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BROKER-DEALER

Division of Trading and Markets and FINRA Staffs Issue Joint Statement on Broker-Dealer Custody of Digital Asset Securities

On July 8, in response to questions raised by market participants regarding the application of federal securities laws and the Financial Industry Regulatory Authority (FINRA) rules to the custody of digital asset securities and transactions, the staffs of the Division of Trading and Markets (the Division) and FINRA issued a joint statement. The joint statement seeks to articulate and clarify various considerations pertinent to many of the questions raised, particularly with respect to the Securities and Exchange Commission's Customer Protection Rule applicable to SEC-registered broker-dealers.

The joint statement highlights the importance of the Customer Protection Rule and details its potential application to digital asset securities. It also discusses the application of the books and records and financial reporting requirements, as well as the Securities Investor Protection Act of 1970, to digital asset securities.

The staffs note several examples of business activities that would *not* involve the broker-dealer engaging in custody functions, including where a broker-dealer facilitates over-the-counter secondary market transactions in digital asset securities without taking custody of, or exercising control over, the digital asset securities. In this example, the buyer and seller complete the transaction directly.

The staffs also note some complications and concerns with custodying traditional securities and digital asset securities. The manner in which digital asset securities are issued, held and transferred may create greater risk for a broker-dealer in custody of them to 1) be victimized by fraud or theft; 2) lose a "private key" required to transfer a client's digital asset securities; or 3) inadvertently transfer a client's digital asset securities to an unknown or unintended address. Further, the joint statement explains that the nature of distributed ledger technology—and the characteristics of digital asset securities—may make it difficult for a broker-dealer to evidence the existence of digital asset securities for the purposes of the broker-dealer's regulatory books and records and financial statements.

Notwithstanding the challenges associated with custody of digital asset securities, both the Division and FINRA staffs reiterated their support for innovation and open dialogue with market participants to work toward developing methodologies for establishing possession or control over customers' digital asset securities.

The complete joint statement is available here.

FINRA Issues Regulatory Notice Requesting Comment on a Proposal to Publish ATS Volume Data for Corporate Bonds and Agency Debt Securities

On July 9, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 19-22 (the Notice) requesting comment on a proposal to publish alternative trading system (ATS) volume data for corporate bonds and agency debt securities, in a format similar to that currently published for equity securities. The published data would include both the total number of transactions and aggregate dollar volume traded for transactions in a particular corporate bond or agency debt security executed within the ATS and reported to FINRA during the aggregation period. The ATS data would be aggregated on a monthly basis and published with a three-month delay. FINRA would not charge for the aggregated ATS fixed income data, which would be published on FINRA's website.

Under the proposal, each ATS self-reports to FINRA its aggregate weekly volume information and number of trades, by security, in corporate and agency debt securities that are TRACE-eligible. Self-reporting by ATSs would occur on a security-by-security basis within seven business days after the end of each week. FINRA would then publish the data as described above. FINRA staff would compare the self-reported ATS volume data with the transaction information firms report to TRACE to verify the accuracy of volume and trade counts, and once it is comfortable with relying on trade reporting data to calculate the volume, it would eliminate the self-reporting requirement and derive the published data directly from the transaction information reported to TRACE. The Notice also includes a series of specific questions for which FINRA is seeking feedback. FINRA will consider alternatives based on feedback to the proposal.

In the Notice, FINRA encourages all interested parties to comment on the proposal to publish the ATS data by September 7.

A full copy of the Notice is available here.

FINRA Issues Regulatory Notice Supplementing Prior Guidance on Credit for Extraordinary Cooperation

On July 11, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 19-23 (the Notice) to restate and supplement prior guidance regarding the circumstances by which a firm or individual may influence the outcome of an investigation by exhibiting extraordinary cooperation. The Notice incorporates FINRA's prior guidance and further clarifies how FINRA defines "extraordinary cooperation" and whether a potential respondent's cooperation rises to such a level, as distinct from the level of cooperation expected of *all* member firms and their associated persons.

In determining what constitutes extraordinary cooperation, FINRA's *Sanction Guidelines* direct FINRA Enforcement to consider whether a respondent:

i. accepted responsibility for an acknowledged the misconduct prior to detection and intervention by the firm or a regulator;
ii. voluntarily employed subsequent corrective measures, prior to detection or intervention by the firm or by a regulator, to revise general and/or specific procedures to avoid recurrence of the misconduct;
iii. voluntarily and reasonably attempted, prior to detection and intervention by a regulator, to pay restitution or otherwise remedy the misconduct; and
iv. provided substantial assistance to FINRA in its examination and/or investigation of the underlying misconduct.

