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CAPITAL MARKETS REPORT – MODERNIZING AND RATIONALIZING REGULATION OF THE U.S. CAPITAL MARKETS

AUGUST 10, 2017

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EXECUTIVE SUMMARY

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Core Principles for Regulating the United States Financial System

(a) Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;

(b) Prevent taxpayer-funded bailouts;

(c) Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;

(d) Enable American companies to be competitive with foreign firms in domestic and foreign markets;

(e) Advance American interests in international financial regulatory negotiations and meetings;

(f) Make regulation efficient, effective and appropriately tailored; and

(g) Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

The Treasury Secretary's preparation of periodic reports to President Trump on the extent to which financial laws and regulations promote and support the President's Core Principles is an important opportunity to evaluate whether the laws and regulations that govern the U.S. capital markets can be modernized or otherwise improved to foster economic growth and make regulation efficient, effective and appropriately tailored. SIFMA strongly supports the Core Principles as the right framework for approaching these policy discussions.[1]

This White Paper covers those key topic areas relating to the U.S. capital markets where the SIFMA membership believes that regulation can be modified to spur market activity, increase market access or lower costs for market participants, without sacrificing investor protection or compromising systemic stability.

Each topic in this White Paper is covered in a separate Chapter and includes: equity market structure; fixed income markets in U.S. Treasuries, corporate credit and municipal securities and infrastructure financing; securitization; capital formation; research rules and regulation; derivatives; the role of self-regulatory organizations; and fiduciary regulation.

Each Chapter describes developments or problems in each topic area and explains SIFMA's proposed solutions and the reasons behind them in detail. A short-form grid of the recommendations is set forth at the end of this Executive Summary.[2]

This Executive Summary begins by explaining the strength and importance of U.S. capital markets. It then describes the critical role that appropriately tailored regulations play in making U.S. capital markets the strongest and deepest in the world, but identifies recent worrisome trends that suggest that these regulations should be modified or modernized to best serve their purposes. Finally, this Executive Summary identifies adjustments that can be made to reverse these trends.

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[1] This White Paper supplements SIFMA's submission to Treasury on May 1, 2017, Rebalancing the Financial Regulatory Landscape, that principally covered the regulation of banking organizations (link) (the "May White Paper").

[2] At the end of this White Paper is a glossary.

A. The Strength and Importance of the U.S. Capital Markets

> "[C]apital markets offer tremendous benefits to our respective economies. Studies show that robust capital markets can add percentage points to the economic growth of a country. This means job creation, infrastructure development, and increased standard of living for future generations. With economic growth comes a direct and measurable reduction in mortality and morbidity rates—so we, if we do our jobs right, it literally means saving lives."[3]
>
> *– Michael S. Piwowar, Commissioner, SEC*

The U.S. capital markets include the equity and debt markets, which connect savers with entrepreneurs and businesses that need capital, as well as the derivatives markets that allow investors and businesses to hedge and transfer risk. The U.S. capital markets are the bedrock of our nation's economy and the deepest and most liquid in the world. Our capital markets drive capital to the best ideas and enterprises, enabling businesses to grow, workers to save for retirement, families to pay for education and communities to finance infrastructure development.

The capital markets are the core of the United States' economic engine. According to the Federal Reserve, the capital markets provide almost 80% of debt financing for businesses in the United States. This central role played by U.S. debt capital markets contrasts with other major economies, where a far greater proportion of commercial finance is provided by traditional bank lending. For instance, in both the EU and Japan, 75% or more of debt financing for businesses is bank-financed. Studies have connected greater reliance on capital markets financing, as in the United States, over bank financing to better economic performance. An emphasis on capital markets financing is also consistent with the American entrepreneurial spirit, as it allows the public marketplace to identify and fund the best ideas.

The U.S. capital markets are the most efficient in the world and the envy of foreign markets. Their sheer magnitude make them critical to creating investor opportunities, facilitating capital formation, offering U.S. companies a greater diversity of funding sources, more efficiently allocating risk among investors and ultimately promoting job creation and economic growth.

- The U.S. corporate bond market is the largest in the world: over 1,300 companies issued $1.5 trillion in corporate bonds in the United States to fund their operations and growth in 2016.[4]

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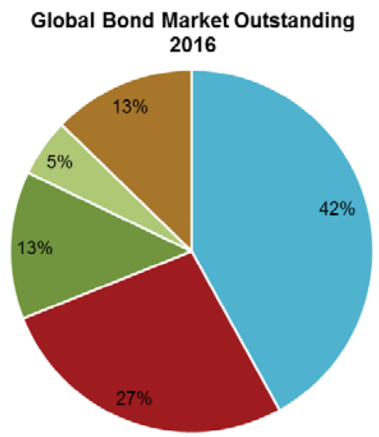
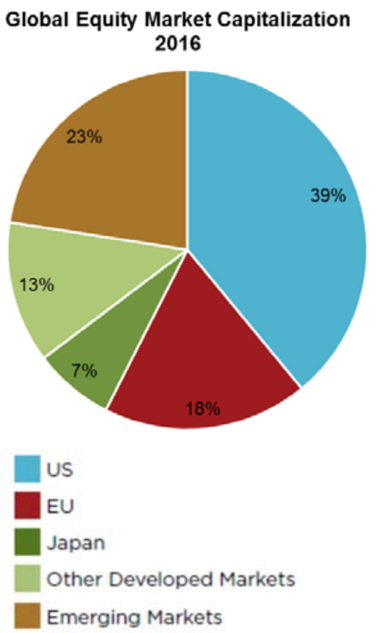
[3] Michael Piwowar, SEC Commissioner, Remarks Before the 27th International Institute for Securities Market Growth and Development (Mar. 27, 2017) (link).

[4] Thomson Reuters.





Note: *Equity market capitalization is of domestically listed companies*

Source: *SIFMA Research, World Bank, Bank of International Settlements*

- As of December 31, 2016, market capitalization—the total value of all publicly traded domestic companies—of the U.S. stock market was $27.4 trillion, larger than the combined market capitalization of the stock markets of the next 10 countries.[5]

- 107 companies conducted IPOs in 2016 in the United States, raising over $17.8 billion.[6]

- Municipal issuers raised over $445.8 billion in 2016 to finance important community infrastructure projects including roads, bridges, hospitals and universities.[7]

The U.S. capital markets are also global. As Treasury stated in the Treasury Report, foreign firms operating in U.S. markets play a meaningful role in the U.S. financial system, in part by helping connect consumers and businesses to global economic opportunities and propelling economic growth and by helping to diversify the risk of the financial system.

- The U.S. capital markets are the top choice for foreign companies looking to list their equity securities in another market. While U.S. companies rarely list overseas, foreign companies choosing to list their securities on a foreign exchange choose the U.S. markets twice as much as any other jurisdiction.[8]

- At the same time, approximately 43% of marketable U.S. Treasury debt is held by foreigners.[9]

- Similarly, nearly 93% of U.S. single name credit-default swaps involve a foreign domiciled counterparty.[10]

The key position of the U.S. capital markets is thus central to furthering the Core Principles, including:

[5] World Bank, Market Capitalization of Listed Domestic Companies (current US$) (link).

[6] Dealogic.

[7] Thomson Reuters.

[8] Ernst & Young, Looking Behind the Declining Number of Public Companies—An Analysis of Trends in U.S. Capital Markets (May 2017) (link).

[9] Treasury, TreasuryDirect (link).

[10] SEC, Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30967 (May 23, 2013) (link).

- Fostering economic growth and vibrant financial markets (Core Principle (c));
- Providing Americans with the power to make financial decisions and informed choices in the marketplace, save for retirement and build individual wealth (Core Principle (a));
- Enabling U.S. companies to be competitive with foreign firms in domestic and foreign markets (Core Principle (d)); and
- Advancing U.S. interests in international settings (Core Principle (e));

as well as related goals including providing for job growth and enabling capital formation.

B. Recent Trends and Vulnerabilities

> "The U.S. financial system is the most efficient, effective, best regulated market in the world. We don't need more regulation; we need better regulation."[11]
>
> *– Henry M. Paulson, Jr., Former Secretary, Treasury*

The success of the U.S. capital markets is closely linked to its safety and liquidity, both of which are heavily influenced by regulation. Well-regulated and liquid markets foster investor confidence. Robust investor confidence and participation is essential to creating deep and efficient markets. Well designed and cost-effective regulation—that is, regulation that achieves the policy goals of stable, fair and efficient markets but does not impede the growth and functioning of these markets—is the foundation of successful capital markets.

Regulation is not without cost, however, and excessive regulation can deter entrepreneurs from seeking to raise capital and expand their enterprises. Optimally regulated capital markets should offer entrepreneurs more benefits than costs, attracting issuers who wish to use their participation in the market as a signal of quality that their practices meet the high standards required by market regulators. The SEC's mission today acknowledges and reflects these multiple priorities: "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[12] Recent trends suggest that certain modifications need to be made to regulations governing the capital markets to satisfy these multiple priorities. This Section outlines these trends, and the following Section thematically describes the modifications that need to be made.

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[11] SIFMA 2016 Annual Meeting.

[12] SEC, What We Do (last updated June 10, 2013) (link).

1. Initial Public Offerings

> "While there are many factors that drive the decision of whether to be a public company, increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive to companies that only a decade ago would have been all but certain candidates for the public markets. And, fewer small and medium sized public companies may mean less liquid trading markets for those that remain public. Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential effects of such an outcome to the economy and society are, in two words, not good."[13]
>
> *– Jay Clayton, Chairman, SEC*

The number of companies going public in the United States has been dwindling. This is a problem because U.S. public equity markets provide a critical source of financing for businesses, fueling economic growth (Core Principle (c)) as well as opportunities for investors to participate in the capital markets to save for retirement and build individual wealth (Core Principle (a)).

The U.S. public equity market is the largest in the world, with an aggregate market capitalization that is almost 150% of annual U.S. GDP.[14] The number of new IPOs has significantly decreased, however, falling from an average of 245 IPOs per year from 1996 to 2006, to an average of 121 per year from 2007 to 2016. Despite rising valuations, the amount of dollars raised has similarly declined.[15] While IPOs and mergers and acquisitions activity typically exhibit a high degree of correlation, ticking upwards in response to strong equity markets, recent data shows a divergence, with increased mergers and acquisitions activity in the face of a declining IPO market,[16] potentially indicating that younger companies are choosing to sell themselves, rather than to raise capital for future expansion and growth through an IPO.

It is difficult to quantify the role that regulation has played in driving this trend, but it is clear that the Sarbanes-Oxley Act of 2002, which created new and expanded responsibilities for boards of directors and management, has had a significant impact in raising the costs relative to the benefits of being a public company. An ever-increasing amount of mandatory disclosure and heightened fees and requirements imposed by exchanges and other SROs have also diminished the attractiveness of being a public company.[17]

[13] SEC Chairman, Remarks at the Economic Club of New York (July 12, 2017) (link).

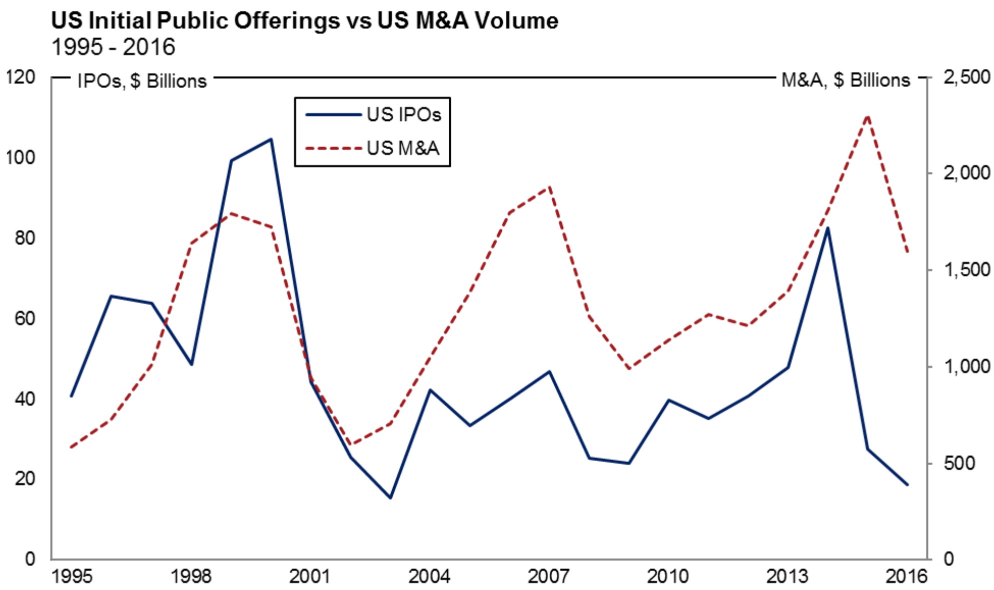
[14] World Bank, Market Capitalization of Listed Domestic Companies (% of GDP) (link).

[15] Dealogic, see charts in Chapter 6.

[16] Credit Suisse, The Incredible Shrinking Universe of Stocks—the Causes and Consequences of Fewer U.S. Equities (Mar. 22, 2017) (link).

[17] *Id.*

Figure 1 – IPO Proceeds vs. M&A Volume



***Note**: IPO data includes SEC registered IPOs > $25 million; excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts; M&A includes rank eligible completed, partially completed and pending deals in which buyer or seller is a U.S. company.*

***Source**: Dealogic.*

When young companies are increasingly drawn towards private markets and to selling themselves rather than going public, average citizens lose out on opportunities to grow their nest eggs for college tuition, retirement and other major life expenses. The consequences of this are especially stark because equity investing has become a primary means through which U.S. households build wealth. Private equity markets are not open to most individual investors.[18]

Some researchers have cited the drop in IPOs as causing a serious drag on the economy. New firms drive net job creation, whereas old firms shed more workers than they hire in most years. In particular, firms that were more than 16 years old had net headcount losses in 14 of the 23 years between 1992 and 2014. With more young firms selling themselves to incumbents rather than going public and continuing their high-growth

[18] Luigi Zingales, The Future of Securities Regulation, 47 Journal of Accounting Research 391 (May 2009) (link).

trajectories as standalone firms, the U.S. economy loses out on a major engine of job creation.[19]

2. Fixed Income Markets

> "Regulatory authorities made a mistake when they looked at each institution and they said you'll be safer if you withdraw from the markets a bit, and then forgot that if all institutions withdraw from the markets a bit, the markets will be less liquid. The markets themselves will be less safe, and that will in the end hurt all the institutions."[20]
>
> *– Lawrence H. Summers, Former Secretary, Treasury*

Bond markets have become significantly less liquid in recent years as banking organizations have reduced their inventories of both U.S. Treasuries and of corporate debt in response to new regulations, including the Volcker Rule and capital and liquidity rules. Less liquid bond markets are problematic because they are more fragile and susceptible to freezing under stress conditions and thus do not create the conditions necessary for economic growth and vibrant financial markets (Core Principle (c)).

The average size of a large trade in U.S. investment-grade corporate bonds has declined by more than 30% since 2007, suggesting that it has become more difficult to transact in bond markets without affecting prices.[21]

As Treasury stated in the Treasury Report, implementation of the Volcker Rule as well as a wide range of capital and liquidity rules, and the manner in which these rules interact, may be limiting resources for market liquidity and hindering market making functions.[23] SIFMA thanks Treasury for its thoughtful consideration of these issues in the Treasury Report and anticipates responding to the OCC's public notice regarding the Volcker Rule.

> "[F]ixed income markets are in a state of transition. Dealers have continued to cut back their market-making capacity in many jurisdictions. Demand for market-making services, in turn, continues to grow. The effects of these diverging trends have, thus far, not manifested themselves in the price of immediacy services, but rather they are reflected in possibly increasingly fragile liquidity conditions."[22]
>
> *– William C. Dudley, President, Federal Reserve Bank of New York*

The narrow set of permissible market making related activities under the Volcker Rule and the prescriptive conditions for engaging in those activities have led many financial institutions to scale back their trading operations as well as their inventories of financial assets. These financial institutions may take a conservative approach, even for types of trading activities permitted under the Volcker Rule, in order to avoid uncertainty about whether the

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[19] Economic Innovation Group, Dynamism in Retreat: Consequences for Regions, Markets, and Workers (Feb. 2017) (link).

[20] Patti Domm, CNBC, Summers Agrees with Dimon: There's a Liquidity Problem (Apr. 9, 2015) (link).

[21] Bank of England, Financial Stability Report (July 1, 2015) (link).

[22] Bank of International Settlements, Fixed Income Market Liquidity, CGFS Papers, No. 55 (Jan. 2016) (link).

[23] *See, e.g.*, Treasury, A Financial System That Creates Economic Opportunity—Banks and Credit Unions, at 7 (June 2017) (link) (the "Treasury Report"). As this White Paper was being finalized, the SEC's Division of Economic and Risk Analysis published a report on August 9, 2017 regarding access to capital and market liquidity. SIFMA is reviewing and continuing to analyze that report.

> The Volcker Rule may have "serious consequences for corporate bond market functioning in stress times."[24]
>
> *– Federal Reserve Finance and Economics Discussion Series Working Paper (Sept. 2016)*

> "The problem is on the days when you need liquidity, it probably won't be there."[26]
>
> *– Gary Cohn, as President, Goldman Sachs*

activities are within the bounds of the complex parameters of the Volcker Rule. The Volcker Rule's proprietary trading restrictions have reduced liquidity in financial markets and have resulted in higher market execution costs and delays for would-be issuers and investors.

That the Volcker Rule has impacted firms' ability to make markets and provide market liquidity, particularly in times of stress, is supported by data in a recent Federal Reserve staff paper, which concluded that "the Volcker Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times."[25]

Capital rules, such as the SLR, and liquidity rules, such as the LCR, are rife with excessively conservative and unrealistic assumptions that do not consider the effects on market liquidity. As Treasury acknowledged in its June report, the risk-insensitivity and interaction of these rules create incentives that discourage critical banking functions that support market liquidity.

While there have been no major recent disruptions in corporate bond markets, both market participants and regulators are becoming increasingly concerned about the ability of market makers to absorb shocks in times of stress. Historically, liquidity tends to evaporate suddenly.[27] Studies have found that when corporate bond holdings by dealers are low, or when their market making ability is impaired, sharp drops in market liquidity are more likely than when dealers are holding larger inventories of corporate bonds relative to the size of their balance sheets.[28]

If bond markets are indeed becoming less liquid, this is also a problem because studies have linked well-developed and liquid markets with present and future rates of economic growth through faster capital accumulation and better resource allocation. This may well be because such markets help

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[24] Jack Bao, Maureen O'Hara and Alex Zhou, Federal Reserve, The Volcker Rule and Market Making in Times of Stress (2016) (link).

[25] *Id*.

[26] Alexandra Scaggs, Bloomberg, Wall Street Sounds Bond Warnings as Holdings Shift Sparks Concern (June 3, 2015).

