firms in FINRA's BC/DR Testing

The Financial Industry Regulatory Authority released Regulatory Notice 15-43 to alert member firms of its authority to designate certain member firms as mandatory participants in FINRA's business continuity/disaster recovery (BC/DR) testing. Under Regulation SCI, FINRA must establish, maintain and enforce BC/DR standards in addition to designating which firms must participate in the testing of its BC/DR plans.

Under Rule 4380, FINRA will choose designated firms for mandatory participation based on their volume of activity on a FINRA market system over a certain period of time. FINRA set forth specific participation criteria for the following six member-facing systems: equity trade reporting facilities, equity order audit trail systems, equity quotation display and trade reporting facilities, unlisted equity quotation display facilities, and fixed income trade reporting systems. FINRA's designation criteria would result in five to nine firms per system being included in the BC/DR tests. Such coverage would represent at least 50 percent of the activity on each system. If a member firm is designated to participate in FINRA's mandatory BC/DR testing, that firm will be required to comply with certain testing requirements, such as processing test scripts to simulate trading activity.

Regulatory Notice 15-43 is available here.

DERIVATIVES

See "CFTC Extends Swap Data Reporting Relief to Certain Non-US SDs and MSPs" in the CFTC section and "ESMA Reopens Consultation on Indirect Clearing Arrangements" in the EU Developments section.

CFTC

CFTC Provides Responses to Frequently Asked Questions Regarding Commission Form CPO-PQR and CTA-PR

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight has issued responses to frequently asked questions (FAQs) regarding Commission Forms CPO-PQR and CTA-PR. The FAQs for Commission Form CPO-PQR focus on issues such as filing requirements, reporting thresholds, and responding to specific issues contained in the CPO cover page and Schedules A-C. The FAQs for Commission Form CTA-PR focus on filing requirements, question 1 issues related to Trading Programs, and question 2 issues regarding pool registration and assets.

The FAQ responses are available here.

NFA Issues Notice to CPOs and CTAs Regarding EasyFile Logistics for CTA FORM PR and CPO Form PQR

The National Futures Association issued a notice explaining how Commission Forms CPO-PQR and CTA-PR can be filed through the NFA's EasyFile System. To address member feedback on the EasyFile procedures, NFA has launched frequently asked question pages for both CTA Form PR and CPO Form PQR. NFA also has added a tutorial video that explains how to file the Form PR.

The NFA notice on EasyFile logistics can be found here.

The frequently asked questions on EasyFile procedures for CTA Form PR is available here.

The frequently asked questions on EasyFile procedures for CPO Form PQR is available here.

The tutorial video on Form PR filing procedures is available here.

CFTC Extends Swap Data Reporting Relief to Certain Non-US SDs and MSPs

The Division of Market Oversight of the Commodity Futures Trading Commission has extended relief from swap data reporting obligations for swap dealers (SDs) and major swap participants (MSPs) that are non-US persons established in Australia, Canada, the European Union, Japan or Switzerland, and that are not part of an affiliated group in which the ultimate parent entity is a US SD, MSP, bank, financial holding company or bank holding company. The relief provides that such SDs and MSPs are exempt from Part 45 and Part 46 swap data reporting obligations with respect to swaps with non-US counterparties that are not guaranteed or conduit affiliates of a US person.

The no-action letter additionally clarifies that such relief does not extend to swap recordkeeping requirements in Parts 45 and 46 of CFTC Regulations.

The relief was initially granted in 2013 and subsequently extended in 2014. The relief will expire upon the earlier of December 1, 2016 or 30 days after the CFTC issues a comparability determination for the applicable jurisdiction.

CFTC Letter No. 15-61 is available here.

BANKING

FFIEC Issues New IT Management Booklet

The Federal Financial Institutions Examination Council (FFIEC) members on November 10 issued a revised *Management* booklet, which is part of the *FFIEC Information Technology Examination Handbook* (IT Handbook). The *Management* booklet, including the examination procedures, has been substantially revised. The booklet outlines the principles of sound governance and, more specifically, information technology (IT) governance. The booklet explains how IT risk management relates to enterprise-wide risk management and governance.

The updated examination procedures assist examiners in evaluating the following areas:

- IT governance as part of overall governance in financial institutions.
- IT risk management as part of enterprise-wide risk management in financial institutions.

Other relevant changes include:

- Incorporation of cybersecurity concepts as part of information security.
- Incorporation of management-related concepts from other booklets of the IT Handbook.
- Augmentation and further delineation of the stages of the IT risk management process, including risk identification, measurement, mitigation, monitoring and reporting.

The IT Handbook is available here.