In addition to the factors described above, FINRA states that it may provide credit in the following areas, and provides additional guidance:

- where there are steps taken to correct deficient procedures and systems;
- where restitution is made to customers;
- where violations are self-reported; and
- where substantial assistance is provided to assist in FINRA investigations.

The Notice further explains that when FINRA determines that a firm should be given credit for extraordinary cooperation, that credit may take many forms ranging from closing an investigation with no further action or with a Cautionary Action letter, to reduced sanctions in an enforcement proceeding.

Finally, the Notice describes FINRA's efforts to be more transparent about credit for extraordinary cooperation for both firms and individuals.

A full copy of the Notice is available here.

FINANCIAL MARKETS

FATF Publishes Updated Standards Include Interpretative Note on Virtual Assets

On July 3, the Financial Action Task Force (FATF) published an updated version (dated June 2019) of its anti-money laundering (AML) and counter-terrorist financing (CTF) standards.

This version includes a recently adopted interpretative note to recommendation 15 (new technologies), in which the FATF explains how its standards apply to virtual asset activities and virtual asset service providers (VASPs).

Among other things, the FATF explains that countries should:

- identify, assess and understand the money laundering and terrorist financing (ML/TF) risks emerging from virtual asset activities and the activities or operations of VASPs. Based on that assessment, countries should apply a risk-based approach to ensure that ML/TF prevention or mitigation measures are commensurate with the risks identified;
- adopt and apply legal or regulatory measures to prevent criminals and their associates from controlling, being beneficial owners of or holding management functions in a VASP;
- require VASPs to be licensed or registered and require them to identify, assess and take effective action to mitigate their ML/TF risks;
- ensure that VASPs are subject to adequate regulation and supervision or monitoring for AML/CFT and are effectively implementing the relevant FATF recommendations, to mitigate ML/TF risks emerging from virtual assets. VASPs should be subject to effective systems for monitoring and ensuring compliance with national AML/CFT requirements; and
- rapidly, constructively and effectively provide the widest possible range of international cooperation in relation to money laundering, predicate offences, and terrorist financing relating to virtual assets. In particular, supervisors of VASPs should exchange information promptly and constructively with their foreign counterparts, regardless of the supervisors' nature or status and differences in the nomenclature or status of VASPs.

The FATF plans to monitor the implementation of these virtual asset standards by carrying out a review in June 2020.

The updated standards are available here.

DERIVATIVES

See "CFTC Issues Guidance on Initial Margin Documentation Requirements," "CFTC Grants DCO Registration to Eris Clearing," "CFTC Staff Provide Guidance, No-Action Relief With Respect to the Treatment of Separate Accounts by FCMs" and "CFTC and Financial Services Agency of Japan Issue Joint Statement on Comparability of Derivatives Trading Venues" in the CFTC section; and "FCA Consults on Prohibiting Sale to Retail Clients of Investment Products Referencing Cryptoassets" in the UK Developments section.

CFTC Report Concerning On-Venue and Cleared Swaps

On July 8, the staff of the Division of Swap Dealer and Intermediary Oversight (DSIO) of the Commodity Futures Trading Commission issued a report containing data and analysis concerning possible exclusions from the calculation of the swap dealer *de minimis* registration threshold for swaps executed on a regulated exchange and/or cleared by a derivatives clearing organization. The report has numerous charts that estimate the number of registered swap dealers that would drop out of registration under various exclusion scenarios. While it is long on data, the report is short on explicit conclusions. However, Commissioner Brian Quintenz issued an accompanying statement that gives his views on the significance of the report: "First, the report shows that the removal of exchange-traded and cleared swaps from the *de minimis* calculation would result in no reduction of regulatory coverage. Second, the report highlights once again the glaring deficiencies of using notional value as the registration threshold triggering swap dealer registration."

The CFTC report is available here.

The accompanying statement from Commissioner Quintenz is available here.

CFTC

CFTC and SEC Propose Changes to Margin Requirements for Security Futures

The Commodity Futures Trading Commission and the Securities and Exchange Commission have jointly proposed amendments to the minimum customer margin requirements for security futures contracts.

In 2002, the CFTC and SEC adopted rules establishing margin requirements for unhedged security futures at 20 percent. Under the current proposal, this requirement would be reduced to 15 percent.