[27] Mark D. Flood, John C. Liechty and Thomas Piontek, Office of Financial Research, Systemwide Commonalities in Market Liquidity, Working Paper 15-11 (Dec. 14, 2016) (link).

[28] International Monetary Fund, Chapter 2: Market Liquidity—Resilient or Fleeting, in Global Financial Stability Report: Vulnerabilities, Legacies, and Policy Challenges: Risks Rotating to Emerging Markets (Oct. 2015) (link).

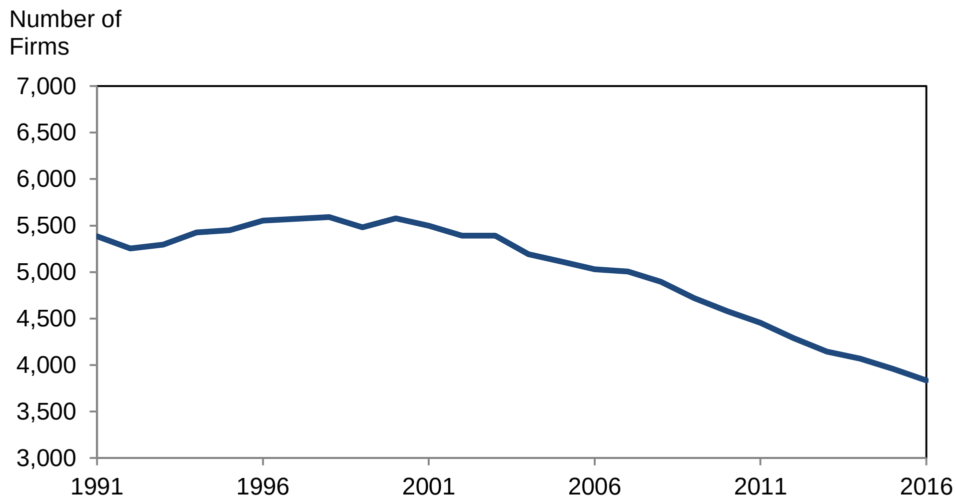
maintain confidence by investors in the value of the information associated with trading, encouraging further investment.[29]

3. Consolidation in the Securities Industry

There has been tremendous consolidation among firms in the securities industry over the last several decades, which has accelerated since the financial crisis. This consolidation is a problem because it reduces the ability of consumers to make choices in the marketplace (Core Principle (a)) and undercuts the role that securities firms, especially small- and medium-sized ones, play in promoting economic growth and vibrant financial markets (Core Principle (c)).

Twenty-five years ago, there were 5,386 firms registered as broker-dealers with FINRA—then the National Association of Securities Dealers. Today there are just 3,835, nearly 30 % fewer.[30] In 1988 there were 46 firms recognized by the Federal Reserve Bank of New York as primary dealers, firms authorized to trade directly with the Federal Reserve Bank of New York. Today there are just 23.[31]

Figure 2 – Number of FINRA-Registered Broker-Dealers 1991–2016



***Note**: FINRA-registered broker-dealers doing business in the United States. **Source**: FINRA.*

[29] Guglielmo Maria Caporale, Peter G. A. Howells and Alaa M. Soliman, Stock Market Development and Economic Growth: The Causal Linkage, 29 Journal of Economic Development 33 (June 2004) (link).

[30] Source: FINRA.

[31] Federal Reserve Bank of New York, Primary Dealers (last visited July 26, 2017) (link).

An ever-growing list of obligations on broker-dealers:

- Market Access Rule
- Large Trading Registration and Reporting
- Acceleration of TRF Reporting
- Expansion of FINRA's OTC Reporting Facility and OATS Reporting Requirements
- Consolidated Audit Trail
- Municipal Advisor Registration
- Broker-Dealer Pay-to-Play Rules
- Regulation SCI
- Broker-Dealer Annual Custody and Compliance Reports
- Amendments to Broker-Dealer Financial Responsibility Rules
- Tick Size Pilot
- Limit Up/Limit Down
- Regulation SHO Expedited Close-Out Requirements
- Supplemental FOCUS Filings
- Markup/Markdown Disclosure Requirements
- New Debt Research Rules
- Expedited Settlement Cycle (T+2)
- Expansion of FINRA Margin Rules to TBAs
- Expansion of Electronic Blue Sheet Reporting Requirements
- New FINRA ATS Recording and Reporting Requirements
- New Registration Requirements for Operations Professionals and Algorithm Developers
- Enhanced Best Execution Obligations
- DOL Fiduciary Regulation

This trend exists throughout the industry. Looking at the top 25 underwriters of municipal securities in 1991 as an example, 18 of the 25 have merged with other firms, stopped participating in the municipal securities business, or folded altogether.[32]

One driver of industry consolidation has been the rise in regulations and associated compliance costs. Whether large or small, all securities firms need to contend with an ever-increasing array of regulations, examples of which include anti-money laundering audits, custody audits, an ever-growing FINRA rule book and, most recently, the DOL fiduciary regulation.

In this case, scale provides definite advantages. It is simply more economical to spread compliance expenses over a larger business. The growth in regulation has put particular pressure on smaller and medium-size firms, who find it increasingly difficult to compete as compliance costs drive overall firm expenses. For these firms, which may have compliance departments consisting of a single employee, a new rule can require doubling their compliance headcount to two employees, significantly raising overhead. It is usually more difficult, however, to quantify the incremental cost of any single new regulation. Instead, it is a "death by 1,000 cuts" story, where employees spend an ever-increasing amount of time dealing with paperwork, forms and staying up to date on new regulations, resulting in opportunity costs: both money and attention must be redirected to compliance and away from critical new technology, providing better services to customers and innovating.

High regulatory and compliance costs force smaller broker-dealers to make tradeoffs with investments in technology that are necessary for them to compete effectively. It prevents them from being able to afford to make such investments in an increasingly technology-driven sector. Moreover, the relative impact of these regulatory and compliance costs is heavier on smaller broker-dealers than it is on larger broker-dealers because of economies of scale, making it even harder for smaller broker-dealers to compete effectively and spur economic growth and jobs creation. It also makes smaller broker-dealers more vulnerable to competition from fintech companies.

[32] Thomson Reuters.

If the number of firms in the industry continues to shrink, issuers and investors will have fewer choices. The firms that remain will face weaker competitive pressures, driving less innovation as a result. If only the largest firms can survive, regional and local economies could lose the benefits that often come when financial services partners understand the unique needs of their communities.

C. Improvements to the Regulation of U.S. Capital Markets

It is essential for policymakers to seek out ways to spur and sustain economic activity. Certain adjustments and improvements should be made to the regulation of U.S. capital markets to ensure that they remain of the highest quality—deep and broad centers of liquidity, standard-setters for market best practices—staunch defenders of investors' interests that meanwhile remain attractive to business and investment.

1. Need for Modernization

Capital raising in the United States is governed by a regulatory framework that was first put in place more than 80 years ago, when trading took place on floors, order tickets were on paper and information was conveyed by telephone. There have been incremental regulatory and legislative efforts to update the framework, such as the SEC's Securities Offering Reform initiative in 2005 and the JOBS Act in 2012. However, capital markets participants—including investors, issuers, and intermediaries—still operate in a regulatory structure that has not kept pace with the revolutions in information and communications technologies that have transformed nearly every other aspect of U.S. commercial activity in the last few decades.

Financial markets and the technology supporting them evolve and move faster than any regulation can keep up with, and regulations frequently become out of date soon after finalization. As a result, trying to craft prescriptive rules that will stand the test of time is hopeless. Regulations should be drafted to be more flexible and principles-based so that regulators can be more nimble in reacting to market developments, and should come with sunset or frequent look-back requirements to ensure that they do not grow stale.

The need for modernization of capital markets regulation is discussed throughout this White Paper, and is the particular focus of the discussion of

> "Dodd-Frank and other new rules dictated by the U.S. and European central bankers and bank prudential regulators with little practical understanding of trading markets seek to control borrowing and leverage in the financial system. Yet, they are tying up billions in capital on the books of global financial institutions."[33]
>
> *– J. Christopher Giancarlo, Commissioner, CFTC*

> "There is the tendency we often observe, both domestically and internationally, to impose bank prudential regulation in the capital market space. This is a misplaced idea for numerous reasons, but foremost because while banks are in the business of minimizing risk, the capital markets are in the business of allocating risk."[34]
>
> *– Michael S. Piwowar, Commissioner, SEC*

Regulation NMS in Chapter 1, the discussion of capital formation in Chapter 6 and discussion of self-regulatory organizations in Chapter 9.

2. Coordination and Cooperation between Market Regulators and Prudential Regulators

Prudential regulators have, since the financial crisis, often extended their reach into the regulation of capital markets indirectly through regulating the activities of participants that are active in these markets. In some cases, the prudential regulators have sought to apply bank macro-prudential policies into non-banking areas of the industry, such as asset management, securities dealing, derivatives trading and back-office services and infrastructure.

In several cases, the prudential regulators have adopted regulations without due consideration of or deference to the expertise of the market regulators. In the immediate aftermath of the financial crisis, a singular concern with financial stability above all other policy goals was critical, but the markets have since stabilized. The prudential regulators have often adopted regulations without balancing the costs to job creation and economic growth, lending, market liquidity, the availability of financial products and services to U.S. consumers and businesses, or taking into account the extent to which regulations may lead to procyclicality, herding behavior and regulatory arbitrage. Market and prudential regulators should instead work together and avoid duplicating each other's roles, engage in information sharing and avoid making rules that conflict with another regulator's rules or policies.

These prudential regulations, including capital and liquidity regulation and the Volcker Rule, are discussed in the May White Paper. As stated above, the Volcker Rule's proprietary trading restrictions have reduced liquidity in financial markets and have resulted in higher market execution costs and delays for would-be issuers and investors. Capital and liquidity rules are rife with excessively conservative and unrealistic assumptions that do not consider the effects on lending, market liquidity and other contributors to banking and capital markets and economic growth. These regulations pose among the most serious issues facing the U.S. capital markets at this

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[33] J. Christopher Giancarlo, CFTC Commissioner, Fidelity Guest Lecture Series on International Finance (Dec. 1, 2015) (link).

[34] Michael Piwowar, SEC Commissioner, Remarks Before the 27th International Institute for Securities Market Growth and Development (Mar. 27, 2017) (link).

moment, and SIFMA thanks Treasury for its thoughtful consideration of these issues in the Treasury Report.

3. Compliance Burden

Regulatory requirements have accreted over the years, increasing the burden for companies without a full consideration of whether these requirements actually provided real incremental benefits to investors and capital markets.

Both prudential and market regulators have developed duplicative and sometimes conflicting regimes, and SROs sometimes add another layer of compliance obligations to achieve the same goals. In key markets, the authority to regulate the market is split by statute between several regulators, or multiple regulators are assigned overlapping jurisdiction. For instance, even though over 95% of the notional value of the OTC derivatives market is subject to primary regulation by the CFTC, the Dodd-Frank Act assigns the authority to regulate margin and capital among seven regulators. While efforts have been undertaken to regulate these markets consistently, further harmonization among regulatory approaches between market regulators, prudential regulators and deference to foreign jurisdictions is essential to maintaining efficient and vibrant markets.

The compliance burden has had a significant impact on many aspects of the market, including the decision to go public as well consolidation in both the financial services industry and the economy more broadly. These issues are covered throughout this White Paper, and are in particular the focus of Chapter 6 on capital formation, Chapter 8 on derivatives and Chapter 10 on the DOL's fiduciary regulation.

4. The Need for U.S. Leadership and Harmonization

As Treasury stated in the Treasury Report, U.S. leadership in international standard-setting bodies is critical to ensuring a level playing field for U.S. financial services firms. As also noted by Treasury, however, U.S. involvement with these bodies and implementation of international standards must be aligned with U.S. domestic financial regulatory objectives.[35]

Where international standards harm U.S. capital markets, the United States should push the responsible international standard-setting bodies to reopen

[35] *See, e.g.*, the Treasury Report, at 55.

negotiations. Where international standards are appropriate, U.S. regulators should implement those standards without goldplating, and should ensure that other jurisdictions are implementing the same standards as to not disadvantage the U.S. capital markets.

Where international standards work—that is, where global regulators implement regulations with similar goals—U.S. regulators should avoid broad extraterritorial jurisdiction, even if the regulations put into place in other jurisdictions are not identical to U.S. regulations. In addition to negatively and unfairly impacting foreign firms, a broad extraterritorial reach encourages foreign regulators to follow suit, erecting barriers to entry into new markets, harming U.S. financial firms and cutting off channels for economic growth. For instance, broad extraterritorial reach of derivatives regulation, even into jurisdictions with similar regulations in place, has caused overlap and conflicts with foreign laws. The resulting duplicative or inconsistent requirements can lead to global market fragmentation, harming U.S. competitiveness and chilling participation in U.S. markets and consumer choice.

These issues are covered throughout this White Paper, and are in particular the focus of Chapter 8 on derivatives.

D. Recommendations to Promote the Core Principles

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
1. Equity Markets Structure Issues	
Regulation NMS	
■ Reevaluate the Order Protection Rule in light of current market dynamics and consider whether modifications or exemptions are needed. Potential modifications could include a requirement that a venue must meet a volume threshold for its quotations to receive protected quotation status and instituting a block-size trade exemption for executions of significant size. Also consider eliminating the OPR outright, relying instead on enhanced best execution principles.	SEC
■ Consider reducing the access fee cap to no more than $0.0005 (from $0.003), implementing the SEC's Equity Market Structure Advisory Committee's access fee pilot recommendation, or eliminating rebates and linkages between passive posting of limit orders and transaction pricing.	SEC
The Use and Governance of National Market System Plans	
■ Require NMS Plans to have direct representation by both securities market participants (broker-dealers and asset managers) and the public, where representatives have voting power on the operating committees of the NMS Plans.	SEC
■ Make NMS Plan agendas, meetings and minutes transparent and open to the public.	SEC
Availability of Affordable Quality Market Data	
■ Require improvement of SIP feeds, including depth-of-book data and odd-lot quotes, so that SIP data alone is sufficient for sophisticated trading and regulatory obligations, and all market participants are able to engage in the market with the same information.	SEC
■ Alternatively, replace the single-consolidator model of market data dissemination represented by the SIPs with a distributed model.	SEC, Congress
2. Fixed Income: U.S. Treasuries	
■ Exercise Treasury's primary supervisory / regulatory authority of the U.S. Treasury market in order to ensure consistency and coherence across the regulatory and supervisory landscape for the U.S. Treasury market.	Treasury
■ Assess aspects of regulations and risk management, monitoring and trading practices that may be disproportionately affecting some market participants or products in a manner that is detrimental to the efficient and effective functioning of the market, with a view towards establishing an activity-level approach to market regulation such that the same types of market conduct are similarly regulated.	Treasury

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
■ Assess the coherence of capital and liquidity-related regulations with regard to their impact on liquidity for the U.S. Treasury market to ensure that regulations are appropriately calibrated and harmonized to promote the goal of safety and soundness while at the same time minimizing any negative impact on U.S. Treasury market liquidity.	Treasury
■ Recommend that the Federal Reserve make the three specific deductions from the SLR denominator, as recommended by Treasury in the Treasury Report, for cash on deposit with central banks, U.S. Treasuries and initial margin for centrally cleared derivatives. Also include securities financing transactions as a specific deduction from the SLR denominator.	Treasury
■ Treasury should continue to take the lead on the careful review and analysis of data that is being submitted through FINRA's TRACE engine before any additional regulatory actions are taken. Treasury should also consider including market participants who are not currently subject to FINRA's TRACE reporting requirements, to enhance the data available to regulators.	Treasury
■ Refrain from pursuing public disclosure mandates of positions or transactions in the absence of clear, compelling, demonstrable benefits to overall liquidity from such disclosure.	Treasury
3. Fixed Income: Credit	
Pre-Trade Transparency Initiatives	
■ Allow the best execution and markup disclosure rules to take full effect and monitor the effects of those rules on pre-trade transparency before implementing any further pre-trade transparency regulatory initiatives.	SEC, FINRA, MSRB
Post-Trade Transparency for Block Trades	
■ Recalibrate the current corporate bond reporting structure for block trades to better support and balance the desire for transparency and the need to promote liquidity, including additional delays beyond the 15-minute threshold for reporting.	SEC, FINRA
The Fixed-Income ATS Transparency Regime	
■ Develop an ATS transparency regime that is tailored specifically to the attributes of the fixed income market.	SEC
■ Consider methods to publicly disclose ATS-related transaction information while taking into account both the desire to continue to promote innovation and the competitive disadvantages to newly formed ATSs during the first few years of operation.	FINRA, MSRB
The Markup Disclosure Rules	
■ Revise the implementation date for the markup disclosure rules to November 2019 to ensure firms and vendor partners have sufficient time to address and implement the rule.	FINRA, MSRB
■ Revise the markup disclosure rules so that dealers can develop a process to streamline and automate compliance.	FINRA, MSRB

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
■ Reconsider a markup solution implemented through industry utilities like FINRA's TRACE system or the MSRB's EMMA platform.	FINRA, MSRB
■ Provide additional guidance that better enables firms to run functionally separate trading desks for retail and institutional clients.	FINRA, MSRB
Best Execution	
■ Provide more detailed guidance with respect to the reasonable diligence required to ascertain the best market for a security.	FINRA, MSRB
■ Provide more specific guidance on documentation requirements under the rules that minimize compliance burdens while providing sufficient means to verify compliance.	FINRA, MSRB
■ Amend the SMMP rules such that a representation from an investor with respect to its status as an SMMP should be sufficient to establish an investor's status as an SMMP for all applicable MSRB rules.	MSRB
4. Fixed Income: Municipal Securities and Infrastructure	
Pre-Trade Price Transparency	
■ See summary recommendations set forth in the above section.	SEC, MSRB
The Markup Disclosure Rules	
■ See summary recommendations set forth in the above section.	MSRB
Best Execution	
■ See summary recommendations set forth in the above section.	MSRB
Municipal Advisor Regulation	
■ Amend the municipal advisor registration rules to amend the basis for treatment as a municipal advisor so that an entity would need to be engaged by a state or local government or obligated person to provide municipal advisory services in order to be treated as a municipal advisor.	SEC
■ Short of amending the definition of municipal advisor, provide an exemption from the municipal advisor rule such that advice provided to a sophisticated municipal entity would not require registration as a municipal advisor, and amend the rule so that when a dealer requests from an issuer or obligated person confirmation that an investment account does not include bond proceeds and receives no response, the dealer may proceed as if the account does not include proceeds.	SEC
Municipal Disclosure Regulation	
■ Include a clear, bright-line condition for disclosure, similar to one used elsewhere by the SEC in disclosure filings, with respect to its outstanding proposal on Rule 15c2-12, which is overly broad, will lead to over disclosure and contains a vague materiality qualifier.	SEC

