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STRUCTURED THOUGHTS

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IN THIS ISSUE

EUROPEAN COMMISSION CONSULTATION ON EU BENCHMARK REGULATION

Page 1

FINRA: SUITABILITY AND SALES PRACTICES REMAIN AN ISSUE

Page 5

SEC CHARGES SWITZERLAND-BASED DEALER FOR SELLING TO U.S. INVESTORS UNREGISTERED SECURITY-BASED SWAPS FOR BITCOINS

Page 7

REGULATORS PROPOSE DELAY IN INITIAL MARGIN PHASE-IN FOR SWAPS WITH CERTAIN FINANCIAL END USERS

Page 8

EUROPEAN COMMISSION CONSULTATION ON EU BENCHMARK REGULATION

The European Commission ("**Commission**") published a public consultation document[1] in October 2019 relating to the review of Regulation (EU) 2016/1011 (the "**Benchmark Regulation**"). Under the Benchmark Regulation, the Commission has to review and report to the European Parliament and to the Council by January 1, 2020 on the functioning and effectiveness of various aspects of the Benchmark Regulation, as well as on the operation of third-country benchmarks in the EU.

Broadly, the consultation covers the following areas:

- Critical benchmarks
- Authorization and registration
- Scope of the Benchmark Regulation

[1] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-benchmark-review-consultation-document_en.pdf.

- ESMA register of administrators and benchmarks
- Benchmark statement to be published by administrators
- Supervision of climate-related benchmarks
- Commodity benchmarks

CRITICAL BENCHMARKS

IBOR REFORM

In the context of the ongoing reforms applicable to inter-bank offered rates (**IBORs**), EU competent authorities may in future be faced with the situation that a particular IBOR is no longer representative of the market or economic reality it is intended to measure, for example, because one or more contributors is withdrawing from the IBOR's panel. In such a situation, the Benchmark Regulation empowers the competent authority, *inter alia*, to require a change to the benchmark's methodology or to its other rules.[2] The consultation asks whether competent authorities should be given broader powers to require an administrator to change the methodology of a critical benchmark. It also asks whether there are any other amendments to Article 23(6)(d) (*Mandatory contribution to a critical benchmark*) that would improve the robustness, representativeness, and reliability of a benchmark.

If it considers the input data to the critical benchmark to be no longer representative of the market or economic reality, an administrator is required either to change the input data, contributors, or methodology to preserve the representativeness of the critical benchmark, or to cease provision of the benchmark.[3] In cases where an immediate cessation of the benchmark could lead to market instability, the consultation recognizes that it is useful for a competent authority to have the power to compel a change to the benchmark's methodology (alongside the existing power to compel continued publication for a period of time),[4] in which case the consultation asks whether such corrective powers should be given also when the administrator has indicated the intention to cease publication of the benchmark, and not just when mandatory contributions to a critical benchmark are triggered.

ORDERLY CESSATION OF A CRITICAL BENCHMARK

The Benchmark Regulation requires benchmark administrators to publish their contingency plans for changes to or cessation of their benchmarks,[5] in order to avoid disruption to users and the financial markets when the benchmarks are materially changed or ceased to be published. The consultation seeks the view of the public as to whether such plans should be approved by national competent regulators. In the case of supervised entities, the consultation also asks whether those entities should provide contingency plans to cover circumstances where a critical benchmark is no longer representative of the underlying market, not just where a benchmark materially changes or ceases to be published.

COLLEGES

There are currently three critical benchmarks subject to the supervision of colleges set up in accordance with the Benchmark Regulation: EURIBOR, EONIA, and LIBOR. A supervisory college is made up of the competent authority for the relevant administrator, the European Securities and Markets Authority (**ESMA**), the competent authorities responsible for the supervision of each of the members of the panel of the critical benchmark, and the competent authorities for the EU member states for which the benchmark is of particular importance. The consultation asks whether the current structure of the supervisory colleges for critical benchmarks continues to be appropriate.