Agencies Issue Guidance on Capital Deduction Methodology

The Office of the Comptroller of the Currency (OCC), along with the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, on November 6 issued interagency guidance to banking organizations within their respective jurisdictions. The interagency guidance addresses the deduction from regulatory capital for certain investments in covered funds pursuant to section 13 of the Bank Holding Company Act, also known as the Volcker Rule. The guidance clarifies the interaction between the deduction for covered funds under the Volcker Rule and the deductions required for certain investments in non-consolidated financial institutions under the respective capital rules of the agencies.

The Volcker Rule deduction became effective on July 21 for investments in covered funds made after December 31, 2013. The September 30 call report was the first in which banking organizations were required to report Volcker Rule deduction amounts. For investments made before December 31, 2013, the Volcker Rule deduction does not become effective until July 21, 2017. The OCC release noted that community banks are subject to the Volcker Rule deduction only if they engage in covered fund activities that result in holding an ownership interest in covered funds.

Highlights from the interagency guidance:

- The interagency guidance describes the steps that a bank should follow to determine its deduction for covered funds subject to the Volcker Rule.
- An investment that must be deducted from regulatory capital because it is a covered fund under the Volcker Rule also may be subject to a deduction from regulatory capital because the investment meets the definition of an “investment in the capital of an unconsolidated financial institution” under the regulatory capital rule. Therefore, the Volcker Rule and regulatory capital rule deduction requirements may overlap. The purpose of the steps in the interagency guidance is to prevent a double deduction.
- Deductions made according to requirements of the regulatory capital rule at 12 CFR 3 take precedence and should be deducted first. To the extent the deduction requirements overlap, the interagency guidance clarifies that the 12 CFR 3 deductions may count toward the required Volcker Rule deduction at 12 CFR 44, which should be calculated after 12 CFR 3 deductions have been made.
- Amounts deducted according to the regulatory capital rule or the Volcker Rule are deducted from the numerator and the denominator for purposes of calculating regulatory capital ratios.

FDIC Issues Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations

The Federal Deposit Insurance Corporation (FDIC) on November 6 issued an Advisory to update information contained in the *FDIC Advisory on Effective Credit Risk Management Practices for Purchased Loan Participations* (FIL-38-2012). This updated Advisory addresses purchased loans and loan participations and reminds FDIC-supervised institutions of the importance of underwriting and administering these purchased credits as if the loans were originated by the purchasing institution. The updated Advisory also reminds institutions that third-party arrangements to facilitate loan and loan participation purchases should be managed by an effective third-party risk management process. The FDIC noted that:

- some institutions are relying on lead or originating institutions and nonbank third parties to perform risk management functions when purchasing: loans and loan participations, including out-of-territory loans; loans to industries or loan types unfamiliar to the bank; leveraged loans; unsecured loans; or loans underwritten using proprietary models.
- institutions should underwrite and administer loan and loan participation purchases as if the loans were originated by the purchasing institution. This includes understanding the loan type, the obligor's market and industry, and the credit models relied on to make credit decisions.
- before purchasing a loan or participation or entering into a third-party arrangement to purchase or participate in loans, financial institutions should:
  - ensure that loan policies address such purchases,
  - understand the terms and limitations of agreements,
  - perform appropriate due diligence, and
  - obtain necessary board or committee approvals.
- the Advisory supplements existing guidance and rescinds and replaces the FDIC Advisory on Effective Credit Risk Management Practices for Purchased Loan Participations, FIL-38-2012.

Agencies Find Weaknesses in Shared National Credits

Credit risk in the Shared National Credit (SNC) portfolio remained at a high level, according to an annual review of large shared credits released November 5 by federal banking agencies. The SNC review has been conducted since 1977 by the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency to assess risk in the largest and most complex credits shared by multiple financial institutions. Leveraged lending, which accounts for approximately one quarter of the SNC portfolio, remained a focus of the agencies. This year's review found that banks "are making progress in aligning their underwriting practices with the leveraged lending guidance issued by regulators in 2013. However, the review highlighted continuing gaps between industry practices and the expectations for safe and sound banking. Leveraged transactions originated within the past year continued to exhibit structures that were cited as weak by examiners. The persistent structural deficiencies found in loan underwriting by the agencies warrant continued attention. The review also noted an increase in weakness among credits related to oil and gas exploration, production, and energy services following the decline in energy prices since mid-2014. Aggressive acquisition and exploration strategies from 2010 through 2014 led to increases in leverage, making many borrowers more susceptible to a protracted decline in commodity prices.

Comptroller Revises Credit Card Lending; Announces Rescissions

The Office of the Comptroller of the Currency (OCC) issued the "Credit Card Lending" booklet of the *Comptroller's Handbook* on November 4. The revised booklet "replaces the 'Credit Card Lending' booklet issued in October 1996. The revised booklet also replaces section 218, 'Credit Card Lending,' issued in May 2006 as part of the former *Office of Thrift Supervision Examination Handbook* for the examination of federal savings associations (FSA)."