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
■ Provide interpretive guidance as to the sufficiency under the antifraud provisions of reliance on certification by an official responsible for disclosure compliance.	SEC
■ Amend Rule 15c2-12.	SEC
■ Improve the EMMA platform to, among other things, enhance the search function and introduce procedures to reduce errors and enhance efficiency.	MSRB
Liquidity Coverage Ratio	
■ As recommended by Treasury in the Treasury Report, revise the LCR rules to permit municipal securities to be treated as HQLA.	OCC, FDIC
■ Revise the LCR rule to expand recognition of municipal securities.	Federal Reserve
■ Short of action by the regulatory agencies, enact legislation mandating HQLA treatment for municipal securities under the LCR Rule.	Congress
Closing the Infrastructure Deficit	
■ Preserve the federal tax exemption for interest earned by investors on bonds issued by states and localities to finance infrastructure.	Congress
■ Amend the Internal Revenue Code so that state and local governments could issue tax-exempt bonds for infrastructure projects with private participation in the same manner that they issue bonds for purely public projects.	Congress
■ Expand the use of private activity tax-exempt bonds for infrastructure.	Congress
■ Encourage federal infrastructure projects to promote the use of design build as a state and local procurement mechanism.	Federal Agencies, States
■ Provide a tax credit for equity investors in infrastructure projects and to private investors who commit equity capital to infrastructure projects.	Congress
■ Expand alternative federal financing programs.	Federal Agencies
5. Securitization	
Capital and Liquidity Rules	
■ Limit the capital requirements to maximum loss on a position.	Federal Reserve, OCC, FDIC
■ Base capital treatment, including for securitizations that transfer credit risk, on risk transfer and not accounting treatment.	Federal Reserve, OCC, FDIC
■ Refine and recalibrate the CCAR global market shocks applied to securitization positions.	Federal Reserve
■ Postpone implementation of banking and trading book capital rules until they are recalibrated and recalibrate the Basel Committee's securitization banking book capital rules before implementation.	Federal Reserve, OCC, FDIC

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
■ Provide more equitable treatment for securitizations in liquidity rules and clarify their application.	Federal Reserve, OCC, FDIC
Regulation AB II	
■ Revise Regulation AB II asset-level data requirements and abandon application to Rule 144A.	SEC
Credit Risk Retention Rules	
■ Revise risk retention rules to provide more flexibility and reduce conflicts.	Federal Reserve, OCC, FDIC, FHFA, HUD, SEC
Derivatives Rules for Non-Cleared Swaps	
■ Exempt securitization special purpose entities from margin posting requirements and treat these swaps with these entities in substantially the same manner as swaps with non-financial end users.	Federal Reserve, OCC, FDIC, SEC, CFTC
Volcker Rule	
■ As recommended by Treasury in the Treasury Report, revise the overly broad definition of covered funds, as securitization structures and special purpose entities are neither hedge funds nor private equity funds.	Federal Reserve, OCC, FDIC, SEC, CFTC
6. Promoting Equity Market Issuance	
■ Extend JOBS Act accommodations to all companies.	SEC
■ Reduce burdens on companies' access to market.	SEC
■ Expand definition of accredited investor.	SEC
■ Revise Regulation D bad actor disqualification.	SEC
■ Amend Rule 144.	SEC
■ Include municipal securities in Level 2B liquid assets.	Congress, Federal Reserve, FDIC, OCC
7. Research Rules and Regulation	
■ Provide U.S. broker-dealers, as soon as possible, with an exemption from the Advisers Act for the receipt of unbundled research compensation under MiFID II.	SEC
■ Revise the debt research rule or otherwise issue additional guidance to provide both clarity and greater flexibility with respect to the interactions between research and trading personnel.	FINRA

TOPICS AND RECOMMENDATIONS	RELEVANT AGENCIES
■ Modify the desk commentary safe harbor in a manner that takes into account the value of desk commentary in an environment that relies heavily on electronic communications and the necessary interactions among sales and trading personnel and with clients.	FINRA
8. Derivatives	
■ Modify Title VII's cross-border framework to reverse market fragmentation by creating a level playing field for U.S. and non-U.S. firms.	CFTC, SEC, FDIC, OCC, Federal Reserve, FCA, FHFA
■ Recalibrate margin and clearing requirements to unlock resources for lending and investment by focusing the requirements solely on what is appropriate to mitigate risk.	CFTC, SEC, FDIC, OCC, Federal Reserve, FCA, FHFA
■ Simplify, harmonize and streamline other Title VII requirements to eliminate unnecessary inconsistencies, overlap and undue prescription.	CFTC, SEC
9. The Role of Self-Regulatory Organizations	
■ Conduct a comprehensive review of the self-regulatory status of exchanges, and ultimately propose potential amendments that Congress should adopt to the securities laws.	Congress, SEC
■ Conduct a comprehensive review of the regulatory structure of SROs. This review should also consider the self-regulatory model more broadly and amendments to SEC rules and recommendations to Congress for amendments to the Exchange Act to reinvigorate the *self*-regulatory nature of those entities that remain SROs.	Congress, SEC
10. DOL Fiduciary Regulation	
■ Delay any further implementation of related aspects of the DOL fiduciary regulation at least until a full study is completed as anticipated by the President's memorandum of February 3, 2017.	DOL
■ Establish a best interest standard of conduct for broker dealers that builds upon their existing regulatory structure and that applies when they are providing personalized investment advice about securities to retail customers in all broker-dealer accounts, not just IRA accounts.	SEC
■ If after the study required by the President's memorandum, DOL adopts a final fiduciary regulation, ensure that the conduct standards for broker-dealers remain high, consistent and harmonized across all regulatory regimes.	DOL, SEC

Chapter 1

EQUITY MARKET STRUCTURE

Relevant Agencies

- SEC
- FINRA
- National Securities Exchanges

Chapter 1 –
Equity Market Structure

The U.S. public equity markets are critical to the nation's economy, providing businesses with access to capital to hire and grow, and providing the public with the opportunities to invest in companies in order to save for retirement, a child's college education or to meet other family goals. The way the market is structured is of great importance, as it dictates the manner in which investors are able to buy and sell, how their orders interact, how much information about the market they have available, and ultimately, what their transaction costs will be.

The U.S. equity market structure has a solid foundation and is generally very well functioning, with investors able to buy or sell a stock very quickly at ever-lower costs. It has been over a decade, however, since the SEC implemented the core equity market structure regulation, Regulation NMS, during which time there have been significant changes to the marketplace, both in terms of electronic trading and automation, as well as the competitive dynamics between participants. This Chapter discusses some of the elements of equity market structure that SIFMA believes have fallen behind, and proposes solutions for modernization and improvement.

A. Regulation NMS

1. The Problem (Implicates Core Principles (c) and (f))

Adopted in 2005 by the SEC, Regulation NMS was intended to modernize and strengthen the regulatory structure of the equity markets. Regulation NMS was predicated on the need to foster more efficient markets by promoting fair competition among individual markets, while at the same time assuring that the markets were linked to encourage the interaction of—and competition between—the orders of buyers and sellers.[1]

The centerpiece of Regulation NMS is Rule 611, the Order Protection Rule ("OPR"), which provides intermarket price protection to protected quotations, generally prohibiting a trade from being executed on one trading venue while a better price is displayed on another. In conjunction with the OPR, Rule 610 addresses fair access, access fees, and locked and crossed

[1] *See* SEC, Regulation NMS, 70 Fed. Reg. 37496, 37498 (June 29, 2005) (link).

markets. Regulation NMS also implements Rule 612, the Sub-Penny Rule, to address concerns related to the practice of stepping ahead of displayed limit orders by trivial amounts.

These key provisions of Regulation NMS were intended to address discrete policy goals that the SEC sought to achieve. Specifically, the OPR sought to address market inefficiencies by further automating the markets and providing strong intermarket price protection in order to promote the display of limit orders, as well as to assure that those investors who submit market orders receive the best price available.[2] Further, in adopting the fair access provisions of Rule 610, the SEC recognized the importance of interlinking in a manner that provided market participants with the ability to efficiently and fairly access a trading center's protected quotations.

Regulation NMS has been accompanied by a variety of unintended consequences and has not kept pace with the technological developments impacting the marketplace. In particular, Regulation NMS has contributed to a complex and fragmented market, where every exchange's quotes must be considered before any trade may be executed, generally regardless of other execution considerations. This fragmentation, in turn, has resulted in a bifurcated market that has placed a significant focus on the speed of execution, with broker-dealers facing escalating costs for essential connectivity and data services with little competitive constraint.

> "The net result of these changes, both regulatory and technological, is that today's market is much different than it was in 1975 and is even unrecognizable from the market of 10 years ago when Regulation NMS went into effect."[3]
>
> *– Jeff Brown, Senior Vice President, Charles Schwab*

Additionally, intending to assure fair access, Rule 610 of Regulation NMS hard coded into the equity market structure a cap on access fees that exchanges could charge for accessing displayed quotations. Instead of representing a cap, this amount became the default fee that has persisted and is now used primarily to fund rebates to those market participants that post liquidity. Since Regulation NMS was adopted, competition and technological advancements have caused bid-ask spreads to narrow and commissions to significantly decrease. But access fees have been frozen in time, making these fees outsized relative to today's other competitive market dynamics. As a result, much market structure complexity arises from efforts by market participants to trade in ways that avoid paying access fees, or conversely, to ensure that they receive the rebates that the access fees fund.

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[2] *Id.* at 37501.

[3] Jeff Brown, Senior Vice President, Charles Schwab, Written Testimony on Behalf of SIFMA Before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment (June 27, 2017) (link).

Thus, while Regulation NMS may have achieved many of the intended objectives in terms of promoting a more accessible and significantly more automated market with narrower quoted spreads, the equity markets have evolved considerably since 2005 and Regulation NMS is overdue for review and modernization.

2. The Solution

Any change to Regulation NMS would have consequences and must therefore be carefully considered. Acknowledging this possibility, the SEC should do the following, which can be accomplished without statutory change:[4]

- The SEC should reevaluate the OPR in light of current market dynamics and consider whether modifications or exemptions are needed. Although a review of the OPR may lead to a conclusion to maintain the status quo, potential modifications could include a requirement that a venue must meet a volume threshold for its quotations to receive protected quotation status and instituting a block-size trade exemption for executions of significant size. The SEC should also consider eliminating the OPR outright, relying instead on enhanced best execution principles.

- The SEC should consider implementing the SEC's Equity Market Structure Advisory Committee's access fee pilot recommendation, reducing the access fee cap to no more than $0.0005 (from $0.003) or eliminating rebates and linkages between passive posting of limit orders and transaction pricing.

B. The Use and Governance of National Market System Plans

1. The Problem (Implicates Core Principles (c) and (f))

Section 11A of the Exchange Act authorizes the SEC to direct self-regulatory organizations ("SROs")[5] to act jointly in planning, developing,

[4] SIFMA has provided the SEC with an analysis of the potential impacts of these various solutions. *See* SIFMA Letter to SEC Regarding Notice of Meeting of Equity Market Structure Advisory Committee Meeting (Mar. 29, 2017) (link).

[5] For these purposes, the SROs include FINRA and the national securities exchanges.

operating, or regulating a national market system through what is commonly known as an NMS Plan. NMS Plans are a particularly useful tool for the SEC to use where market change and modernization can only be accomplished by several SROs acting jointly. The SEC first used NMS Plans to direct the SROs to develop and implement systems for consolidating and disseminating each SRO's market data to the public. In recent years, the SEC has increasingly relied on NMS Plans to implement broader SEC market structure initiatives, including the Consolidated Audit Trail ("CAT"), the Tick Size Pilot Program and the Limit Up-Limit Down Plan.

NMS Plans are structured so that the important operational decisions are made by an operating committee, which is composed of one representative of each of the SROs that are participants in the NMS Plan. Since the inception of NMS Plans, however, concerns have been expressed regarding the lack of SRO member or public participation in the NMS Plans, and this issue has become even more significant as many exchanges compete with their members in the provision of execution services. Unlike when NMS Plans were first used, most SROs are no longer member-owned organizations but are often part of large for-profit corporations that, in many cases, compete with their members.

When the SEC adopted Regulation NMS in 2005, it sought to address these concerns by broadening participation in the governance of the market data plans by creating non-voting advisory committees. The advisory committees were intended to provide the non-SROs with an opportunity to be heard on plan business, particularly that of the plan operating committees. The SEC, at the time, explained that it was reluctant to make additional changes to the structure of the NMS Plans, hoping that improvements to the governance structures at the SROs themselves would also contribute to improved governance of the NMS Plans.[6] The SEC noted, however, that the governance amendments were a useful first step and that it would continue to monitor and evaluate plan developments to determine whether any further action is warranted.[7]

The advisory committees have been, in short, a failure. Advisory committee members are given no substantive voice in the operation of the NMS Plans, their role is without authority and there is no mechanism for them to elicit or report feedback from the broad constituencies that depend

[6] SEC, Regulation NMS, 70 Fed. Reg. 37496, 37561 (June 29, 2005) (link).

[7] *Id*.

on the utilities operated by NMS Plans. In addition, the SROs have a long history of conducting all meaningful NMS Plan business in executive session, from which advisory committee members are excluded.

SRO members and the general public deserve a greater view into and voice regarding the way these critical market structure operations are run. There is nothing in the Exchange Act, or the applicable rules thereunder, that prohibits broker-dealers or other securities industry members from fully participating in the governance of NMS Plans or from making the proceedings more transparent. Unless and until that happens, the governance of NMS Plans will continue to be rife with conflicts of interest, inherently unfair and inefficient.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should require NMS Plans to have direct representation by both securities market participants (broker-dealers and asset managers) and the public. These representatives should all have voting power on the operating committees of the NMS Plans. The representatives should be selected in an open process independent from the SROs.

- The SEC should require that NMS Plan agendas, meetings, and minutes be made transparent and open to the public. These changes would make the governance of NMS Plans consistent with the existing statutory fair representation requirements governing the SROs themselves, and assure transparency in governance to further the public interest and the protection of all investors.

C. Availability of Affordable and High-Quality Market Data

1. The Problem (Implicates Core Principles (a), (c) and (f))

The availability of affordable and high-quality market data is critical to the proper functioning of the U.S. equity markets. The SEC has acknowledged that one of its most important responsibilities is to preserve the integrity and affordability of its consolidated data stream.[8] The SEC has recognized that

[8] *Id*. at 37503.

that its consolidated market data model allows investors to evaluate the execution quality of their orders by obtaining data from a single, consolidated source that is highly reliable and comprehensive.[9]

Under the current system, developed as a result of the 1975 amendments to the Exchange Act, broker-dealers are required to report their best bids and offers and last sales transactions in listed equity securities to the SROs, which are required to participate in an NMS Plan for consolidating and distributing some of that data. Securities Information Processors ("SIPs") make available, for each listed equity security, the best displayed round lot bids and offers (called top-of-book data) on each SRO's trading facility along with the last sale price (together, called core data).

Over time, the evolution of market structure and technology have rendered the data reported by SIPs obsolete for sophisticated or competitive trading platforms. Exchanges now offer, at high fees, deeper and more detailed reporting than the core data disseminated by SIPs. These non-core data proprietary feeds are distributed directly to purchasers through fast connections (rather than via the older SIP infrastructure) and contain much more detailed information about the exchanges' trading books, including the bids and offers below the top-of-book (called depth-of-book information). The SIP data, taken alone, is insufficient for accurate price discovery. SIP data is used primarily for non-trading informational purposes, administrative messages and to provide stale (from the perspective of computerized trading) price information to retail customers who rely on the SIP data as their primary market data source.

In addition to the need to purchase data feeds from exchanges for commercial reasons, many broker-dealers believe that they are effectively required to purchase exchange data feeds to meet best execution and other regulatory obligations. FINRA has stated that firms using depth-of-book data for proprietary trading are "expected to also be using these data feeds to determine the best market under prevailing market conditions when handling customer orders to meet [their] best execution obligations."[10] In light of their best execution obligations, broker-dealers understandably feel that they face significant regulatory risk if they do not purchase depth-of-book data in addition to SIP data.

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[9] *Id*. at 37558.

[10] *See* FINRA, Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets, Regulatory Notice 15–46, at 13, note 2 (Nov. 2015) (link).

With the SIPs no longer providing sufficient information, market participants must purchase *all* of the individual exchanges' proprietary data feeds and consolidate this information to get the necessary market data. These data feeds are extremely costly. Each exchange has the power to set its own fees for their data. Further, the exchanges have never provided evidence that their ever-increasing market data fees are fair and reasonable or constrained by any competitive forces.

The SEC has the power to reject exchange fees it believes are not fair and reasonable, but has been reluctant to use this authority. SIFMA has challenged these fees through three legal actions—two in the U.S. Court of Appeals for the D.C. Circuit, and then most recently at the SEC before an administrative law judge.[11] In the latter, the administrative law judge concluded, SIFMA believes erroneously, that the exchanges' data products compete with and can be substituted for each other. This conclusion is contrary to significant evidence that broker-dealers must purchase all exchange market data products both to remain competitive and to fulfill applicable regulatory requirements. SIFMA has appealed the administrative law judge's decision to the SEC.

Because a complete view of the market requires knowledge of trades on all relevant exchanges, each exchange has no incentive to curb data fees, which have become an increasingly important source of their revenue. For the same reason, these exchanges, which as SROs operate the SIPs through NMS plans, have no incentive to modernize the SIPs.

The outdated SIP system, the related need to purchase proprietary exchange data feeds and the high cost of such feeds are leading to the development of a multi-tiered landscape in which some market participants have access to trading information that others do not. This has a large number of anticompetitive effects, including making it harder for smaller broker-dealers to offer competitive trading platforms.

[11] NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010); NetCoalition v. SEC, 715 F.3d 342 (D.C. Cir. 2013); In re SIFMA, SEC Initial Decision Release No. 1015, File No. 3-15350 (June 1, 2016). The court found that, based on the record before it, no rational person could conclude that fees for depth-of-book data feeds are constrained by competitive forces and hence do not comport with the requirements of the securities laws. An overview of the proceedings before the D.C. Circuit and the SEC is available on SIFMA's website (link).

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should require improvement of SIP feeds, including depth-of-book data and odd-lot quotes, so that SIP data alone is sufficient for sophisticated trading and regulatory obligations, and all market participants are able to participate in the market with the same information.

- Alternatively, the SEC could replace the single-consolidator model of market data dissemination represented by the SIPs with a distributed model. Under a distributed model, competing market data aggregators ("CMDAs") could compete with the SIPs and each other to provide requisite market data feeds using the fastest, direct sources of market data.

  - CMDAs could be subject to specific and consistent performance and transparency standards. The CMDA model would introduce competition, reducing latency, providing redundancy, promoting fairness and mitigating exchanges' conflicts of interest. The CMDA model would assure that competition among market data providers could thrive, fostering innovation while assuring competitive controls against monopolistic pricing power.[12]

[12] *See* Committee on Capital Markets Regulation, U.S. Equity Market Structure Report n.6 (July 27, 2016) (link) ("After requiring disclosure of exchange market data revenues, the SEC should adopt a 'Competing Consolidator' model for data dissemination. As a first step to implementing this framework, the SEC should promote reforms in the governance and transparency of the current SIPs.").