AUTHORIZATION AND REGISTRATION

AUTHORIZATION, SUSPENSION, AND WITHDRAWAL

Article 35 of the Benchmark Regulation allows a competent authority to withdraw or suspend the authorization or registration of an administrator in certain circumstances, following which the use of all

[2] Article 23(6)(d), Benchmark Regulation. [3] Article 11(4), Benchmark Regulation.

[4] Article 21(3), Benchmark Regulation.
[5] Article 28(1), Benchmark Regulation.

benchmarks provided by such administrator would be prohibited (unless the exception under Article 35(3) of the Benchmark Regulation (see discussion below) applies). The consultation suggests that it may be necessary to clarify that a competent authority should also have the option to withdraw or suspend authorization or registration in respect of one or more individual benchmarks provided by such administrator rather than suspending the administrator, and seeks the public's view as to whether the current Benchmark Regulation is sufficiently clear that the competent authority has such an option.

CONTINUED USE OF NON-COMPLIANT BENCHMARKS

National competent authorities currently have power under Article 35(3) of the Benchmark Regulation to allow for the continued use of benchmarks provided by a suspended administrator in legacy contracts in certain circumstances. The consultation suggests that extending this power to allow the use of benchmark in legacy contracts where the administrator has had its authorization withdrawn (and not just suspended) may be useful. The Benchmark Regulation also allows for the use of non-compliant benchmarks in cases where their cessation or changes would result in a force majeure event, or would frustrate or otherwise breach the terms of any financial contract, instrument, or the rules of any investment fund that references that benchmark.[6] The consultation asks whether stakeholders consider the current powers in the Benchmark Regulation allowing for the use of non-compliant benchmarks in these specified circumstances to be sufficient.

SCOPE

The preamble to the Benchmark Regulation states that the scope of the Benchmark Regulation should be "as broad as necessary to create a preventive regulatory framework," and applies to all types of benchmarks regardless of their underlying markets. However, during its exercise of assessing third country jurisdictions with the aim of granting equivalence, the Commission has noticed that certain third countries have adopted an approach where supervision and regulation is restricted only to the most critical or systemic financial benchmarks administered in the relevant jurisdiction. The consultation seeks to review the scope of the Benchmark Regulation, in terms of its application to non-significant benchmarks, whether the quantitative thresholds (and their calculation methods) currently used to establish the categories of benchmarks (non-significant, significant, and critical) are appropriate, whether any alternative methodology (or combination) would be useful, and whether there should be an alternative approach to certain benchmarks that are less prone to manipulation (such as regulated data benchmarks).

ESMA REGISTER OF ADMINISTRATORS AND BENCHMARKS

ESMA maintains a register listing benchmark administrators that have either been authorized or registered in the EU, as well as benchmarks and administrators approved for use in the EU through equivalence, recognition, or endorsement. However, benchmark users have commented that the functioning of the register could be improved; for example, it is difficult to identify benchmarks that are authorized or registered for use in the EU, as the register only lists an EU-authorized or EU-registered administrator but not the administrator's benchmarks, yet it is possible for certain administrators that operate on a global basis to apply for authorization or registration in respect of certain benchmarks only. On the other hand, the Commission noted that it would be challenging to maintain an up-to-date list of benchmarks approved for use in the EU in respect of large administrators with a constantly changing portfolio of benchmarks. The consultation seeks the view of users on their experience with the register, how it may be improved, and whether benchmarks should be listed in addition to (or instead of) the current list of EU-authorized or EU-registered administrators.

BENCHMARK STATEMENT

A benchmark statement is intended to provide key information that allows its users to understand the

[6] Article 51(4), Benchmark Regulation.

economic reality such benchmark (or family of benchmarks) is measuring, and the risks of such benchmarks. However, the form and content of the benchmark statements vary among the administrators, which impedes comparability. Some administrators prepare a benchmark statement for each benchmark, whilst others consolidate information for a family of benchmarks that may comprise thousands of benchmarks. Often there are overlaps between the benchmark statement and the benchmark methodology, which reduces their usefulness.

The consultation asks stakeholders to share their experience with the benchmark statement, any recommendation on improving the format and content, and whether to maintain the option to allow for the benchmark statement to be prepared either at the benchmark or at the family level.