The revised booklet incorporates national bank and FSA statutes and regulations, guidance, and examination procedures. The booklet also provides updated guidance to examiners on assessing and managing the risks associated with credit card lending activities. The new booklet:

- rescinds the following advisory letters, which are largely superseded by the 2009 Credit Card Accountability Responsibility and Disclosure Act (CARD Act) and its implementing regulations in Regulation Z:
  - Advisory Letter 2004-4, "Secured Credit Cards" (April 28, 2004), and
  - Advisory Letter 2004-10, "Credit Card Practices" (September 14, 2004).

- makes the following applicable to FSAs:
    - OCC Bulletin 1997-24, “Credit Scoring Models: Examination Guidance” (May 20, 1997).
- provides updated guidance to examiners on assessing the quantity of risk associated with credit card lending and the quality of credit card lending risk management.
- addresses the CARD Act, which further amended the Truth in Lending Act.

UK DEVELOPMENTS

Recent FCA Commentary on Internal Investigations by Firms

On November 6, the UK Financial Conduct Authority (FCA) published a speech by Jamie Symington, director in enforcement (wholesale, unauthorized business and intelligence), on FCA-regulated firms' internal investigations of their own affairs when problems arise, either at their own initiative or through an agreement with the FCA. Often such investigations and reports are prepared by firms when there is no likelihood of enforcement action, i.e. they are prepared for internal purposes and/or are uncontroversial and may be shared with FCA supervisors. However, problems may arise if firms conduct internal investigations of matters while there also is enforcement action by the FCA. Firms should take great care not to prejudice any such action, such as when the FCA carries out criminal investigations of insider-dealing or fraud.

Mr. Symington noted that FCA-regulated firms often achieve good standards of conduct in industry and markets and that in-place systems and controls prevent problems from arising. However, if problems do arise, then firms bear the primary responsibility for correcting them. Firms must establish the nature and extent of the problem, its root causes and where accountability lies for their own purposes and should proactively investigate when there are issues or concerns. Firms do not need to report minor issues to the FCA, but if there are substantive issues, firms need to ask whether or not they should self-report and engage with the FCA and if so, how early.

Early engagement with the FCA: Mr. Symington emphasized that self-reporting is the bare minimum required of firms and reminded them that the FCA has fined firms more than £10 million for breaching Principle 11 by failing to self-report. Principle 11 states that a “firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.” Mr. Symington reminded firms that the FCA will give credit to those firms that assist the FCA in unravelling potential misconduct and help the FCA to conduct enquiries quickly and efficiently. This is often when the firm's own investigation can be particularly helpful.

Ground rules: In his speech, Mr. Symington listed typical questions that the FCA would ask a firm that is conducting an internal investigation:

- To what extent will the FCA be able to rely on the report in any subsequent enforcement proceedings?
- To what extent will the FCA have access to the underlying evidence or information that was relied upon in producing the report?
- To what extent, and on what basis, is the firm willing to disclose material over which they claim legal privilege, and how can the FCA use it?
- How will evidence be recorded and retained?
- Have any conflicts of interest been identified?
- What are the proposals to manage conflicts of interest appropriately?
- Will the report describe the roles and responsibilities of identified individuals?
- Will the investigation be limited to ascertaining facts, or will it also include advice or opinions about breaches of FCA rules or requirements?
- How does the firm intend to inform the FCA of progress and communicate the results of the investigation?
- What is the expected timescale for completion?

Transparency: Mr. Symington stressed that transparency is a core value. He noted that the FCA fully understands and respects the needs of firms to claim and protect their rights to legal privilege when appropriate, but firms should not let legal privilege become an unnecessary barrier when sharing the output of internal investigations with the FCA. He advocated striking the right balance and emphasized that when firms carry out or commission an internal investigation they should share the core product of their investigation, i.e. the evidence, with the FCA. Consequently, the FCA will negotiate in early discussions what materials the firm will provide to it.

Confidentiality: Mr. Symington reminded firms that information provided to the FCA does *not* lose all protections from onward disclosure and it is possible that the FCA may use and disclose information in furtherance of its own functions or to assist other regulators. However, the FCA is subject to strict statutory restrictions on the onward disclosure of confidential information and reports, and underlying materials provided voluntarily to the FCA by a firm, whether covered by legal privilege or not, are confidential for these purposes and benefit from the statutory protections. He emphasized that the FCA carefully considers whether it is appropriate to disclose material provided voluntarily by a firm and that the FCA knows that firms are more likely to volunteer information when they know that the FCA is mindful of the impact of potential disclosure. If the FCA is considering disclosing materials voluntarily provided by a firm, that firm will normally be notified and given an opportunity to make representations to the FCA.

The text of Mr. Symington's speech is available here.