Chapter 2

FIXED INCOME: U.S. TREASURIES

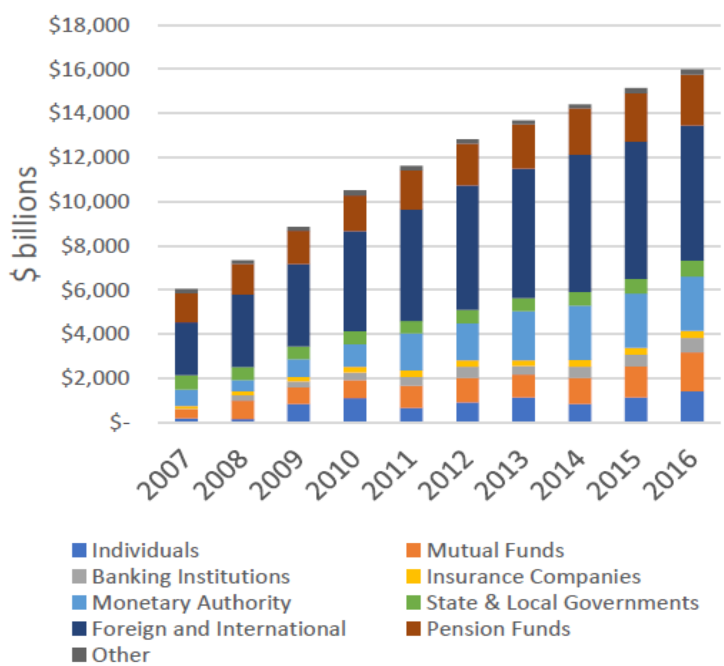
Relevant Agency

- Treasury

Chapter 2 –
FIXED INCOME: U.S. TREASURIES

The U.S. Treasury market is the most important financial market in the world.[1] As the largest segment of the fixed income market, the U.S. Treasury market facilitates U.S. monetary policy through a uniquely robust and active secondary market and a principal-driven auction process that has significant implications for the U.S. dollar's status as global reserve currency. Additionally, as a benchmark asset that carries the expectation that it can be readily converted to cash, the U.S. Treasury market underpins the safety and soundness framework of U.S. financial markets and serves as a global benchmark for risk pricing and hedging. U.S. Treasuries also underpin the new prudential regulatory framework for liquidity of U.S. and many other global financial institutions that have made the U.S. financial system significantly more resilient.

Figure 3 – Holdings of U.S. Treasuries by Investor Category, 2007–2016



***Source**: SIFMA (link).*

[1] The description of the U.S. Treasury market and the recommendations in this White Paper are drawn from the SIFMA and ABA Letter to Treasury Regarding Request for Information on Evolving Treasury Market Structure (Apr. 22, 2016) (link) submitted in response to the Treasury's 2015 Request for Information. For a comprehensive description of the market, market structure and market participants, see Promontory Financial Group, Emerging Issues in the Functioning of the U.S. Treasury Market (Apr. 22, 2016) (link) (the "Promontory White Paper").

Given the importance of this market, there must be continued study and review to ensure that the U.S. Treasury market remains the efficient centerpiece of the economic framework. Any changes to regulation should be carefully calibrated to support both the resiliency and the role of the U.S. Treasury market and recognize the unique structure and auction process that has allowed Treasury to finance government activity at a low cost to taxpayers. This Chapter describes generally the uniqueness of the U.S. Treasury market and certain areas of the U.S. Treasury market that need to be improved in order to enhance our capital markets and proposed solutions for each.

Importance of the Auction Process and Role of Primary Dealers

Treasury's ability to borrow to finance the U.S. federal government's debt is built around a principal-based market structure, one that is not easily or appropriately comparable with more traditional agency (e.g., equities) markets. The fundamental starting point of this market rests in the Treasury auction process.[2]

Treasury has structured the auction process to minimize government costs by promoting broad, competitive bidding.[3] Primary dealers—banks and broker-dealers that have been approved to trade in U.S. Treasuries with the Federal Reserve Bank of New York—have traditionally constituted the largest group of buyers in such auctions, bidding on behalf of their own accounts or on behalf of identified customers.[4] Other direct auction bidders include investment funds, pensions and retirement funds, insurance companies, foreign accounts and others. Primary dealers are, however, the only market participants who are obligated to participate in all auctions of U.S. government debt, with all bids to be made, at a minimum, for an amount of securities representing their pro rata share of the offered amount.

Obligations of Primary Dealers

In addition to obligations to participate in all auctions, the Federal Reserve Bank of New York expects primary dealers to act as "responsible counterparties and market participants in their overall conduct and support

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[2] *See* Federal Reserve Bank of New York, Treasury Auctions (link).

[3] *See* Kenneth D. Garbade and Jeffrey F. Ingber, Federal Reserve Bank of New York, The Treasury Auction Process: Objectives, Structure, and Recent Adaptations, Current Issues in Economics and Finance (Feb. 2005) (link).

[4] The Federal Reserve Bank of New York currently recognizes 23 primary dealers. The list of primary dealers is available at Federal Reserve Bank of New York, Primary Dealers (link).

of market efficiency and liquidity."[5] The obligation to support market liquidity extends not only to on-the-run securities but also to a host of less liquid off-the-run securities. In meeting those obligations set forth by the Federal Reserve Bank of New York, and in attempting to satisfy market and client demands, primary dealers are frequently required to commit capital in significant size. Principal trading activity in the when-issued market, during auctions, in the aftermarket of auctions and in the secondary market (including with respect to off-the-run securities) correspondingly requires these dealers to hedge their positions with other Treasury products (both in the specific security and other related securities) on a confidential basis. The ability of primary dealers to do so is critical to the overall functioning of the U.S. Treasury market and to helping maintain appropriate levels of liquidity in this market.

Other market participants are not similarly bound by the market making obligations that require primary dealers to provide both buy and sell quotes on a more or less continuous basis. Corporate hedgers and hedge funds, for example, seek to hedge specific business risks but do not serve clients as in a typical broker-dealer business model and are generally liquidity takers, rather than liquidity providers. Principal trading firms ("PTFs") similarly do not serve clients but play a more pronounced role in providing liquidity, trading for their own accounts and in volume to maximize profit on all trades, for which very limited capital is committed. Asset managers, by contrast, serve investors and clients as fiduciaries, on a low-leverage, long-term investment basis, and while they have the capacity to provide liquidity, their primary obligation is to serve their clients and investors, making them predominantly liquidity takers.[6] At the same time, each of these non-primary dealer market participants contributes in unique and important ways to the liquidity profile of the U.S. Treasury market.[7]

Other U.S. Treasury Market Participants and Market Segments

A wide range of market participants—including bank portfolio and asset managers, fixed income and swaps dealers, bond underwriters, and mortgage bankers and servicers—rely on U.S. Treasuries to actively assume interest-rate risk or to manage the rate risk inherent in their business

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[5] *See* Federal Reserve Bank of New York, Policy on Counterparties for Market Operations (Nov. 9, 2016) (link).

[6] PricewaterhouseCoopers LLP, Global Financial Markets Liquidity Study, at 22 (Aug. 2015) (link) ("GFMA Study"); Joint Staff Report, Appendix A (link).

[7] *See generally* Promontory White Paper (link).

activities. Each of these participants will have a unique risk profile by term and duration, scale, and variability. Collectively, they rely on the availability of U.S. Treasuries across an extensive term structure for their investment and hedging needs.

Significant differences among market participants may also be seen in their business models, functions, trading practices and strategies.

The characteristics of the U.S. Treasury market also vary significantly across product segments, particularly with respect to the on-the-run and off-the-run segments, with the on-the-runs trading much more frequently and electronically (i.e., typically on many-to-many platforms in both the cash and futures markets).

A. The U.S. Treasury Market Structure

1. The Problem (Implicates Core Principles (c) and (f))

U.S. monetary policy, and global monetary conditions more generally, have profoundly impacted liquidity dynamics in the United States. In particular, the Federal Government's policy of Quantitative Easing ("QE") boosted demand for U.S. Treasuries and lifted asset prices, improving liquidity and, according to some, lowering associated risks. On the other hand, large scale purchases of government bonds by the Federal Reserve under QE programs has likely reduced the overall volume of U.S. Treasuries available for trading.[8] Outstanding Treasury debt has also substantially increased, while buyers of size (e.g., foreign central banks) have grown significantly, both outright and when viewed as a percentage of all holders.[9] These factors are not risk free, and a normalization of monetary policy involves a risk of an analogous but reverse level of impact on markets.

Moreover, new technologies, regulatory developments, and changing strategies, demands and expectations among participants have significantly reshaped U.S. Treasury market structure over the past decade. These changes have led to the growing role of electronic trading venues and a surge in the prominence of exchange-traded funds, index and passive funds, algorithmic trading and active money managers.

[8] *See generally* Promontory White Paper (link).

[9] Treasury, Federal Reserve, Federal Reserve Bank of New York, SEC, CFTC, Joint Staff Report: The U.S. Treasury Market on October 15, 2014 (July 13, 2015) (link) ("Joint Staff Report").

Electronification has also significantly increased the speed of trading and the ease of matching buyers and sellers, creating new incentives for market participants to shift trading strategies, and for new participants to enter the market. PTFs for example, many of which rely in large part on high frequency algorithmic trading strategies, now account for a substantial volume of all trading and the majority of all on-the-run U.S. Treasuries.[10] The rapid growth of PTFs, in number of firms and market share, has paralleled these technological developments and has created a valuable source of new and growing liquidity.

Traditionally, regulation of the U.S. Treasury market has been limited to primary dealers under the oversight of Treasury and the Federal Reserve. With changes in market structure has also emerged a class of market participants who largely remain outside of the current regulatory framework and whose business models are fundamentally different than those of traditional, principal-based participants that traditionally had been responsible for most of the volume in the market. The result can be higher volumes and lower trade sizes.[11] While these newer participants are responsible for increases in volumes, this does not mean that such participants are establishing and holding positions or willing to meaningfully provide liquidity during stress events. Primary dealers, who traditionally provided and continue to provide liquidity during stress events, are engaging in relatively less market making activity than before the financial crisis, as illustrated in Figure 4 and Figure 5. These factors tend to exacerbate volatility in rapidly changing markets, even absent fundamental catalysts.

[10] *Id.* at 6.

[11] Joint Staff Report, at Appendix A (link).

Figure 4 – Gross Treasury Positions of Primary Dealers

Note: *4-week moving average; sum of dealers' short and long positions.*
Source: *Treasury, Joint Staff Report: U.S. Treasury Market on October 15, 2014 (Oct. 15, 2015) (link).*

Figure 5 – Estimated U.S. Treasury Market Making Positions of Primary Dealers

Note: *4-week moving average; smaller of each dealer's short and long position in each reporting bucket, aggregated across dealers and buckets.*
Source: *Treasury, Joint Staff Report: U.S. Treasury Market on October 15, 2014 (Oct. 15, 2015) (link).*

With the increased presence of these new participants and greater availability of electronic trading technology, inter-dealer markets have adapted and now "resembl[e] . . . other highly liquid markets, including equities and foreign exchange markets, where PTFs and dealers transact in automated fashion" in large sizes and at high speed.[12] Of some concern as a result of these changes is an increase in clearing and settlement being facilitated by inter-dealer brokers outside of regulated CCP platforms, i.e., the Government Securities Division of the Fixed Income Clearing Corporation ("FICC"), and therefore not subject to the same level of risk mitigation standards (e.g., margin collection, clearing fund balance requirements, predefined loss sharing agreements) as regulated CCP platforms. Much of this activity is driven, in particular, by PTFs who are not clearing at FICC or through an FICC member and who trade in very large volumes through the inter-dealer broker platforms. This shift increases risks when intermediating and managing intraday settlement.

2. The Solution

Treasury should do the following, which can be accomplished without statutory change:

- Treasury should exercise its primary supervisory / regulatory authority over the U.S. Treasury market as appropriate in order to ensure consistency and coherence across the regulatory and supervisory landscape for the U.S. Treasury market.

- Treasury should exercise its authority over all participants in the U.S. Treasury market, regardless of the type of entity.

- Treasury should assess aspects of regulations and risk management, monitoring and trading practices that may be disproportionately affecting some market participants or products in a manner that is detrimental to the efficient and effective functioning of the market, with a view towards establishing an activity-level approach to market regulation such that the same types of market conduct are similarly regulated.

    - Treasury should adopt a risk-sensitive approach to regulation that ties regulations to activities and ensures that best practices are observed by market participants.

[12] Treasury, Notice Seeking Public Comment on the Evolution of the Treasury Market Structure, 81 Fed. Reg. 3928 (Mar. 23, 2016) (link).

- Treasury should adopt and update the regulatory framework applicable to the U.S. Treasury market to optimize stability and resiliency, and ensure the market's continuing viability, given that technology has improved and with it the diversity of market participants and complexity in trading practices and strategies.[13]

- Treasury should consider encouraging all market participants to comply with the Treasury Market Practices Group Best Practices,[14] including material non-primary dealer market participants; currently, only primary dealers are required to attest that they comply.

B. Prudential Regulations Applicable to the U.S. Treasuries Market

1. The Problem (Implicates Core Principles (f) and (g))

Prudential regulatory reform has attracted particular scrutiny in recent writings and analysis, which note a gradual and systematic deleveraging by bank-affiliated primary dealers to comply with prudential regulations.[15] Increased capital charges for low risk, low yielding assets held for LCR purposes as well as in trading inventories are compelling banks to reexamine and reduce their traditional roles as liquidity providers and raising the threshold under which they can confidently step in and remain in the market to support it during times of stress, a development that is "potentially introducing new and unforeseen risks to our markets and economy."[16] PTFs, among other types of market participants, on the other hand, are appearing to fill some of the void resulting from a decreased

[13] New entrants to the market participate significantly and often pursuant to high-speed algorithmic trading strategies. These new entrants are not subject to the same scrutiny as primary dealers by the Federal Reserve Bank of New York or other brokers/dealers that must report activity to FINRA.

[14] Treasury Market Practices Group, Best Practices (link). Among the more important best practices in this environment are that (i) all market participants should behave in a manner that supports market liquidity and integrity; (ii) market participants should be responsible in quoting prices and should promote overall price transparency across trading platforms; (iii) internal control policies should further a firm's ability to detect and prevent potentially disruptive trading activity by identifying the specific trading trends, positions, strategies, or behaviors within the trading operation that constitute triggers for mandatory business and compliance review; and (iv) similar best practices should extend to electronic trading.

[15] *See, e.g.*, GFMA Study, at Appendix C (link); Promontory White Paper (link).

[16] *Id.* at 7. Basel Committee, Implementation (link).

ability or willingness of primary dealers to provide various aspects of liquidity as readily as before.

Some factors and forces that have been reshaping the U.S. Treasury market have enhanced liquidity and stability, whereas others have had more negative effects. In addition, the possibility that cash Treasuries trading activity may be shifting toward the futures market, or other markets, increases the importance of understanding the reasons for these changes, and how an appropriate regulatory response could enhance market operations while facilitating greater liquidity. These changes suggest continued study of this important market to ensure that it operates safely, efficiently and with no disruption to the important role that it plays.

For example, the prudential regulators' liquidity and capital requirements have had a material impact on banks' traditional role as primary dealers and their associated market making function in the U.S. Treasury market and their willingness and ability to hold inventory. Specifically, the measurable reduction in primary dealer inventory and market making capacity that is potentially affecting U.S. Treasury market liquidity can be tied, at least in part, to banks' responses to the implementation of new prudential regulations. The rules increase the amount and quality of capital that banks must hold and introduce a minimum leverage ratio requirement designed to limit excessive leverage in the banking sector[17] without regard for asset quality, liquidity or risk.

While SIFMA is supportive of the capital and liquidity regulations that have been put in place since the crisis to improve the safety and soundness of banking institutions, SIFMA is concerned that the resulting reduction in primary dealer inventory and market making capacity may be hampering the ability of primary dealers to provide liquidity to market participants. Their ability to continue to act as market makers and provide market liquidity can be particularly impaired in stressed environments, as regulatory requirements constrict their ability to service customers.

SIFMA supports the Treasury recommendation concerning the SLR in the Treasury Report, in which Treasury suggested that "[s]ignificant adjustments should be made to the calculation of the SLR." Specifically, the Treasury Report suggests the following deductions from the leverage exposure denominator:

[17] GFMA Study, at 36 (link).

- Cash on deposit with central banks;
- U.S. Treasuries; and
- Initial margin for centrally cleared derivatives.

Implementation of such a recommendation would have a positive influence on the ability of firms to intermediate. It would also recognize the risk-free status of Treasuries (i.e., that U.S. Treasuries are a distinct sovereign, viewed as the risk free standard globally) and cash and the fact that they are not sources of leverage. These positive effects would be enhanced by a further exclusion from the SLR of financing activity on U.S. Treasuries. The existence of a deep and liquid financing market would reinforce the depth of liquidity in the cash market for Treasuries.

As a liquidity management tool, U.S. Treasuries—interest-bearing claims on currency against Treasury—are treated as fungible with currency. Before the eSLR requirement, banks provided low-risk intermediation of secured financing transactions in U.S. Treasuries to market participants seeking to raise or deploy liquidity. After the eSLR requirements, banks are less willing to facilitate this low-risk activity, despite its critical importance to market depth, Treasury and the broader economy.

While a critical step, carving out central bank cash and initial margin—but not U.S. Treasuries financing transactions—may further disincentivize banks from providing this useful, low-risk intermediation. This would increase the opportunity cost of holding securities collateral versus cash, which would have a direct impact on the cost of the U.S. Treasuries funding program.

Moreover, structural changes in bank balance sheets post-LCR have created a structural need for liquid HQLA. If central bank liquidity is recognized as a deduction from the leverage exposure denomination, but secured financing activity in U.S. Treasuries is not, market depth will likely further erode in favor of increased reserve balances. This likely complicates forward monetary policy implementation and increases the frictions, and therefore costs, of managing Treasury's issuance program.

The requirement for bank-affiliated primary dealers to hold HQLA illustrates another concern. As banks, primary dealers are required to hold a buffer of HQLA (e.g., U.S. Treasuries) to meet the requirements of the LCR rules. The U.S. rule's narrow HQLA definition can influence market actions even in apparent market tranquility as they encourage acquisition of HQLA as a matter of normal course. This impacts the liquidity of assets favored by the LCR. The HQLA buffer requirement is driven by certain excessively conservative cash outflow rates and assumptions that should be modified to reflect banking organizations' historical experience. The increased demand for HQLA has decreased their supply and has decreased the level of inventory that may otherwise be available. Relatedly, higher capital charges on banks for low yielding assets (through the SLR) have increased the banks' need to hold higher yielding collateral and decreased their ability to act as dealers or market makers in low yielding assets such as U.S. Treasuries.