When the amending regulation to the Benchmark Regulation[7] (the "**Amending Benchmark Regulation**") relating to climate-related benchmarks is published, there will be further clarity relating to objectives of the benchmark statements, and a requirement for standardized disclosure of Environmental, Social, and Governance (**ESG**) information for all benchmarks (except currency and interest rate benchmarks) in the benchmark statement.

SUPERVISION OF CLIMATE-RELATED BENCHMARKS

The Amending Benchmark Regulation, when published, will introduce two new types of "climate-related benchmarks" and the qualifying criteria for each: the EU Paris-aligned Benchmark and the EU Climate Transition Benchmark. The Amending Benchmark Regulation will also require ESG disclosures for all investment benchmarks (other than currency and interest rate benchmarks). The minimum standards relating to these two benchmarks as well as the content of ESG disclosures will be further specified in delegated acts to be adopted in early 2020.

[7] Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks (COM(2018)/355 final).

In order to give effect to the Amending Benchmark Regulation, the Commission considers that national competent authorities should be given powers that will allow them to effectively monitor the investment firm or fund manager that offers products that reference a climate-related benchmark, as well as any investment strategy that references it, in order to verify that (a) the chosen benchmark is compliant with the requirements in the Amending Benchmark Regulation, and (b) the relevant investment strategy aligns with the chosen benchmark.

The consultation seeks the view of the public as to whether the competent authorities should have explicit powers relating to the above.

COMMODITY BENCHMARKS

The consultation highlights two areas in relation to commodity benchmarks that it would like to address:

- Currently, commodity benchmarks are subject to the requirements set out in Annex II of the Benchmark Regulation (*Commodity Benchmarks*) instead of those set out in Title II (*Benchmark Integrity and Reliability*) (except for Article 10 (*Outsourcing*)), unless such benchmark is a regulated-data benchmark or where a majority of its contributors are supervised entities. This latter case in particular has been criticized by benchmark providers.

  In addition, Title II requirements will nevertheless apply to a critical benchmark where the underlying asset is gold, silver, or platinum.

  There are currently no benchmarks that fulfil these criteria. The consultation therefore asks whether the existing conditions under which Title II requirements would apply continues to be appropriate.

- There is a *de minimis* threshold below which a benchmark is exempt from the Benchmark Regulation, provided that (a) instruments referencing the benchmark can only be admitted

to trading on a single trading venue, and (b) the total notional amount of those instruments is less than or equal to €100 million. Due to seasonal effects, it is possible for a benchmark's usage to exceed the threshold at one point during the year but fall below the threshold again during the same year. The consultation asks whether this compound *de minimis* threshold is appropriately set.

NON-EEA BENCHMARKS

From January 2022, EU-supervised entities can only use benchmarks provided by administrators located in a third country if (a) the Commission has adopted an equivalence decision, (b) the benchmark administrator has been recognized by an EU-competent authority, or (c) the benchmark has been endorsed by an EU-supervised entity. Of these conditions:

- the Commission commented that equivalence may not allow for the continued use of a majority of the indices administered outside the EU where the country in question has only applied the IOSCO-compliant benchmark rules in respect of systemic or critical benchmarks; and

- recognition by the EU-competent authority will require the relevant benchmark administrator to have a legal representative in the EU. Stakeholders have said that the tasks and responsibilities of the legal representative will need to be clarified further.

There is a risk that third-country administrators will not have any incentive to seek recognition or endorsement in order for their benchmarks to be used in the EU, which means that such third-country benchmarks can no longer be used by EU-supervised entities following the extended transition period.

Further, certain FX spot rates for currencies that are not fully convertible will not comply with the conditions set out under the Benchmark Regulation, which means they cannot be used in calculating the payments due for EEA-listed non-deliverable forwards from January 2022.

The consultation wishes to find out the extent of the impact of the FX spot rate issue on stakeholders, and would like recommendations for improving the procedures relating to the granting of equivalence, recognition, or endorsement in respect of third-country benchmarks.

The consultation closes on December 6, 2019. The Commission will consider the responses to this consultation in its report to the European Parliament and to the Council to be delivered by January 1, 2020, as well as in a separate report concerning the operation of third-country benchmarks in the EU to be delivered by April 1, 2020.