EU DEVELOPMENTS

European Commission Acknowledges a Year's Delay to the Implementation of MiFID II May Be Necessary

Recent weeks have seen increasing numbers of market participants and trade bodies in the European Union (including the Investment Association and the European Fund and Asset Management Association) calling for the start date of Markets in Financial Instruments Directive (MiFID II) (and the associated Markets in Financial Instruments Regulation (MiFIR)) to be delayed by a year because of complexities in getting the detailed rules finalized and in getting the necessary information technology (IT) and transaction reporting infrastructure in place. It now appears that EU legislative bodies also may arrive at the same conclusion.

While the recast MiFID II and the associated regulation (MiFIR) were finalized on May 15, 2014—at which time January 3, 2017 was set as the date that the new rules were to come into effect, it was only on September 28, 2015 that the European Securities and Markets Authority (ESMA) published its recommendations for the detailed rules that financial firms will have to comply with (in the form of various regulatory technical standards (RTS) and implementing technical standards (ITS)). The RTS and ITS have still to be endorsed by the European Commission (it has a deadline of December 28, 2015 to do so) and they must then be transposed into national law in each of the 28 EU member states before they can be complied with by any financial firms—a process that could take at least another six months from the date that the Commission endorses them—whenever that may be.

On November 10, 2015, Steven Maijoor, chairman of ESMA, announced in a speech to the Economic and Monetary Affairs Committee of the European Parliament that the January 3, 2017 deadline for MiFID II implementation was going to be difficult. He said: "The timing for stakeholders and regulators alike to implement the rules and build the necessary IT systems is extremely tight. Even more, there are a few areas where the calendar is already unfeasible. This relates to the fact that it will take some time, and well into 2016, before the text of the RTS will be stable and final. The building of some complex IT systems can only really take off when the final details are firmly set in the RTS and some of the most complex IT systems would need at least a year to be built." He added "We have therefore raised these timing issues with the European Commission, and the fact that some IT systems will not be ready in January 2017, and the uncertainty this will create as they are needed for the execution of certain elements of MiFID II. Related to that, we have raised with the Commission whether this uncertainty would need a legislative response with delaying certain parts of MiFID II, mainly related to transparency, transaction and position reporting."

It also has been widely reported that Martin Merlin, director for financial markets at the Commission, has acknowledged that further delay to MiFID II may be necessary particularly so as to smooth the implementation process. In his view, the simplest and most legally sound approach would be to delay the whole package by a year, which would shift the start date to January 3, 2018.

However, any delay would need to be agreed upon between the Commission, European Parliament and Council of Ministers, and would likely entail implementing a further piece of EU legislation to defer the start date.

The full text of Mr Maijoor's speech is available here.

A Reuters article on Mr. Merlin's comments is available here.

ESMA Reopens Consultation on Indirect Clearing Arrangements

On November 5, the European Securities and Markets Authority (ESMA) published a consultation paper relating to indirect clearing arrangements (CP). The CP consists of a review of the existing regulatory technical standards under the European Markets Infrastructure Regulation (EMIR RTS) applicable to indirect clearing of over-the-counter (OTC) derivatives as well as further consideration of the proposed regulatory technical standards under the new Markets in Financial Instruments Regulation (MiFIR RTS) applicable to indirect clearing of exchange-traded derivatives (ETDs). The MiFIR RTS on indirect clearing were notably absent from the package of final proposals for RTS and implementing technical standards for MiFIR and the revised Markets in Financial Instruments Directive (MiFID II) published by ESMA in September 2015.

First introduced in EMIR, the phrase “indirect clearing arrangements” refers to circumstances in which a clearing member provides clearing services to an “indirect client”, that is, a client of the clearing member’s direct client. Mindful of the need to ensure greater access to clearing to meet the G20 obligations to clear standardized OTC derivatives, and in order to establish a common European framework for indirect clearing, the EMIR RTS set out certain requirements applicable to indirect clearing arrangements, primarily to ensure adequate levels of protection to indirect clients in the event of the default of the clearing member, or the clearing member’s direct client. However, due to certain operational and other challenges in complying with the EMIR RTS on indirect clearing, clearing members have struggled to bring to market a viable indirect clearing solution for OTC derivatives.

The MiFIR RTS on indirect clearing attempted to mitigate certain of these challenges for the ETD markets. However, the approach to indirect clearing of ETDs proposed by ESMA was criticized by industry groups. The CP therefore represents an attempt by ESMA to reconsider indirect clearing arrangements for both the ETD and OTC markets in a comprehensive and coordinated fashion, in order to produce a common approach to indirect clearing for both markets. ESMA’s proposals in the CP focus primarily on account structure and segregation models for indirect clients as well as the obligations on liquidation or porting of indirect client positions and assets as part of default management activities.

Comments on the CP must be received by December 17, 2015. The CP is available here.

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