2. The Solution

"External parties—chiefly the banking regulators—are calling for the imposition of new regulatory requirements for nonbank financial institutions and on certain activities by all financial actors. Unfortunately, those proposals seem to be premised on a misunderstanding of the capital markets and show little appreciation for the SEC's mission. I am very concerned about the extent, fervor, and momentum of those proposals."[18]

– Michael S. Piwowar, Commissioner, SEC

Treasury should do the following, which can be accomplished without statutory change:

- Treasury should assess the coherence of capital and liquidity-related regulations with regard to their impact on liquidity for the U.S. Treasury market to ensure that regulations are appropriately calibrated and harmonized to promote the goal of safety and soundness while at the same time minimizing any negative impact on U.S. Treasury market liquidity.

  - Treasury should review the coherence of the current regulatory regime, which should include, among other assessments, an evaluation of several issues, including, for example, how the U.S. Treasury market is impacted by the LCR.

  - Treasury should also review and assess, in conjunction with banking and other regulators, the above concerns by examining duplicative and overly burdensome capital and liquidity regulations on market participants, and determine whether they are having the unintended effect of reducing or weakening market liquidity.

  - Treasury should recommend that the Federal Reserve and the OCC make the three specific deductions from the SLR denominator, as recommended by Treasury in the Treasury Report, for cash on

[18] Michael S. Piwowar, SEC, Remarks Before the Exchequer Club of Washington, D.C. (May 20, 2015) (link).

deposit with central banks, U.S. Treasuries and initial margin for centrally cleared derivatives.[19] Treasury should also include securities financing transactions as a specific deduction from the SLR denominator. Changing the treatment, for example, of liquidity on deposit with central banks and held in U.S. Treasuries, but not liquidity lent against U.S. Treasuries, dislocates the incentive for banks to facilitate Treasury financing. SIFMA believes this would create dislocations in the market and impact the efficient functioning of the U.S. Treasury market.

- Allowing cash, but not U.S. Treasuries or securities financing transactions, to be included in the SLR denominator deductions would be greatly disruptive to the U.S. Treasury market, as banks would prefer cash over U.S. Treasuries, which would be problematic for U.S. monetary policy.

C. Reporting of Secondary Market Transactions

1. The Problem (Implicates Core Principles (c), (f) and (g))

Market participants have called for additional public dissemination of secondary market transaction data. There is, however, already an abundance of publicly available and timely information of Treasury secondary market activity sufficient to allow market participants to obtain information needed to trade in a competitive, fair and efficient manner. Indeed, the unique nature of the U.S. Treasury market and the U.S. Treasury auction process, described above, with the need for primary dealers to be able to hedge their positions on a confidential basis, counsels extreme caution in moving forward with additional public disclosure.

SIFMA supports the recent implementation of reporting secondary market Treasury transactions through FINRA's TRACE engine, which will materially increase the official sector's ability to fulfill its market surveillance duties. The additional data now available to Treasury and the other regulators is significant in terms of volume and coverage within the market.

[19] Implementation of such a recommendation would have a significant positive effect on firms' ability to continue important intermediation services and would recognize the risk-free status of U.S. Treasuries and cash and permit fully secured U.S. Treasury repo activity—which aids in reinforcing the deep liquidity in the cash market for U.S. Treasuries—to continue in an efficient manner.

For the most liquid Treasury products (e.g., on-the-run securities), executions and a range of other data are observable by monitoring information available from the primary execution venues for these products. Specifically, there is considerable price transparency in the on-the-run market through trading platforms such as BrokerTec and NASDAQ Fixed Income and the futures markets, where indicative bids and offers are available and executable, and, for customers, through direct access to multiple dealer franchises. For less liquid Treasury products (e.g., some off-the-run securities), indicative pricing and other market data are available from Tradeweb and Bloomberg, and customers also have multiple options for direct access to dealer franchises that can also provide indicative bids for less liquid products.

Moreover, increased reporting of Treasury transactions to the public would not have any net positive effect on improving market functionality or liquidity. Specifically, there are significant identifiable and predictable risks to market diversity, liquidity and resiliency that arise from the prospect of mandatory increased public disclosures that outweigh any potential—as yet unidentified—benefits. Two aspects in particular should be considered in this context.

First, managing large positions would be more difficult. A range of market participants would be inhibited in their investing activity if they deemed the detail and frequency of public data dissemination too high, particularly for the off-the-run market and large trades across market segments. Parts of the U.S. Treasury market are very concentrated and transactions occur in large sizes.[20] Third-party investors, particularly those providing the principal-based liquidity that is so critical to this market, have a legitimate and well-established interest in maintaining the confidentiality to be able to trade without concern that too much public information will hurt bilateral price formation.

Second, primary dealer hedging would be compromised. The ability of primary dealers to hedge their positions around U.S. Treasury market auctions and in meeting counterparty demand in the secondary market, which is critical for such market participants to continue serving as principal-based liquidity providers for a diverse investor base, would be compromised if they were unable to do so on a confidential basis. Without this ability, it would be materially more difficult for primary dealers to

[20] *See* Joint Staff Report, at 52 (link).

commit significant amounts of capital to satisfy market and client demands and to meet their obligations set forth by the Federal Reserve Bank of New York. Given the importance of primary dealers' role in the auction process and for maintaining liquidity in the market, the prospect of losing confidentiality for these market participants would have serious consequences for their critical role and the market more broadly.

2. The Solution

Treasury should do the following, which can be accomplished without statutory change:

- Treasury should continue to take the lead on the careful review and analysis of data that is being submitted through FINRA's TRACE engine before any additional regulatory actions are taken. While FINRA is acting as agent for Treasury in collecting this data, care should be taken to ensure that Treasury provides appropriate guidance and supervision with respect to enforcement and market supervision.
    - Treasury should consider including market participants who are not currently subject to FINRA's TRACE reporting requirements, to enhance the data available to regulators.
- Treasury should preserve and promote a diversity of market participants by refraining from pursuing public disclosure mandates of positions or transactions in the absence of clear, compelling and demonstrable benefits to overall liquidity from such disclosure.

Chapter 3

FIXED INCOME: CREDIT

Relevant Agencies

- SEC
- FINRA
- MSRB

Chapter 3 – Fixed Income: Credit

U.S. businesses rely on the credit markets to finance investment in new assets and growth in the economy. The primary credit market is active and in recent years has experienced significant growth given the interest rate and economic climate with both a rise in annual issuance, together with a rise in the average deal size, and a commensurate rise in the dollar volume of bonds outstanding. Secondary market trading volume in most fixed income markets is unsurprisingly dominated by trading in newly issued securities. Similar to the municipal securities market, however, it is not uncommon for more seasoned bonds to trade very infrequently in the secondary markets, which can make price discovery more challenging.

Market structure in the credit market, which historically relied heavily on dealer intermediation over the phone, has evolved in recent years in response to technological, regulatory and market forces. There has been significant competition and innovation in electronic trading platforms and increased investment in data aggregation and client connectivity generally. There has also been an increasing market focus on better data capture and more efficient use of trade data to aid in price discovery and in finding ready buyers, as well as a marked increase in the availability and utilization of pricing systems and analytics to measure best execution. While the adoption of electronic trading has been slow among institutional market participants, these technological advances together with the growth in electronic trading platforms will change the way these products trade over time.

The changes in credit market structure have increased transparency and the trade information available to market participants. Regulatory requirements to advance market structure and further transparency, however, must be carefully designed to reflect the differing structure of fixed income markets to avoid unintended consequences, such as negatively impacting market liquidity. This Chapter describes a number of current and potential regulatory frictions and proposed solutions for each.

A. Pre-Trade Transparency Initiatives

1. The Problem (Implicates Core Principles (c) and (f))

In recent years, the credit markets have seen significantly increased pre-trade transparency. Market participants have increased their use of pricing systems that facilitate price discovery. Some fixed income ATSs also provide analytical pricing tools as well as transparency of dealer bids and offers.

The SEC has also demonstrated interest in pre-trade transparency. In its 2012 paper on the municipal securities market, the SEC made two recommendations to enhance pre-trade price transparency.[1] First, the SEC suggested that it might consider amendments to Regulation ATS to require an ATS with material transaction or dollar volume in municipal securities to publicly disseminate its best bid and, on a delayed and non-attributable basis, responses to bid-wanted auctions. Second, the SEC suggested that the MSRB might consider rules requiring a broker's broker with material transaction or dollar volume in municipal securities to publicly disseminate the best bid and offer prices on any electronic network it operates and, on a delayed and non-attributable basis, responses to bid-wanted auctions.

SIFMA believes that this is not the right time to move forward on these initiatives. The SEC's 2012 findings and recommendations suggesting further pre-trade initiatives are out of date. The SEC's suggestions are five years old—an eternity in the rapidly developing financial markets. Part of the SEC's analysis leading to its recommendations was based on an academic study published 11 years ago, using data that is now 17 years old.[2]

A new pre-trade transparency regulatory initiative could be expensive to develop and implement while yielding limited useful information for investors. Policymakers should be cognizant that the transparency of the market has improved significantly since 2012 as a result of further development of the post-trade reporting regime, the forthcoming regulatory requirements on markup disclosure, and from market-driven efforts to improve data collection and aggregation, develop pricing tools and

[1] SEC, Report on the Municipal Securities Market, at 143–144 (July 31, 2012) (link).

[2] Lawrence E. Harris and Michael S. Piwowar, The Journal of Finance, Secondary Trading Costs in the Municipal Bond Market, at 1362 (May 16, 2006) (link).

standardize data communication protocols. The regulators need to carefully and thoroughly assess the costs of any additional pre-trade transparency initiatives given with the potential limited benefits.

Moreover, implementing a pre-trade price transparency initiative now could discourage dealers from participating in price discovery mechanisms such as voice brokers and trading platforms. Firms spend significant resources developing the means to price bonds and respond to those seeking quotations. The quotes that firms develop, therefore, arguably represent proprietary information, and mandating public dissemination could deter firms from engaging in that process, particularly because the vast majority of secondary market price discovery auctions in the municipal market do not even result in a trade.

2. The Solution

The SEC, MSRB and FINRA should do the following, which can be accomplished without statutory change:

- The SEC, MSRB and FINRA should allow the best execution and markup disclosure rules, including the amendments recommended elsewhere in this White Paper, to take full effect and monitor the effects of those rules on pre-trade transparency before implementing any further pre-trade transparency regulatory initiatives.

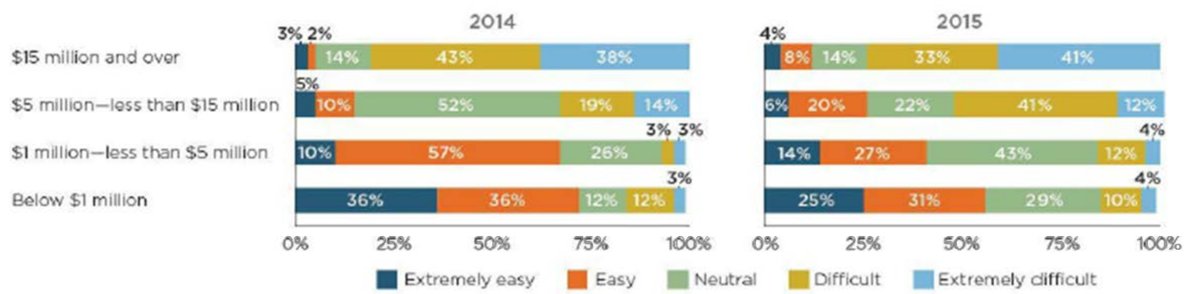
B. Post-Trade Transparency for Block Trades

1. The Problem (Implicates Core Principles (c) and (f))

FINRA's current TRACE rules require bond trades to be reported as soon as practicable but not later than 15 minutes after the time of trade. TRACE requires public disclosure of the actual trade size up to certain thresholds. For large trades, known as block trades, the actual trade size is masked for a period of time. Specifically, if a trade in an investment-grade corporate bond is above $5mm, it will be publicly disclosed as having a size of $5mm+. If a trade in a non-investment-grade corporate bond is above $1mm, it will be publicly disclosed as having a size of $1mm+. The actual trade size is released 18 months after execution, though a recent FINRA rule change will result in the release of the actual size of the trade after 6 months.

Although the current TRACE framework masks the actual size of block trades, the dissemination of transactions within 15 minutes of the time of the trade can negatively impact the facilitation of large block trades and the liquidity of the corporate bond market generally. Dealers, who provide the primary source of liquidity for block trades, risk their capital until they can locate a willing buyer or seller on the other side of the trade. The market signal provided by the block trade report, together with the dealer buy and dealer sell indicator, reduces the dealer's ability to cost effectively intermediate the transaction. Dealers may even find it difficult to hedge their risk effectively to allow for more time to locate willing buyers and sellers. Thus, the current reporting structure can serve to reduce dealers' appetite to facilitate block trades. The frictions caused by the current framework can raise search costs and transaction costs for market participants and do not serve to promote efficient, liquid and orderly markets.

Figure 6 – Reponses by Institutional Investors to the Question: "How Hard Is It to Trade Corporate Bonds, by Trade Size?"



***Source**: Kevin McPartland, Greenwich Associates, Understanding the U.S. Fixed Income Market (Sept. 22, 2016) (link).*

A March 2015 Oliver Wyman and Morgan Stanley report states that "immediate post-trade transparency requirements (e.g., in TRACE) discourage large order transactions, as buyers that are uncertain of ultimate size become concerned about being run over [and a recalibration] may give brokers the incentive to take reasonable risk to facilitate client flow."[3]

While the current framework that provides for masking of block trade size was clearly created with some recognition of these frictions, changes to liquidity conditions and market structure warrant a reconsideration of the existing framework. The concerns addressed by the Oliver Wyman and Morgan Stanley report quoted in the sidebar still exist two years after the publication of that report and are exacerbated by the more illiquid pockets of the market for securities that do not trade frequently.

Other reporting regimes have incorporated additional measures to address these frictions. For example, MiFID II allows for delayed dissemination on

[3] Morgan Stanley and Oliver Wyman, Wholesale & Investment Banking Outlook Liquidity Conundrum: Shifting Risks, What it Means (Mar. 19, 2015) (link).

an end of day T+2 basis for large-in-scale trades in corporate bonds (i.e., trade size is at 90th percentile and above for the preceding period). In the United States, equity block trades (i.e., trades distinguished from ordinary trades by their magnitude and use of special selling efforts) are not publicly disclosed.

Industry experience with current rules suggests that liquidity could be enhanced in a number of fixed income markets, particularly through careful review of the time periods for reporting large trades, given the significant variations among different categories of fixed income securities.

2. The Solution

The SEC and FINRA should do the following, which can be accomplished without statutory change:

- The SEC and FINRA should recalibrate the current corporate bond reporting structure for block trades to better support and balance the desire for transparency and the need to promote liquidity, including additional delays beyond the 15-minute threshold for reporting.

C. The Fixed Income ATS Transparency Regime

1. The Problem (Implicates Core Principles (c) and (f))

In November 2015, the SEC proposed a new rule to enhance operational transparency and regulatory oversight of ATSs that trade stocks listed on a national securities exchange (“NMS Stocks”).[4] In the adopting release to that rule, the SEC expressed its preliminary belief that the operational transparency conditions to the exemption from the definition of exchange in Exchange Act Rule 3a1-1(a) should only apply to NMS Stock ATSs. The SEC, however, requested comment on whether its initial view is warranted for categories of non-NMS Stock ATSs, including fixed income ATSs.

The SEC noted that fixed income ATSs primarily compete against other trading venues with limited or no operational transparency requirements or standards.

[4] SEC, Regulation of NMS Stock Alternative Trading Systems (Dec. 25, 2005) (link).

Given the growing universe of fixed income electronic trading platforms and the diversity in trading protocols, SIFMA believes further consideration is required to promote greater operational transparency for fixed income ATSs. Any proposed revisions to the disclosure requirements for fixed income ATSs under Regulation ATS, however, should be specifically tailored to the attributes of the fixed income market because, as currently proposed, the disclosure requirements for Regulation ATS do not address the realities of the fixed income ATSs.

Additionally, FINRA and the MSRB now require trades executed through fixed income ATSs to be tagged when reported post trade, although those statistics are not currently reported publicly. As a result, the public has very few aggregated statistics available on ATS volumes and such data could be useful to market participants.

2. The Solution

The SEC, FINRA and the MSRB should do the following, which can be accomplished without statutory change:

- The SEC should develop an ATS transparency regime that is tailored specifically to the attributes of the fixed income market.
- FINRA and the MSRB should consider methods to publicly disclose certain ATS-related transaction information while taking into account both the desire to continue to promote innovation and the competitive disadvantages to newly formed ATSs during the first few years of operation.

D. The Markup Disclosure Rules

1. The Problem (Implicates Core Principles (c) and (f))

In November 2016, the SEC approved new FINRA and MSRB rules requiring dealers to disclose on retail customer confirmations their markups on securities transactions, calculated from the security's prevailing market price. The markup disclosure rules, effective as of May 2018, are aimed at assisting retail customers to determine the markups[5] that brokerage firms

[5] Markups are defined as the difference between the price charged to the customer and the inter-dealer price for the bond at the time of the customer trade.

receive for securities transactions. Dealers ultimately favor disclosure of relevant transaction data to retail investors, as such transparency supports investor trust and confidence in the markets. The markup disclosure rules, however, raise significant compliance concerns for dealers. Dealers are now in the process of trying to develop the systems and controls to calculate and record markups and markdowns in a systematic and automated manner. Moreover, as in the case of the best execution requirements discussed below, the markup disclosure rules' implementations fail to take into account the substantial differences between fixed income markets and equity markets as well as the variations among the large number of instruments traded within fixed income markets.

Before the upcoming May 2018 effective date, or later if the recommendations in this White Paper are adopted, the markup disclosure rules need revision in order to reduce operational complexities for dealers who must comply with the rules. As the rules are currently written, firms are required to have systems in place to determine the appropriate markup for disclosure on certain retail customer confirmations.

The process for determining the prevailing market price on days when the market has moved during the time between transactions is complex and subjective. For example, where hours have passed between the dealer's purchase and sale, market prices may have shifted. In such cases, the rules will require the dealer to calculate the markup based not on the acquisition price but on the prevailing market price at the time the position is sold.

The vast majority of municipal and corporate bonds trade infrequently relative to equity securities and, therefore, determining the value of a security at any point in the day when there may not have been many or any recent inter-dealer transactions in the security is both an art and a science. Experienced bond traders are adept at using their expert judgment in determining bond prices, particularly since determining the prevailing market price is ultimately a subjective determination with some level of inherent variability.

> "[D]etermining the prevailing market price for municipal securities, particularly those that are illiquid, can be a complex task. . . . [The] specific degree of accuracy, as well as the specific actions that a dealer may need to take to assess market value, will vary with the facts and circumstances."[6]
>
> *– SEC, Report on the Municipal Securities Market*

The overly specific nature and order of the steps prescribed in the rules, therefore, makes automation to the strict letter of the rules challenging, if not impossible, and creates significant compliance burdens. This results from the incorporation of a regulatory standard that was historically focused

[6] SEC, Report on the Municipal Securities Market (July 31, 2012) (link).

on a range of reasonableness of markups—in the context of a rule designed to prevent excessive markups—and is now used to determine the accuracy of a specific data point derived from subjective analysis—in the context of a rule designed to provide customers with precise markup percentages and dollar amounts.