FINRA: SUITABILITY AND SALES PRACTICES REMAIN AN ISSUE

In October 2019, FINRA released its "2019 Report on Examination Findings and Observations." The report is intended to reflect key findings and observations identified in FINRA's recent examinations of broker-dealers. The report also describes practices that FINRA deemed to be effective and that could help firms improve their compliance and risk management programs. In this article, we summarize aspects of FINRA's report that are relevant to the structured products industry. The full report may be found at the following link: https://www.finra.org/rules-guidance/guidance/reports/2019-report-exam-findings-and-observations/supervision.

INSUFFICIENT WRITTEN SUPERVISORY PROCEDURES FOR NEW OR AMENDED RULES

FINRA reported that some broker-dealers did not adequately address newly adopted or amended rules by developing controls to address recently enacted regulatory requirements and updating their written supervisory procedures (WSPs). These rules include:

- Fixed income mark-up disclosure requirements under FINRA Rule 2232 (Customer Confirmations);[8]

- Trusted contact person information requirements under FINRA Rule 4512 (Customer Account Information);[9]

- Rules relating to temporary holds, supervision and record retention requirements under new FINRA Rule 2165 (Financial Exploitation of Specified Adults).[10]

The report reminds broker-dealers that FINRA expects them to evaluate which new and amended laws and regulations apply to their businesses and review whether their supervisory systems, WSPs and training programs need to be amended or updated to comply.

LIMITED SUPERVISION AND INTERNAL INSPECTIONS

FINRA noted that some broker-dealers did not have reasonably designed branch supervision and inspection programs. According to the report:

> "…some firms did not adequately understand the activities being conducted through their branch offices, including products and services that were offered only at certain branch locations, which could prevent such firms from effectively supervising and addressing the unique risks of each branch location. Many firms also did not conduct periodic inspections of non-branch locations as required by FINRA Rule 3110(c) (Internal Inspections); did not determine relevant areas of review at branch offices or non-branch locations, taking into consideration the nature and complexity of the products and services offered or any indicators of irregularities or misconduct; failed to reduce the inspections and reviews to a written report; or did not follow through on corrective action determined to be necessary through their branch inspections."

INADEQUATE SUPERVISION OF PRODUCT EXCHANGES

FINRA also noted in the report that some firms did not maintain a supervisory system reasonably designed to assess the suitability of recommendations that customers exchange certain products, such as mutual funds, variable annuities or unit investment trusts (UITs). In particular, some firms did not maintain processes to identify patterns of unsuitable recommendations of exchanges involving long-term products. In addition, FINRA stated that some firms did not reasonably supervise exchanges because they could not verify the information provided by registered representatives in their rationales in order to justify a recommended exchange, such as inaccurate descriptions of product fees, costs and existing product values. In other cases, a firm's supervision team did not detect that the source of funds for a purchase was misrepresented (i.e., it was represented as "new" money and not properly represented as funds coming from sales of other products).

As previously discussed in this publication,[11] this topic has already been addressed by the SEC. For example, the SEC's opinion is that exchanges of structured notes prior to maturity can be profitable for the relevant broker-dealer, but can subject the relevant investor to additional risk of loss.

LIMITED SUPERVISION TO IDENTIFY "RED FLAGS" FOR SUITABILITY

FINRA explained that some firms' supervisory systems were not reasonably designed or used to detect red flags of possible unsuitable transactions. According to FINRA:

> "For example, some firms did not identify or question patterns of similar recommendations by

[8] See our discussion in the following issue of this publication: https://media2.mofo.com/documents/160914-structured-thoughts.pdf. In addition, the report identifies a variety of issues in how firms complied with the new requirements. See page 14 of the report.

[9] See our discussion in the following client alert: https://www.bdiaregulator.com/2017/04/sec-approves-finras-rules-to-protect-seniors-from-financial-exploitation/.

[10] See preceding footnote.