Public comments on the proposal are due with 30 days after publication in the *Federal Register*.

More information is available here.

CFTC Issues Guidance on Initial Margin Documentation Requirements

The Division of Swap Dealer and Intermediary Oversight (DSIO) of the Commodity Futures Trading Commission has issued an advisory clarifying that the initial margin documentation requirement for swap dealers does not apply until the initial margin amount exceeds the regulatory posting threshold of $50 million (which is measured on a group basis). More specifically, DSIO's advisory provides that swap dealers subject to the CFTC's margin requirements are not required to complete documentation governing the posting, collection and custody of initial margin until the amount of initial margin exchangeable between the swap dealer and a counterparty exceeds $50 million. However, because the CFTC also makes the point that it expects that a swap dealer will take appropriate steps to have the required initial margin documentation fully executed on before the date the initial margin exposure threshold is reached, a dealer faces the practical challenges of estimating when that event will occur and starting the documentation effort well in advance of that estimated date.

More information, including access to CFTC Letter No. 19-16, is available here.

CFTC Grants DCO Registration to Eris Clearing

The Commodity Futures Trading Commission has issued an order granting registration as a derivatives clearing organization (DCO) to Eris Clearing, LLC. The order permits Eris Clearing to clear fully collateralized virtual currency futures contracts. These contracts will be listed for trading on Eris Clearing's affiliate, Eris Exchange, LLC.

Concurrently, the CFTC's Division of Clearing and Risk issued a no-action letter to Eris Clearing. The letter provides relief from certain regulatory requirements for DCOs due to Eris Clearing's fully collateralized clearing model.

More information is available here.

CFTC Staff Provide Guidance, No-Action Relief With Respect to the Treatment of Separate Accounts by FCMs

The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight and Division of Clearing and Risk have issued CFTC Staff Advisory 19-17 (the Advisory), providing 1) guidance with respect to CFTC Rule 1.56(b); and 2) time-limited no-action relief with respect to CFTC Rule 39.13(g)(8)(iii), as those rules relate to the treatment of separate accounts of the same customer (i.e., beneficial owner). The Advisory responds to several requests for guidance following the publication of Joint Audit Committee (JAC) Regulatory Alerts #19-02 and #19-03.

JAC Regulatory Alert #19-02 complements CFTC Rule 39.13(g)(8)(iii), which provides that each derivatives clearing organization (DCO) must require its clearing members to assure that their customers do not withdraw funds from their accounts with such clearing members, unless the net liquidating value plus the margin deposits remaining in the customer's accounts after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to the products or portfolios in the customer's account cleared by the DCO. JAC Regulatory Alert #19-02 instructs FCMs to combine for margin purposes all accounts of the same beneficial owner for the same account classification type (i.e., segregated, secured, cleared swaps). While separate accounts may be continue to be margined separately, the FCM must combine all accounts of the same regulatory classification—even those under different control—to assess whether it may release excess funds from one account of a beneficial owner.

The Advisory adopts time-limited no-action relief, pursuant to which a DCO may permit the FCM to treat the separate accounts of a customer as accounts of separate entities for purposes of Rule 39.13(g)(8)(iii), provided the FCM's written internal controls and procedures require the FCM to comply with the terms and conditions set out in the Advisory. The no-action relief extends to June 30, 2021, during which time, CFTC staff will consider whether to recommend that the CFTC adopt more permanent relief. DCOs are expected to take action promptly to implement the no-action relief.

JAC Regulatory Alert #19-03 begins by restating the provisions of CFTC Rule 1.56(b), which provides that no FCM may: 1) directly or indirectly guarantee a client against loss; 2) limit the loss of a customer; or 3) agree not to call for margin as established by the rules of an exchange. The alert explains that, where a beneficial owner has multiple accounts with multiple advisers at an FCM (or even multiple accounts with the same adviser traded pursuant to different programs), the FCM cannot agree that it will never look to recover losses in any one account from other accounts beneficially owned by the same owner—even if the other accounts are managed by another adviser, or subject to a different program of the same adviser.

The Advisory confirms that an FCM may not enter into an agreement with any customer, the terms of which conflict with the provisions of Rule 1.56(b). Further, the Advisory provides that, to address any shortfall in any separate account, "the FCM must retain the ability to ultimately look to funds in other accounts of the beneficial owner, including accounts that may be under different control, as well as the right to call the beneficial owner for additional funds."

CFTC Staff Advisory 19-17 is available here.