Specifically, the rules includes prescriptive list and priority of factors that dealers must comply with to determine the prevailing market price under these circumstances, referred to as a waterfall. These factors include the prices of any contemporaneous inter-dealer trades, institutional trades or quotations. If such factors are not available, the rules specify additional factors that dealers must review to establish the prevailing market price, including prices, or yields calculated from prices, of contemporaneous inter-dealer trades, institutional trades, or quotations for similar securities. The rules include a number of indicators to determine whether another security is similar to the security in question. If these factors involving similar securities are not available, dealers must use economic models to determine the prevailing market price, and if that is unreliable, the dealer must look to customer transactions and make adjustments to calculate the prevailing market price.

The prescriptive yet subjective waterfall does not lend itself to automation in an environment that is increasingly adopting electronic trading with less human intervention. For example, requiring firms to estimate a prevailing market price to an exact decimal point would introduce substantial operational complexity and new programming challenges for all impacted firms. To enable programmers to build the proper controls, firms will be required to make certain assumptions about their disclosure obligations across a variety of fact patterns and market conditions.

Moreover, dealers have a number of questions regarding the documentation that they must maintain to reasonably demonstrate that the waterfall has been followed to determine the prevailing market price. Many dealers intend to comply with this documentation requirement by relying on vendors' systems, which would automate this process. No vendors, however, have finalized an existing automated, workable compliance solution that codes the waterfall for dealers subject to the rules and that is ready for firms to onboard and test in their own environments. Without the ability to automate compliance for major elements of the rule, it is largely unworkable.

Also, at many firms, especially small- and medium-size dealers, limited resources are available because of other major regulatory objectives with overlapping timeframes, including, for example, implementation of a two-day settlement cycle, the DOL's fiduciary regulation, FINRA's CAT and other major regulatory initiatives. Firms need to begin testing compliance solutions in order to be ready for the May 2018 deadline. With no vendor compliance solutions yet available, many firms simply do not have time to develop internal resources to be able to comply with the rule by May 2018.

Further, the FINRA rule does not adequately address the needs of firms operating both institutional and retail businesses. In particular, although the rule contains an exception that, on its face, seeks to enable firms to maintain an institutional desk functionally separate from its retail desk, relevant guidance imposes conditions on that exception, including an apparent restriction on the retail desk sourcing securities from the institutional desk, that render the exception unworkable in practice.[7] More generally, in the absence of a workable exception, firms operating both a retail and institutional business cannot readily establish a consistent and automated mechanism for satisfying the disclosure requirement, given the complex and subjective waterfall process and the significant differences in the retail and institutional businesses.

Market participants have asked for more flexibility in the implementation standards, but there appears to be an unwillingness to better balance the operational complexities and costs while not significantly compromising the objective of increased transparency. Even in light of the recent guidance, SIFMA remains concerned about unintended consequences of the rules. For example, if dealers face unmanageable compliance risks and significant implementation costs, they may reduce their market activity in ways that ultimately diminish market liquidity.

[7] More specifically, FINRA Notice to Members 17-08 provides that the exception to allow an institutional desk to service an institutional customer, without necessarily triggering the rule's disclosure requirements in relation to a separate retail desk within the firm, is not available "if trades executed on an institutional desk were used to source the transactions at the retail desk." FINRA, Pricing Disclosure in the Fixed Income Markets, at 6, n.9 (Feb. 2017) (link). This condition does not reflect the operational realities of how a firm might seek to source securities to meet the needs of its customers in the most effective manner. It also does not offer an exception that parallels the approach taken by the rule for affiliate transactions, which are permitted without this condition so long as the transaction is conducted at arm's length.

2. The Solution

FINRA and the MSRB should do the following, which can be accomplished without statutory change:

- FINRA and the MSRB should revise the implementation date for the markup disclosure rules to November 2019 to ensure firms and vendor partners have sufficient time to implement and address the rule.
  - Such an extension should be granted in light of the lack of an existing vendor solution, the need to diligence and test vendor solutions when available and the time and testing that will be required to securely onboard the vendor solution.
- FINRA and the MSRB should revise the markup disclosure rules in a manner that would resolve the issues described above so that dealers can develop a process to streamline and automate compliance.[8]
- FINRA and the MSRB should reconsider the scope of the rules. For example, early discussions surrounding markup disclosure focused on riskless principal trades only, but the final rules approved by the SEC apply to more than riskless principal trades.
- FINRA and the MSRB should reconsider alternative solutions that make better use of existing industry utilities like FINRA's TRACE system or the MSRB's Electronic Municipal Market Access ("EMMA") platform.

E. Best Execution

1. The Problem (Implicates Core Principles (c), (f) and (g))

Both FINRA and the MSRB have implemented best execution requirements for fixed income. FINRA incorporated debt securities into Rule 5310 on best execution and interpositioning in 2012, and the three new MSRB rules

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[8] For a more in depth discussion of SIFMA's comments regarding the markup disclosure rules, see SIFMA, Letter to SEC Regarding Customer Confirmations (Oct. 3, 2016) (link); SIFMA, Letter to SEC Regarding Customer Confirmations (Sept. 9, 2016) (link); SIFMA, Letter to MSRB Regarding Request for Comment on MSRB Regulatory Notice 2016-07 (Mar. 31, 2016) (link); SIFMA, Letter to FINRA and MSRB Regarding FINRA Regulatory Notice 15-36 and MSRB Regulatory Notice 2015-16 (Dec. 11, 2015) (link); SIFMA, Letter to FINRA and MSRB Regarding FINRA Regulatory Notice 14-52 and MSRB Regulatory Notice 2014-20 (Jan. 20, 2015) (link).

(Rules G-18, G-48 and D-15) were approved in late 2014 to impose a best execution requirement for municipal securities dealers and to make other related rule changes.[9]

Notably, MSRB's best execution rules are designed to apply only to retail investors, not professional, institutional investors, known under MSRB rules as sophisticated municipal market professionals ("SMMP") while FINRA's rule does not provide a similar institutional exemption. These rules are generally designed to require that broker-dealers have procedures in place to ensure that investors receive the most favorable execution reasonably available under the circumstances. The overall alignment of rules sets between the MSRB and FINRA led to a coordinated release of additional implementation guidance in late 2015.[10]

Several issues arise in the application of best execution requirements for fixed income securities. The rules require that dealers have procedures in place requiring traders to "ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." Under the rule, "market" encompasses a variety of different venues, including but not limited to brokers' brokers, ATSs or platforms and other counterparties, which may include the dealer itself as principal. The rules rely on a reasonable diligence standard but, despite the implementation guidance, regulatory expectations are significantly vague given the fixed income market structure.

As a result of this vagueness, some dealers have taken to requesting quotes for potential customer trades from a wide and often redundant portion of markets, or potential trading venues. The redundancy results from the overlap created when brokers' brokers and trading platforms solicit quotes from the same or similar group of potential counterparties. These multiple requests create confusing market noise and inefficiencies as counterparties often end up responding to the same potential trade a number of times. Moreover, given that the municipal market does not have a robust two-sided market, requiring firms to repeatedly request quotes from the market serves to deteriorate the quality of the municipal markets.

[9] SEC, Order Granting Approval of a Proposed Rule Change Consisting of Rule G-18, Amendments to Rule G-48 and Rule D-15 (Dec. 5, 2014) (link).

[10] FINRA, Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets (Nov. 2015) (link); MSRB, Implementation Guidance on MSRB Rule G-18, on Best Execution (Nov. 20, 2015) (link).

The rules also require documentation of compliance with their policies and procedures with respect to securities with limited quotations or pricing information to specify steps they have taken to survey markets for each transaction. While technological solutions are advancing to aid the ability to create documentation from screen shots and the like, the non-specific requirements can be time consuming and inefficient. Concerns around regulatory expectations have even led some firms to extend the documentation requirements to a broader set of transactions. SIFMA is concerned that in a busy and increasingly electronic market environment, some traders may be hampered in servicing some customer transactions because the documentation requirements can be unduly onerous.

While SIFMA supports an institutional exemption more generally, the SMMP exemption provided by the MSRB requires dealers to obtain written affirmations from SMMPs in order that the dealers' trading activity with SMMP customers is exempt from the best execution rules. It is often difficult for dealers to obtain written SMMP affirmations, in part because the dealers must obtain separate affirmations from customers for SMMP exclusions from other rules as well. Consequently, the burdensome MSRB affirmative consent collection process and the inevitable delays often results in the best execution rule applying to sophisticated institutional investors for whom it was never intended.

2. The Solution

> "Rules are meant to be followed, and the public depends on regulators to make sure that happens. It is incumbent on the Commission to write rules so that those subject to them can ascertain how to comply and—now more than ever—how to demonstrate that compliance. Vaguely worded rules can too easily lead to subpar compliance solutions or an overinvestment in control systems. We must recognize practical costs that are sure to arise."[11]
>
> *– Jay Clayton, Chairman, SEC*

FINRA and the MSRB should do the following, which can be accomplished without statutory change:

- FINRA and the MSRB should provide updated guidance providing more specificity or principles on how dealers should determine whether or not they have used reasonable diligence in the markets checked to comply with the rule. SIFMA believes that the current best execution guidance is too vague and has encouraged dealers in practice to check more markets than necessary to achieve the goals of the rule.
  - The additional guidance should make clear that it may be reasonable to conclude that one or more markets need not be checked if there is

[11] Jay Clayton, SEC Chairman, Remarks at the Economic Club of New York (July 12, 2017) (link).

a significant overlap of participants with another market that was checked.

- The additional guidance should also provide dealers with greater latitude and flexibility to assess whether checking more than one market is necessary or whether doing so would impair execution quality.

- FINRA and the MSRB should provide more specific guidance on documentation requirements under the rule that minimizes compliance burdens while providing sufficient means to verify compliance and flexibility for individual firms to adapt compliance plans to their needs. SIFMA believes that the existing documentation guidance is too vague and has resulted in dealer compliance policies that mandate more documentation than is necessary for examiners to verify compliance. It is imperative to assure that dealer best execution obligations are not misconstrued to impair effective market making by imposing burdensome obligations in a manner that would delay execution or impose undue costs and practical constraints.

- FINRA should consider implementing an institutional exemption for Rule 5310 and to permit for reliance on existing certifications in that regard.

- The MSRB should amend SMMP rules such that an SMMP affirmation provided with respect to any MSRB rule would be sufficient to establish an investor's status as a SMMP for all MSRB.

Chapter 4

FIXED INCOME: MUNICIPAL SECURITIES AND INFRASTRUCTURE

Relevant Agencies

- FDIC
- Federal Reserve
- OCC
- SEC
- MSRB
- IRS
- Other Federal Agencies

Chapter 4 –
FIXED INCOME: MUNICIPAL SECURITIES AND INFRASTRUCTURE

The municipal securities market is crucial to building and maintaining the U.S. infrastructure.[1] Municipal securities are issued by state and local governments to finance investment in schools, roads, airports, water and sewer systems, among others. Approximately 75% of the nation's infrastructure is financed, built and maintained by states and localities, and nearly all of that was financed with municipal securities.

Municipal securities are unique in two overarching respects. First, unlike stocks and corporate bonds, municipal securities are exempt from SEC registration. Municipal bond issuers, therefore, are not directly required to produce prospectuses for new bond issues or file them with the SEC. Instead, SEC rules require dealers to obtain and distribute official statements ("OSs"), for which SEC approval is not required. Municipal issuers must also produce a new OS for each new bond deal; the concept of shelf registration in the municipal market does not exist. Rules that govern the dissemination of disclosure information for municipal issuers after bonds have been issued also differ in the municipal market. Specifically, the SEC does not have statutory authority to regulate municipal issuer disclosure directly. The disclosure rules in the municipal market instead are implemented through dealers.

Second, interest on most municipal securities is exempt from federal and, in many cases, state and local income taxation. The tax-exempt status of municipal securities significantly reduces borrowing costs for state and local governments, and yet market participants effectively are prevented from using municipal securities to hedge across the capital markets.

Despite the important role of municipal securities in our capital markets, recently finalized regulations may impede this unique market. This Chapter describes some of these regulations and proposed solutions for each.

[1] SEC, Report on the Municipal Securities Market (July 31, 2012) (link).

A. Pre-Trade Price Transparency

The municipal securities markets face the same pre-trade price transparency issues described for the fixed income credit markets more generally in Chapter 3.A.

B. The Markup Disclosure Rules

Municipal securities are subject to the MSRB's markup disclosure rule, described (together with FINRA's markup disclosure rule) in Chapter 3.D.

C. Best Execution

Municipal securities are subject to the MSRB's best execution rules, described (together with FINRA's best execution rule) in Chapter 3.E.

D. Municipal Advisor Regulation

1. The Problem (Implicates Core Principles (c) and (f))

The Exchange Act, as amended by the Dodd-Frank Act, requires the SEC and MSRB to regulate entities that provide advice with respect to an enumerated list of activities and products to municipalities (i.e., state and local governments) and nonprofit or private entities that borrow proceeds from a municipal security offering who are obligated by contract or other arrangement to repay all or some portion of the amount borrowed (referred to as obligated persons). Specifically, such entities that provide advice to these municipalities and obligated persons are required to register with the SEC as municipal advisors. The SEC, in September 2013, approved a rule that establishes the definitions of (among others) municipal advisor and advice as well as a permanent process for these entities to register as municipal advisors with the SEC.[2]

Registration as a municipal advisor comes with a significant number of restrictions and obligations, including that a municipal advisor providing advice to a municipal entity has a fiduciary duty to that entity and that a municipal advisor is prohibited from engaging in a principal transaction

[2] SEC, Registration of Municipal Advisors (Sept. 20, 2013) (link).

with the municipal entity client that is the same, or directly related to, the issue of the municipal product to which the municipal advisor is providing, or has provided, advice to that client.[3]

SIFMA supports the principle that advisors to municipal entities and obligated persons should operate in a fair, transparent and well-regulated manner. The SEC's municipal advisor rule, however, goes far beyond Congress's original intent, which was to bring previously unregulated municipal advisors under federal regulation.

Specifically, under the rules, an entity would be required to register as a municipal advisor the moment it provides specific types of advice to municipalities and obligated persons, unless an exemption is met. This is a departure from how other categories of entities regulated by the SEC are defined. For registered broker-dealers or investment advisers, for example, treatment as a regulated entity is not triggered until a person is engaged for compensation by a client to provide dealer or investment adviser services. No such engagement is necessary for an entity to be required to register as a municipal advisor.

The practical implications of requiring an entity to register as a municipal advisor can be illustrated using two examples. First, if an investment banker is discussing a potential bond issuance with a local government client, and that communication veers into what is treated under the rules as advice, the investment banker's firm would be required to register as a municipal advisor, absent an exemption. As a result of the overly broad definition of advice, and the ease with which an entity can inadvertently trigger municipal advisor registration, a number of firms have put policies in place that effectively prohibit any communications whatsoever that could be perceived as being advice to these municipalities, in order to avoid having to register as a municipal advisor and comply with the onerous requirements that attach to such registration. This has ultimately reduced service and increased costs to municipal entities and obligated persons with little corresponding regulatory benefit.

A second example involves an entity that inadvertently provides advice with respect to the investment of the proceeds of a bond sale, which would trigger municipal advisor registration. It is often difficult even for municipalities themselves to determine whether an investment account

[3] *See* MSRB, Rule G-42: Duties of Non-Solicitor Municipal Advisors (Aug. 12, 2016) (link).

includes bond proceeds, and few are willing to certify in writing that an account does not include bond proceeds. As a result, firms have been forced to take extreme caution when discussing possible securities trades with municipality customers to ensure that any communication regarding the trade cannot be treated as advice. This is true even if discussing only marginally material topics associated with a trade.

As a result of these limitations of the rule, state and local governments may not be receiving valuable advice, ideas and proposals that could be financially advantageous.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should amend the municipal advisor registration rules to amend the basis for treatment as a municipal advisor so that an entity would need to be engaged by a state or local government or obligated person to provide municipal advisory services in order to be treated as a municipal advisor.[4]

- Short of amending the definition of municipal advisor, the SEC should implement the following amendments to the rule:

    - Provide an exemption from the municipal advisor rule such that advice provided to a sophisticated municipal entity—defined, for example, by reference to the volume of debt outstanding or the frequency of issuance of an issuer or obligated person—would not require registration as a municipal advisor.

    - With respect to the investment of bond proceeds, amend the rule so that when a dealer requests from an issuer or obligated person confirmation that an investment account does not include bond proceeds and receives no response, the dealer may proceed as if the account does not include proceeds.

[4] In 2012, the U.S. House of Representatives unanimously approved legislation (112th Congress, H.R. 2827 (Sept. 2012) (link)) that would have effected a similar change in the statute. The committee vote on the bill was unanimous, including former Representative Barney Frank.

E. Municipal Disclosure Regulation

1. The Problem (Implicates Core Principles (c) and (f))

Unlike the markets for corporate bonds and equities, the SEC has very limited statutory authority to regulate the financial disclosure practices of state and local government issuers of municipal securities. Issuers of corporate bonds must file a prospectus with the SEC before issuance that reflects the financial condition of the issuer, risks associated with the investment and other prescribed information. The SEC also requires corporate debt and equity issuers to file quarterly financial statements, annual audited financial statements and material event notices as long as they have securities outstanding.

According to Thomson Reuters, in 2005, 57% of new, long-term municipal bond volume was covered by bond insurance. By 2016, that portion had fallen to 6%.[5]

Municipal securities, on the other hand, are exempt from registration under the Securities Act. Moreover, the SEC and MSRB are prohibited under the Tower Amendment from requiring municipal issuers to file any information disclosure as a condition of issuance. The Tower Amendment also prohibits the MSRB from requiring any financial disclosure by issuers.

Because the SEC's authority over municipal disclosure is so limited, the SEC has crafted a municipal disclosure rule (SEC Rule 15c2-12) in which compliance responsibility falls on bond underwriters, not issuers. Instead of requiring issuers to file offering documents for a new bond issue, for example, the rule requires underwriters to obtain from issuers, review, distribute and file OSs before recommending the issuers' securities for sale. Similarly, underwriters must obtain from issuers a contractual commitment, known as a continuing disclosure agreement, to make certain financial filings as long as bonds are outstanding.

"Investors and other market participants cited limitations to the information provided in continuing disclosures. The most frequently cited limitations to the usefulness of this information were: the timeliness of annual financial information, the frequency with which issuers and other obligated persons provided information, and the completeness of the information provided in accordance with the continuing disclosure."[6]

– GAO Report, Options for Improving Continuing Disclosure

Researchers have identified shortcomings in the municipal disclosure regulatory regime. For example, the SEC noted in its 2012 report on municipal market regulation that some investors believe the broad use of bond insurance before the financial crisis diminished the need to more rigorously regulate issuer disclosure. Now that bond insurance is not widely used, market participants have focused more on underlying credits, and disclosure has become more important. As illustrated in the sidebar,

[5] *See* The Bond Buyer, 2010 Yearbook, at 7 (2010); The Bond Buyer, 2016 Yearbook, at 5A (Feb. 13, 2017) (citing Thomson Reuters) (link).