[11] See https://media2.mofo.com/documents/180628-structured-thoughts.pdf.

representatives or branch offices across many customers with different risk profiles, time horizons and investment objectives. In some instances, several customers of a representative or branch office appeared to have made 'unsolicited' transactions in identical securities, which could raise questions around whether the transactions were actually 'unsolicited.'"

INADEQUATE SUPERVISION OF CHANGES TO CUSTOMER ACCOUNT INFORMATION

FINRA noted instances where registered representatives unilaterally changed account information, such as customers' income, net worth or account objectives. In some cases, these changes preceded or were made at the same time as one or more transactions that, if the account change had not been made, would have been subject to heightened supervisory scrutiny, raised suitability concerns or would not have been approved.

UNSUITABLE OPTIONS STRATEGY RECOMMENDATIONS

FINRA reported about situations in which registered representatives recommended complex options strategies to customers who did not have the sophistication to understand the features of an option or the associated strategy, or without adequately considering the customers' individual financial situations and needs. In addition, some firms did not properly implement trade limits and controls in order to identify and prevent options trading that exceeded customer pre-approved investment levels.

SEC CHARGES SWITZERLAND-BASED DEALER FOR SELLING TO U.S. INVESTORS UNREGISTERED SECURITY-BASED SWAPS FOR BITCOINS

In October, the SEC charged a Switzerland-based securities dealer for offering and selling unregistered security-based swaps to U.S. investors using bitcoins and for failing to transact its swaps on a registered national exchange, according to an SEC order instituting cease and desist proceedings (the "Order"). A copy of the Order can be found here.

Without admitting or denying the SEC's findings, the dealer consented to the Order and agreed to cease-and-desist operations. In addition, the dealer agreed to pay disgorgement of $31,687 in commissions, overnight holding fees, and its share of trading profits from its U.S. investors, as well as a civil penalty of $100,000. The dealer also undertook remedial efforts to pay back U.S. investors their trading losses.

According to the Order, from late 2014 through 2019, the dealer targeted U.S.-based retail investors and offered and sold them, through its website, various investments in exchange for payments in bitcoin. Although described with different terminology (such as bitcoin Asset Linked Notes, i.e., "bALNs"), the investments were essentially security-based swaps that track the real-time price of a variety of U.S.-listed securities.

The U.S. resident investors who purchased the security-based swaps at issue did not qualify as "eligible contract participants" with $5 million or $10 million invested on a discretionary basis. As a result, according to the Order, the dealer's conduct violated the securities laws when the swaps were not subject to an effective registration statement and were not traded on a national securities exchange.

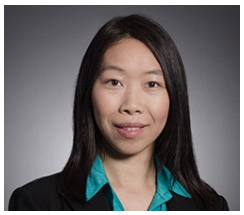
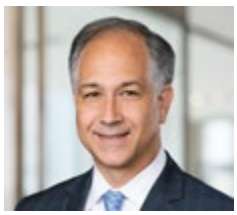
In a parallel action, the CFTC entered into a similar settlement with the dealer arising from similar conduct.

This case illustrates that the use of new technology such as bitcoins and new terminology (such as bALNs) does not exempt investment-product dealers from having to comply with the U.S. federal securities laws.

REGULATORS PROPOSE DELAY IN INITIAL MARGIN PHASE-IN FOR SWAPS WITH CERTAIN FINANCIAL END USERS

In recent weeks both the Commodity Futures Trading Commission (CFTC) and the U.S. prudential banking regulators have proposed rules that would delay the phase-in of initial margin (IM) requirements for swap dealers' non-cleared swaps with certain smaller financial end users. The CFTC's proposed rules, highlighted in this client alert, would postpone until September 1, 2021 the phase-in of IM requirements for swaps with financial end users with $50 billion or less in average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps. The prudential regulators' rules, which we summarized in this further client alert, would provide, for swap dealers subject to prudential banking regulation, a parallel postponement for IM for swaps with such financial end users. The prudential regulators' rules would also, among other things, end IM requirements for inter-affiliate swaps and clarify that certain amendments of legacy swaps (including to accommodate the transition away from LIBOR) may be made without jeopardizing their grandfathered status under the margin rules.

CONTACTS

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