CFTC and Financial Services Agency of Japan Issue Joint Statement on Comparability of Derivatives Trading Venues

The Commodity Futures Trading Commission and the Financial Services Agency of Japan (JFSA) have issued a joint statement on the comparability of certain derivatives trading venues in the United States and Japan.

More specifically, the CFTC has issued an order that exempts electronic trading platforms (ETP) authorized by the JFSA from the requirement to register as a swap execution facility. Likewise, the JFSA has announced that it will facilitate the authorization process of foreign ETP operators for CFTC-registered derivatives platforms.

More information is available here.

DIGITAL ASSETS AND VIRTUAL CURRENCIES

See "Division of Trading and Markets and FINRA Staffs Issue Joint Statement on Broker-Dealer Custody of Digital Asset Securities" in the Broker-Dealer section; "CFTC Grants DCO Registration to Eris Clearing" in the CFTC section; and "FCA Consults on Prohibiting Sale to Retail Clients of Investment Products Referencing Cryptoassets" in the UK Developments section.

UK DEVELOPMENTS

FCA Consults on Prohibiting Sale to Retail Clients of Investment Products Referencing Cryptoassets

On July 3, the UK Financial Conduct Authority (FCA) published a consultation paper (CP19/22) on prohibiting the sale, marketing and distribution to retail clients of derivatives and exchange traded notes (ETNs) referencing certain types of cryptoassets by firms acting in, or from, the UK.

The FCA believes that retail clients cannot reliably assess the value and risks of derivatives and ETNs that reference certain cryptoassets. The FCA states that this is due to the:

- inherent nature of the underlying assets, which have no reliable basis for valuation;
- prevalence of market abuse and financial crime (including cyber thefts from cryptoasset platforms) in the secondary market for cryptoassets;
- extreme volatility in cryptoasset price movements; and
- inadequate understanding by retail clients of cryptoassets and the lack of a clear investment need for investment products referencing them.

The FCA estimates a ban could save from £75m to £234.3m a year in losses to retail investors. However, the FCA is not proposing to extend the ban to professional or eligible counterparty clients, to derivatives or ETNs that reference other tokens, or to collective investment undertakings.

CP19/22 follows the UK's Cryptoassets Taskforce (consisting of HM Treasury, the FCA and the Bank of England) October 2018 report setting out the UK's policy and regulatory approach to cryptoassets (for more information, see the November 2, 2018 edition of *Corporate & Financial Weekly Digest*).

The FCA recognizes that its proposals may encourage some retail consumers to invest directly in unregulated tokens. However, this risk does not alter its proposals. The proposed scope of the ban could also result in evasion by firms, for example by offering derivatives and ETNs referencing other tokens, or encouraging retail clients to 'opt up' to professional client status or move their accounts to affiliated non-UK entities. The FCA states that it will continue to monitor such risks and will work with international regulators to monitor the risks of circumvention of the FCA's measures.

Comments can be made on CP19/22 until October 3. The FCA intends to publish final rules in a policy statement in early 2020.

CP19/22 is available here.

FCA Confirms Permanent Restrictions on Sale of CFDs and CFD-Like Options to Retail Consumers

On July 1, the UK Financial Conduct Authority (FCA) published a policy statement (PS19/18) containing rules on restricting contract for difference (CFD) products and CFD-like options sold to retail clients.

The FCA consulted on the rules in December 2018 in CP18/38 (for more information, see the December 14, 2018 edition of *Corporate & Financial Weekly Digest*). In PS19/18, the FCA confirms that for CFDs and CFD-like options sold to retail clients, firms will be required to:

- limit leverage to between 30:1 and 2:1 depending on the volatility of the underlying asset;
- close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account;
- provide protections that guarantee a client cannot lose more than the total funds in their CFD account;
- stop offering monetary and non-monetary inducements to encourage retail consumers to trade; and
- provide a standardized risk warning, which requires firms to tell potential customers the percentage of their retail client accounts that make losses.

In response to feedback to CP18/38, the FCA has clarified the scope of its CFD-like option restrictions to:

- exclude firms that sell CFD-like options in other jurisdictions where the product is sold through an intermediary outside the UK; and
- exclude the sales and distribution activities of EEA firms outside the UK. These firms are still prohibited from actively marketing unrestricted CFD-like options to UK retail consumers.

The rules go into effect on August 1 for CFDs and September 1 for CFD-like options.

PS19/18 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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UK DEVELOPMENTS

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