[6] GAO, Municipal Securities: Options for Improving Continuing Disclosure (July 2012) (link).

> "Investors and other market participants have emphasized a need for greater and timelier disclosure in several key areas. . . . [C]ommenters suggested that the municipal market has become large and complex enough to warrant a more comprehensive and streamlined approach to the disclosure process."[8]
>
> *– SEC, Report on the Municipal Securities Market*

the SEC has cited investor comments that continuing financial disclosure practices in particular are in need of improvement. A report on municipal securities market disclosure by the Government Accountability Office ("GAO") drew similar conclusions.

Both the SEC and GAO have recommended changes to the municipal disclosure regulatory regime. The SEC made 8 legislative and regulatory recommendations in its 2012 report. The GAO also provided numerous legislative and regulatory options for improving issuer disclosure. Virtually none of these have been acted on. SIFMA and other industry groups have also made recommendations to the SEC for improvements to the regulatory regime.[7]

The only recent regulatory action on municipal disclosure is an SEC proposal to amend Rule 15c2-12 to add two new event disclosure items that underwriters must ensure an issuer has committed to provide before they can underwrite the issuer's bonds.[9] In its release, the SEC has proposed to require dealers to ensure that issuers have committed to disclose these additional events as long as bonds are outstanding:

- Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and
- Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

2. The Solution

The SEC and MSRB should do the following, which can be accomplished without statutory change:

- The SEC should include a clear, bright-line condition for disclosure, similar to one used elsewhere by the SEC in disclosure filings, with respect to its outstanding proposal on Rule 15c2-12, which is overly

[7] *See, e.g.*, SIFMA, Rule 15c2-12 White Paper (Apr. 12, 2016) (link); SIFMA et al., Letter to the MSRB Regarding Recommendations to Improve EMMA Platform (Jan. 23, 2017) (link).

[8] SEC, Report on the Municipal Securities Market (July 31, 2012) (link).

[9] SEC, Report on Proposed Amendments to Municipal Securities Disclosure (Mar. 1, 2017) (link).

broad, will lead to over disclosure and contains a vague materiality qualifier.

- The SEC should provide interpretive guidance as to the sufficiency under the antifraud provisions of reliance on certification by an official responsible for disclosure compliance.[10]

- The SEC should, with respect to Rule 15c2-12 generally, adopt the recommendations in SIFMA's 2016 white paper. These recommendations include, among others, specifying the role of municipal advisors with respect to issuer disclosure[11] and amending Rule 15c2-12 to remove the requirement that issuers report rating changes to the MSRB for dissemination to the market, since that information is now provided directly to the MSRB by rating agencies.

- The MSRB should incorporate improvements to the EMMA platform specified in a letter from SIFMA to the MSRB earlier this year.[12] The EMMA platform is the online portal for disseminating municipal market information, including issuer disclosure, reported trades in municipal securities and other information. SIFMA's recommendations include, among others, enhancing the search function on EMMA and introducing procedures to reduce errors and enhance efficiency.

F. Liquidity Coverage Ratio

1. The Problem (Implicates Core Principles (c), (f) and (g))

In September 2014, the Federal Reserve, the OCC and the FDIC finalized rules to implement the Basel Committee's LCR framework for bank holding companies. The banking agencies' LCR rules establish a means to determine whether certain large bank holding companies have sufficient HQLA to meet their liquidity demands in a 30-day financial stress scenario. They also prescribe assumptions for cash outflows in such a stress scenario.

[10] A full discussion of issues raised by the SEC's proposal is in SIFMA's comment letter filed earlier this year. *See* SIFMA, Letter to SEC Regarding Proposed Amendments to Exchange Act Rule (May 15, 2017) (link).

[11] For example, municipal advisors should have primary due diligence responsibility for the content of OSs on competitive municipal offerings where the municipal advisor's engagement includes assistance with preparing the OS.

[12] *See* SIFMA et al., Letter to the MSRB Regarding Recommendations to Improve the EMMA Platform (Jan. 23, 2017) (link).

The final LCR rules identified the criteria for determining which assets qualify for HQLA treatment. Under those rules, municipal securities did not count as HQLA. In April 2016, the Federal Reserve, acting alone, amended its LCR rule to permit bank holding companies to count certain municipal securities as HQLA. The Federal Reserve's rule change has not provided, however, a practical means for most banking organizations subject to the LCR to treat their municipal bond holdings as HQLA because these banking organizations typically have bank subsidiaries that are subject to the OCC's or FDIC's LCR rules and because the Federal Reserve's amended rule remains too restrictive.

Despite being excluded from HQLA, municipal securities satisfy all the criteria enumerated in the LCR rules of assets that are given HQLA status. These include:

- Trading volume as measured by turnover rate is comparable to other categories of securities like investment-grade corporate bonds that receive HQLA treatment under the rule.

> As of March 31, 2017, banking organizations held $581 billion of municipal securities, over 15% of the $3.8 trillion outstanding, up from 6.3% of the market in 2004.

- Municipal securities exhibit price stability, even in stressed market conditions. Historical price declines for municipal securities in stressed markets are better than or as good as those for assets that are HQLA.
- The municipal market is diverse in terms of breadth of investor participation and the scope of dealers active in the market.
- The municipal market is price transparent. Bond transactions are required to be reported and disseminated in real time. Also, there are established pricing benchmarks and tools that allow dealers and investors to value bonds readily.
- Municipal securities are eligible as collateral for discount window advances at Federal Reserve banks, and haircuts are as favorable or more favorable than other assets that are HQLA under the rule.
- The credit performance of municipal securities is extraordinarily strong, with default rates lower than many assets that are HQLA under the rule.

Banking organizations are one of the most important categories of investors in municipal securities. Although the LCR rule has not yet affected banking organization purchases of municipal securities, banking organization investment in the sector is likely to wane in the coming years as banking organizations adjust their assets to optimize their compliance with the rule. The result will be less demand for municipal securities and higher borrowing costs for state and local governments. SIFMA appreciates Treasury's recognition and thoughtful consideration of this problem in the Treasury Report in expressing support for providing HQLA status to municipal securities.

2. The Solution

The Federal Reserve, OCC and FDIC should do the following:

- The Federal Reserve should revise its LCR rule to expand recognition of municipal securities.
- The OCC and FDIC should revise their LCR rules to permit municipal securities to be treated as HQLA.
- Short of action by the regulatory agencies, Congress should enact legislation mandating HQLA treatment for municipal securities under the LCR Rule.

> The American Society of Civil Engineers estimates that the United States needs to invest $1.4 trillion in infrastructure above what is anticipated to be spent by 2025 and $5.2 trillion by 2040 to replace failing facilities and maintain the capacity needed by a growing economy and population.[13] They also estimate that "if this investment gap is not addressed throughout the nation's infrastructure sectors by 2025, the economy is expected to lose almost $4 trillion in GDP, resulting in a loss of 2.5 million jobs in 2025."[14]

G. Closing the Infrastructure Deficit

1. The Problem (Implicates Core Principle (c))

The United States faces an extraordinary infrastructure deficit. State and local capital investment in the United States as a proportion of GDP fell by more than a third between the late 1960s and 2014. Existing federal programs for financing infrastructure are insufficient to meet this demand. New initiatives for infrastructure finance should recognize the need for a partnership among federal, state and local governments and private investors and developers.

President Trump has called for new federal programs and resources that would result in $1 trillion of infrastructure investment over what will already take place. Among other elements, it is likely that the Trump administration will focus its initiatives on programs that will assist and

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[13] American Society of Civil Engineers, Failure to Act: Closing the Infrastructure Investment Gap for America's Economic Future, at 10 (2016) (link).

[14] *Id.* at 4.

encourage infrastructure investment among state and local governments and the private sector.[15]

Any initiatives by the Trump administration in closing the infrastructure deficit should be designed taking into consideration the following:

- Approximately 75% of our nation's existing infrastructure is financed, built and maintained by state and local governments. The tax exemption for municipal bond interest—where interest earned by investors on most municipal securities is exempt from federal taxation—is the single most important tool the federal government provides to lower the cost to states and localities of infrastructure finance.

- State and local governments are permitted under the tax code to issue bonds on behalf of private borrowers for a limited list of uses, including infrastructure. This issuance comes with significant restrictions, however, such as volume limitations and application of the individual alternative minimum tax, which raises the cost of financing.

- In developing infrastructure projects, state and local governments are often able to achieve savings on project costs by employing design build strategies for procuring engineering and construction services. Design build is a mechanism borrowed from public-private partnership experience that streamlines the process of procuring design and construction services for infrastructure projects. Federal policies do not promote this approach, however, and in some cases effectively prevent it. Many states also prohibit or inhibit the use of design build.

- Public-private partnerships between state or local governments and private developers can provide a meaningful supplement to purely public infrastructure development.

- In addition to grant programs, the federal government maintains credit support programs for infrastructure by, for example, making low-interest, subordinated loans for targeted infrastructure projects through programs like the Transportation Infrastructure Finance and Innovation Act and others.

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[15] Julie Hirschfeld Davis and Kate Kelly, New York Times, Trump Plans to Shift Infrastructure Funding to Cities, States and Business (June 3, 2017) (link).

2. The Solution

Congress, the IRS and federal agencies responsible for infrastructure projects should adopt the following recommendations that would encourage significant new investment in infrastructure, leverage existing financing mechanisms and promote the use of financing models that are underused in the United States (such as public-private partnerships):

- Congress should preserve the federal tax exemption for interest earned by investors on bonds issued by states and localities to finance infrastructure.

- Congress should amend the Internal Revenue Code so that state and local governments could issue tax-exempt bonds for infrastructure projects with private participation in the same manner that they issue bonds for purely public projects.

- Congress should expand the use of private activity tax-exempt bonds for infrastructure. This change should also protect the tax-exempt status of outstanding municipal bonds in cases where an infrastructure asset originally financed on a purely public basis is sold to a private investor.

    - Federal infrastructure projects should promote the use of design build as a state and local procurement mechanism. Federal infrastructure investment programs and state policy should provide incentives for the use of design build by states and localities. This would allow federal, state and local developers the ability to finance more projects with the same limited resources.

- Congress should provide a tax credit for equity investors in infrastructure projects. The federal government should provide a tax credit to private investors who commit equity capital to infrastructure projects. To maximize efficiency, the credit could be sold to other investors and the proceeds used to defray project costs. Similar federal programs have been successful in promoting investment in renewable energy generation and low-income housing.

- Federal agencies should expand alternative federal financing programs. These programs should be expanded and perhaps consolidated through a centralized infrastructure bank-type entity.

Chapter 5

SECURITIZATION

Relevant Agencies

- FDIC
- FHFA
- Federal Reserve
- HUD
- OCC
- SEC

Chapter 5 – Securitization

Two telling statistics illustrate the significance of securitization. The first statistic is that approximately 60% of all consumer credit in the United States in 2016 was financed in the securitization markets.[1] Given how significant securitization is to the financing of consumer credit, the total outstanding amount of which is $12.58 trillion and equal to approximately 70% of the GDP,[2] it is clear that well-tailored securitization rules are a key to restoring the growth and efficiency of the real economy. Tailoring securitization rules more closely to their purposes by paring them of overly conservative and redundant capital and liquidity requirements, and rationalizing disclosure, credit risk retention, derivative, proprietary trading, mortgage origination and other rules would have a material beneficial effect on the provision of credit to consumers and consequently the real economy without compromising the safety and soundness of the financial system.

The second statistic highlights how securitization can contribute to GDP growth. It has been estimated that had the capital requirements for securitization been rationalized, the complexity of disclosure been limited to what was reasonable and other related securitization and lending regulations been similarly tailored, approximately $1 trillion of additional residential mortgage loans would have been made over the last five years, resulting in the increase of GDP by 0.5% in each of those years.[3]

Poorly tailored regulation of securitization is not just a concern of large banking organizations; it is a serious concern for small and mid-size businesses, community banks, and consumers—indeed, the entire economy and all who participate in it. The U.S. financial markets, notwithstanding their undeniable strength, would be even more competitive on a global level with an efficiently functioning securitization market. Much of U.S. consumer, and business, credit is financed through securitization and so much more could be financed on a more competitive basis. While the benefits of securitization are well known, it is worth repeating that securitization in particular can provide to U.S. households and businesses a

[1] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit (Feb. 2017) (link); SIFMA, U.S. Mortgage-Related Issuance and Outstanding (Apr. 6, 2017) (link); SIFMA, U.S. ABS Issuance and Outstanding (Apr. 6, 2017) (link).

[2] The World Bank, GDP (Current U.S. $) (Mar. 23, 2017) (link).

[3] Jamie Dimon, JP Morgan Chase, Letter to Shareholders (Apr. 4, 2017) (link).

lower cost of funding, diversification of sources of funding, greater capital efficiency and enhanced liquidity.

> "[S]ecuritization markets are an important source of credit to U.S. households and businesses and state and local governments. When properly structured, securitization provides economic benefits that lower the cost of credit to households and business."[4]
>
> *– John Walsh, Former Acting Comptroller of the Currency, OCC*

Weaknesses in the securitization process as practiced before the financial crisis are widely understood to have been one of the causes of the crisis. As a result, a host of new and at best loosely coordinated regulations and laws have been adopted to attempt to strengthen those weaknesses. This Chapter describes certain issues related to these new regulations and proposed solutions for each.

A. Application of Capital and Liquidity Rules to Securitizations

1. The Problem (Implicates Core Principle (f))

Two perceived weaknesses in the securitization process were that capital held for securitization positions was inadequate, particularly in times of financial system stress, and that securitization positions might not be as liquid as had previously been thought. Accordingly, the U.S. risk-based capital requirements and Basel Committee global standards have been amended to increase capital for, among other things, securitization positions.[5] Further, the LCR was created and implemented with no credit given in calculating the HQLA numerator for asset-backed securities or non-agency mortgage-backed securities and allocating Fannie Mae and Freddie Mac guaranteed residential mortgage-backed securities to a lower level of HQLA that includes a haircut and caps.[6] Finally, in calculating the adequacy of capital for purposes of CCAR, the shocks calculated for securitization were made extraordinarily high.[7]

SIFMA supports many of the post-crisis regulatory reform efforts in the areas of capital and liquidity, which have helped restore market confidence

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[4] John Walsh, Testimony of Acting Comptroller of the Currency Before the Committee on Banking, Housing, and Urban Affairs (July 21, 2011) (link); Thomas Curry, Testimony of Comptroller of the Currency (Feb. 14, 2013) (link).

[5] OCC, Federal Reserve, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) (link).

[6] OCC, Federal Reserve, FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61440 (Oct. 10, 2014) (link).

[7] Capital Plans, 76 Fed. Reg. 74631 (Dec. 1, 2011) (link).

in the U.S. financial system and generally made the U.S. financial system stronger and more resistant to financial stress. SIFMA believes that now is the appropriate time to evaluate whether and to what extent there are aspects of the U.S. capital and liquidity requirements that impose costs on the U.S. financial markets that outweigh their benefits. This is especially true given the extensive reform and change that has taken place at the securitization structure and collateral level—a host of new rules and practices are in place, mitigating the need for punitive capital treatment.

Capital requirements are increasingly risk insensitive while both capital and liquidity requirements are excessively conservative and do not adequately consider the effects on financial market activity. [8] There are a number of flaws in the capital and liquidity rules applicable to securitization, the overall effect of which has been to diminish the participation by banking institutions in the securitization process both as investors and as originators, and thereby to decrease the availability of funding to the real economy.

Large, medium and small businesses, providers of credit that depend on securitization for some portion of their funding needs and consumers who are or could be their customers each feel the effect of this unwarranted increase in the relative capital intensity of securitization, to the detriment of our economy as a whole. Other forms of financing are not likely to replace securitization which means that the needed funding will not be available at the same price. Instead, many financings may not get done if securitization is less widely available and even if they are done, the cost will be higher. The end result is that less credit will be provided—and what credit is provided will often be more expensive.[9] If capital requirements were rebalanced, and securitization's liquidity characteristics more sensibly recognized, growth and employment would follow without any material diminution in safety or liquidity.

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[8] Even taking solely investment-grade and above securitization positions into consideration, one of SIFMA's members has calculated that in their experience on average the increase in required capital has been approximately 300% to almost 500%; i.e., even for investment-grade securitization positions, it can be generalized that required capital has increased in whole multiples of previously required capital. The effect of this securitization-specific increase is also magnified by the fact that the required amount of capital for the numerator itself in the risk-based capital ratio formula has been materially increased for U.S. banks above all others and especially G-SIBs who accomplish much of the securitization financing for banks in the marketplace, as discussed in Chapter 2.

[9] Faten Sabry and Chudozie Okongwu, NERA Economic Consulting, Study of the Impact of Securitization on Consumers, Investors, Financial Institutions, and the Capital Markets (June 17, 2009) (link).

With sensible reform that continues to protect taxpayers from risks, the capacity to provide substantial additional credit to the U.S. financial markets can be freed up, spurring growth, increasing employment and maximizing the competitiveness of our capital markets. SIFMA appreciates Treasury's recognition and thoughtful consideration of this problem in the Treasury Report in expressing support for recalibrating the treatment of securitizations under the capital and liquidity rules.

2. The Solution

The Federal Reserve, OCC and FDIC should do the following, which can be accomplished without statutory change:

Limit Capital to Maximum Loss

- The Federal Reserve, OCC and FDIC should limit capital to maximum loss. Specifically, in all cases under the risk-based capital requirements, the amount of risk-based capital that must be held against a position should be limited to, in the case of positions in the trading book, the position's then market value, and, in the case of positions in the banking book, the lesser of the dollar amount of the capital for the position, and the total capital required for the entire pool in which such position is an interest. The calibration of capital requirements and the calibration of CCAR global market shocks should be contemplated together to avoid these outcomes across regulatory standards.

    - Under the rules as now written, required capital may exceed the maximum possible loss on the position, i.e., a total write-off. An example of the excessive capital that is proposed to be required in the trading book is a BB-rated junior student loan asset-backed security tranche where the risk-based capital would be calculated using VaR, stressed VaR and the SSFA. Under the SSFA, a junior tranche could receive a 100% or more risk-based capital requirement (1,250% risk weight), which is an assumption of at least a 100% loss. The VaR and stressed VaR capital requirements would be added *on top of* the 100% or more capital requirement from the SSFA, vastly exceeding the position's actual market value and potential for loss. In addition, this same position is subject to the CCAR global market shock discussed above. For a BB-rated student loan, the CCAR shock can be as high as 47%. The capital requirement assumes greater than 100% loss and CCAR then assumes another 47% loss.

Base Capital Treatment on Risk Transfer, Not Accounting Treatment

- The Federal Reserve, OCC and FDIC should base capital treatment on risk transfer, not accounting treatment. Specifically, securitizations that transfer credit risk should be eligible for capital relief based on evidence of risk transfer, irrespective of their accounting treatment. Accounting rules are a set of rules that apply to an entity's presentation of balance sheet and income, which can turn on issues not exclusively of transfer of risk, but other factors such as control. Basing eligibility for capital relief on the question of whether risk has in fact been transferred in substance precisely aligns with the need for more or less capital.

Revise CCAR Shocks for Securitizations

- The Federal Reserve should revise the excessive CCAR rules for calculating capital to deal with defined shocks to the system for securitizations to be less punitive for securitization positions.

- The Federal Reserve should recalibrate the global market shock scenario to recognize that there has been much regulatory reform since the crisis and that bonds backed by different asset classes in securitization will be subject to varying degrees of shock themselves.

    - The global market shocks calculated for securitization assume that market conditions pre-crisis continue to exist today and do not take into consideration the legislative and regulatory reforms that have been implemented, including but not limited to: a leverage ratio, the LCR, rating agency reform, new disclosure requirements both in the Dodd-Frank Act and the now effective Regulation AB II, new minimum underwriting standards, otherwise higher capital requirements, and credit risk retention rules, all of which make it much more unlikely that shocks to the system will occur with the same force as in the financial crisis. For example, the CCAR global market shocks default assumption for AA-rated student loan backed securities, whether prime or subprime, can be as high as 34.7%. Different types of collateral have different characteristics that affect their susceptibility to such shocks. For example, *ceteris paribus*, assets with different loan-to-value ratios will respond to macro shocks with different degrees of resiliency.

Postpone Implementation of Banking and Trading Book Capital Rules until They Are Recalibrated

- The Federal Reserve, OCC and FDIC should postpone implementation of trading book capital rules until they are recalibrated. In the Treasury Report, Treasury recommended that the Fundamental Review of the Trading Book be delayed until it "can be appropriately calibrated and assessed . . . these standards represent additional regulatory burden and would introduce potentially unnecessary capital and liquidity requirements on top of existing capital and liquidity requirements."[10]

- The Federal Reserve, OCC and FDIC should postpone the Basel Committee revisions to securitization banking book capital requirements until they can be appropriately calibrated. The finalized Basel Committee revisions to securitization banking book capital rules are an important input to the trading book rules, and are a primary reason why the Fundamental Review of the Trading Book would result in excessive capital requirements for securitization.

Recalibrate the Basel Committee's Securitization Banking Book Capital Rules Before Implementation

- The Federal Reserve, OCC and FDIC should recalibrate the Basel Committee's securitization banking book capital rules before implementation. Specifically, the recent Basel III revisions to securitization banking book capital requirements,[11] that have not yet been applied to the risk-based capital requirements in the United States, should not be adopted as they were finalized internationally, and should be reopened or reconsidered so that their significant deficiencies may be addressed to prevent the global competitive disadvantage they would create for U.S. banks versus their global counterparts.

- Failing that, the Federal Reserve, OCC and FDIC should permit U.S. implementation of the rules to deviate from the Basel Committee standards in material respects.

- In either case, the Federal Reserve, OCC and FDIC should include in the U.S. risk-based capital requirements for both the banking book and trading book the following terms:

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[10] The Treasury Report, at 13.

[11] Basel Committee, Revisions to the Securitization Framework (Dec. 2014) (link).

- The risk weight floor should be reduced to 15% or lower, as it would have been in the EU, which is adequate to protect banks from unanticipated losses and will maintain parity between the U.S. and European capital markets. Furthermore, while final rules are not in effect at this time, it appears that the implementation of the "Simple, Transparent, and Standardised" regime in Europe will provide a further potential reduction in the risk weight floor to 10%, for certain compliant transactions.

- The p factor, an arbitrary supervisory add-on to create extra capital to distribute among tranches held by third parties, should be maintained at 0.5 in the SSFA (rather than 1.0 as under the Basel III revisions).

  - The p factor is a penalty factor for securitization activity. It represents the multiple of capital requirements on the securitization capital structure above the underlying assets. For example, the risk weight for a portfolio of student loans is 100%. If the portfolio were to be held in securitized form, the risk profile would not change but where p=0.5, the capital requirement for the full capital stack in securitization form is 150%, or 50% higher than in non-securitized form. If the calibration were changed to p=1, the capital requirement for the full capital stack in securitization form would be 200%, or double the capital requirement if in non-securitized form.

  - There is no evidence that such extra capital needs to equal 100% (i.e., p=1) of otherwise required capital instead of the already very conservative extra 50% (i.e., p=0.5) of such capital. The greater the p factor, the less sensitive the formula will be to risk and the more arbitrary capital levels will be on an absolute basis and relative to other jurisdictions.

  - The Kg factor used to calculate capital for securitization positions in the SSFA should be adjusted to be more risk sensitive.

  - Kg represents the capital requirements of the underlying collateral pool were it not securitized and held directly on the balance sheet. This serves as one of the metrics for calculating the capital requirements of the securitization.

- The Kg factor is the same for all asset classes except for certain residential mortgage-backed securities that have a risk weight of 50%. The Kg factor should be adjusted to take account of credit quality at a more granular level since different types of financial assets will have different risk profiles. Because the SSFA already takes into account different credit enhancements (with higher enhancement levels resulting in lower risk weights) and lower quality asset classes require more enhancements, a fixed Kg has the counterintuitive effect of increasing risk weights for higher quality asset classes. For example, subprime residential mortgages have a different credit quality than prime credit card receivables, yet they are treated the same in this calculation, potentially resulting in a more favorable treatment for lower credit quality assets.

- SSFA should be adjusted to take account of the added credit enhancement when a bank purchases a securitization position at a discount.

- The effect on calculating risk-based capital in the advanced approach should be made more risk sensitive by recalibrating the p factor, including the effect on required capital of the maturity of a tranche.

- For example, maturity of a tranche should be calculated by reference to the weighted average life rather than by reference to legal final maturity, which is excessively conservative, as legal final maturity is calculated to ensure that every non-defaulted receivable will be repaid before such date.

- The p factor as currently calibrated in the advanced approach (which is distinct from its calibration in the SSFA discussed above) can be close to triple the capital before securitization. The calibration is especially punitive to non-senior investment-grade asset-backed securities.

Provide More Equitable Treatment for Securitizations in Liquidity Rules and Clarify Their Application

- The Federal Reserve, OCC and FDIC should provide more equitable treatment for securitizations in liquidity rules and clarify their application.

- Non-GSE securitizations are given no credit in the U.S. LCR, and GSE securitizations are given worse treatment than they deserve. Certain high quality residential mortgage-backed securities and asset-backed securities should qualify as Level 2B assets in the LCR subject to the same haircuts and numerator percentage limits to which all Level 2B HQLA are subject, just as certain corporate bonds so qualify. In the EU and in the Basel standards, high quality RMBS have some value as HQLA.

- The Federal Reserve, OCC and FDIC should permit GSE residential mortgage-backed securities to receive Level 1 status in the LCR so long as Treasury supports the GSE's repayment obligations through the preferred stock purchase agreements.

- Residential mortgage-backed securities positions guaranteed by GSEs are now Level 2A HQLA for purposes of the LCR. Level 2A HQLA are subject to a 15% haircut for purposes of calculating the LCR and the total amount of Level 2A and 2B HQLA that can be counted as part of the numerator cannot exceed 40% of the total numerator. The reason for being placed in Level 2A is that Treasury's support for these mortgage-backed securities is not an explicit guaranty. In reality, the Fannie Mae and Freddie Mac mortgage-backed securities market is the second most liquid U.S. fixed income market, trailing only U.S. Treasuries, and averaging approximately $200 billion a day in trading volume.[12]

B. Regulation AB II

1. The Problem (Implicates Core Principle (c))

In addition to desiring to increase capital requirements for securitizations, regulators and legislators also believed that disclosure could be improved and made more robust. Accordingly, the SEC adopted Regulation AB II, which was intended to address the perceived failure to provide adequate disclosure to permit investors to make informed decisions by requiring prospectuses for public offerings of asset-backed securities, among other reforms, to include specified additional asset-level data that would permit

[12] SIFMA, U.S. Bond Market Trading Volume (link).

investors to understand the risks of the related asset-backed securities and to value asset-backed securities accordingly.[13]

Regulation AB II is overly burdensome and has effectively shut down registered markets for non-agency residential mortgage-backed securities and has significantly curtailed registered issuance for smaller or more infrequent asset-backed securities issuers. While private offerings—unregistered, often relying upon Rule 144A—remain viable, they face the risk of proposed similar regulation and, by definition, are constrained sources of capital and funding since the investor base is far smaller than that for registered transactions.

This regulation has effectively constrained real economy activity that public offerings of securitization transactions could more efficiently fund. These prescriptive, inflexible, and excessive requirements substantially increase legal risk to securitizers and put securitization, and their related markets for financial products and services, at a competitive disadvantage compared to other forms of financing. It is time to evaluate whether the costs to financial markets of Regulation AB II outweigh the perceived benefits of the complex disclosure it requires.

2. The Solution

The SEC should do the following, which are needed to properly balance disclosure requirements and issuers' access to markets and which can be accomplished without statutory change:

- As Treasury recommended in the Treasury Report, the SEC should review and rationalize the number of required data fields for various types of asset-backed securities and residential mortgage-backed securities under Regulation AB II, and provide for a more flexible means of compliance.
    - The 72 data fields for auto loan asset-backed securities and 66 fields required for auto lease asset-backed securities have curtailed public issuance for smaller or more infrequent asset-backed securities issuers, are a barrier to entry for prospective first-time issuers, and far exceed what market participants deem to be essential.

[13] SEC, Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57183 (Sept. 24, 2014) (link).

  - The required 270 data fields for residential mortgage-backed securities are a material cause of the shutdown of registered securitization transaction offerings and have forced many issuers to rely on private markets with the related increased costs and expense due to illiquidity. These requirements are unprecedented. GSE offerings include less than one third of the number of required data fields under Regulation AB II and, similarly, secondary mortgage loan portfolios trade in the normal course with significantly less asset-level data.

  - While the regulation permits anonymization of certain data, both domestic and international privacy concerns remain materially unaddressed in the regulation.

  - Regulation AB II should permit a comply or explain option to allow issuers to provide all data that are reasonably obtainable and available, and disclose why other data points are not being provided.

- The SEC should withdraw the proposed application of asset-level data and other requirements under Regulation AB II to private offerings, since the sophisticated investors active in such offerings do not need mandated disclosure. The undue burdens of these requirements have already driven issuers out of the registered markets into less liquid unregistered markets. Application of the registered offering rules to those markets would further restrict capital formation and issuer access to funding.

- The SEC should amend Regulation AB II so that the required three-day waiting period in the offering process does not apply to active asset-backed securities sponsors with significant outstanding asset-backed securities and who are subject to reporting under the Exchange Act. There is no need for the three-day waiting period for such a sponsor.

C. Application of Credit Risk Retention Rules to Securitizations

1. The Problem (Implicates Core Principle (f))

The credit risk retention rules are another cornerstone of the post-crisis regulatory response. Following the financial crisis, there was a concern that many securitizers' business plans were based on an originate to distribute model that left many securitizers with interests that were not aligned with those of their borrowers or investors. As a result, Section 941 of the Dodd-Frank Act provided for, and several regulatory agencies implemented, rules requiring sponsors, subject to some exceptions, to retain an economic interest in the credit risk of the assets that they securitize to promote better alignment of borrower-securitizer-investor incentives.[14] These rules became effective in 2015 and 2016.

The credit risk retention rules are very lengthy, detailed and complex. However, the rules fail to adequately reflect important characteristics of the different kinds of securitization transactions that finance distinct asset classes, such as mortgage loans, auto loans, and commercial loans. In some cases the rules require an excessive amount of risk retention by failing to make any adjustment for the related funding and non-credit risks, for example, market and interest rate risk. The rules are intended, by their terms, to address credit risk. Some securitizations also have significant funding and market risk—5% of the fair value of ABS will include these risks and, as a result, will include more than 5% of the credit risk. Empirical evidence was submitted to the agencies that demonstrated this.[15]

The rules are also overly prescriptive regarding the manner in which the required retention must be held. For example, many asset classes require that the retention be held well beyond the period in which weak underwriting, or other similar moral hazard, would be expected to become evident.

Additionally, the corresponding rules in the EU are materially different from the U.S. rule in several respects. While the EU is, apparently, developing a direct option that may somewhat resemble the U.S. rule, the U.S. and EU rules need to be harmonized and rationalized for efficiency and to ensure a level playing field for U.S. securitizers.

SIFMA appreciates Treasury's recognition and thoughtful consideration of the need to revise the credit risk retention rules as expressed in the Treasury Report.

[14] OCC, Federal Reserve, FDIC, SEC, FHFA, HUD, Credit Risk Retention, 79 Fed. Reg. 77601 (Dec. 24, 2014) (link).

[15] Loan Syndications and Trading Associations, Letter to OCC, Federal Reserve, FDIC, FHFA, SEC and HUD Regarding Credit Risk Retention Proposed Rule (Apr. 1, 2013) (link).

2. The Solution

The Federal Reserve, OCC, FDIC, FHFA, SEC and HUD should do the following, which would increase the competitiveness of U.S. financial markets without unduly limiting the effectiveness of the credit risk retention rules and can be accomplished without statutory change:

- The Federal Reserve, OCC, FDIC, FHFA, SEC and HUD should revise the credit risk retention rules to permit other forms of retention, including permissible forms under the corresponding EU rules, contingent and unfunded support or retained interest on the underlying assets, as well as a simplified horizontal retention method for a securitization transaction.

- The Federal Reserve, OCC, FDIC, FHFA, SEC and HUD should revise the credit risk retention rules to make the included qualifying exceptions for commercial loans, commercial real estate and automobile loans workable and of practical utility. None are used in the securitization markets to a material extent, which clearly attests to their overly prescriptive nature.

- The Federal Reserve, OCC, FDIC, FHFA, SEC and HUD should revise the U.S. credit risk retention rules to include the exception for the qualified CLO proposed by several trade associations, including SIFMA, in a letter to risk retention regulators, dated November 10, 2014.[16]

- The Federal Reserve, OCC, FDIC, FHFA, SEC and HUD should work to reduce conflicts between U.S. and European risk retention rules. These rules conflict in certain ways that impair U.S. companies' access to global markets.

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[16] SIFMA, the Loan Syndications and Trading Association, Structured Finance Industry Group, Letter to OCC, Federal Reserve, FDIC, FHFA, SEC and HUD Regarding Credit Risk Retention; Joint Further Notice of Proposed Rulemaking (Jan. 10, 2014) (link).

D. Application of Derivatives Rules for Non-Cleared Swaps to Securitizations

1. The Problem (Implicates Core Principle (c))

Many legislators and policymakers viewed the inadequate regulation of OTC derivatives as having contributed to the crisis. As a result, the Dodd-Frank Act included substantial reform of OTC derivatives, as described in Chapter 8. Of particular concern here, the rules require securitization transactions to post margin for derivatives that may be embedded in the securitization structure.

In implementing the reforms of the OTC derivatives, the regulators have imposed a complex, costly and over-engineered set of rules, as discussed in Chapter 8. One important corner of markets they have disrupted is securitization because of the requirements for initial and variation margin for uncleared swaps with securitization special purpose entities. Many securitization transactions employ swaps to match or hedge the cash flows that arise from the assets that collateralize the transaction to those which are required to be paid to investors in the liabilities issued by the transaction.

These regulations fail to reflect the fact that special purpose entities are different from typical counterparties on flow-traded swaps. Special purpose entities are not operating companies, and they contain special structural features designed to mitigate counterparty risk, such as the fact that payments by the securitization special purpose entity to a swap counterparty are usually made at a senior position in the related transaction waterfall and that derivatives counterparties have secured creditor status, in the event of a default.

As a practical matter, special purpose entities will find it difficult if not impossible to comply with the margin and clearing requirements as implemented and will either have to forego derivatives and their risk mitigating benefits or find a way to comply, which will not be efficient for the transaction. Either way, the rules will have a harmful effect on the cost and availability of securitization as a financing tool hindering the vibrancy of the financial markets.

2. The Solution

The Federal Reserve, OCC, FDIC, FHFA, FCA and CFTC should do the following, which can be accomplished without statutory change:

- The Federal Reserve, OCC, FDIC, FHFA, FCA and CFTC should revise the margin requirements for swaps used by securitization special purpose entities in the manner previously proposed by SIFMA and others[17] such that uncleared swaps with securitization special purpose vehicles would not be subject to daily margin posting requirements unless the credit analysis of the special purpose vehicles counterparty determined it to be necessary.
- The Federal Reserve, OCC, FDIC, FHFA, FCA and CFTC should treat securitization special purpose vehicles in substantially the same manner as swaps with non-financial end users, and not automatically incur margin posting requirements.[18]

E. Application of the Volcker Rule to Securitizations

1. The Problem (Implicates Core Principles (c) and (f))

The original policy impulses behind the Volcker Rule had nothing to do with securitization, but as implemented by the regulators, the overbroad definition of covered funds has swept up securitization in its wake.
The agencies responsible for implementing the Volcker Rule created an overly inclusive definition of covered fund that subjects many securitization entities to the Volcker Rule's restrictions, even though they are clearly not private equity or hedge funds, as described in Chapter 4 of the May White Paper.[19] SIFMA appreciates Treasury's recognition and thoughtful consideration of this problem in the Treasury Report, which noted that "the covered funds definition is overly broad, including types of entities beyond

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[17] SIFMA, Supplemental Letter to OCC, Federal Reserve, FDIC, FHFA, FCA and CFTC Regarding Margin and Capital Requirements for Covered Swap Entities (Nov. 24, 2014) (link); SIFMA, Letter to OCC, Federal Reserve, FDIC, FHFA, FCA and CFTC Regarding Margin and Capital Requirements for Covered Swap Entities (Nov. 24, 2014) (link); SIFMA Asset Management Group, Letter to OCC, Federal Reserve, FDIC, FHFA, FCA and CFTC Regarding Margin and Capital Requirements for Covered Swap Entities (Nov. 24, 2014) (link).

[18] *Id.*

[19] The May White Paper.

private equity and hedge funds."[20] The compliance burden for banking organizations that hold or trade securitization transactions is significant, with no or few corresponding benefits. This misapplied rule has had a deleterious impact on the securitization markets and has required some types of securitization transactions to be restructured to avoid its burdens.

2. The Solution

The Federal Reserve, OCC, FDIC, SEC and CFTC should do the following, which can be accomplished without statutory change:

- The Federal Reserve, OCC, FDIC, SEC and CFTC should revise the overly broad definition of covered fund, as discussed in previous SIFMA submissions. This is because securitization structures and special purpose entities are neither hedge funds nor private equity funds.

[20] The Treasury Report, at 77.

Chapter 6

PROMOTING EQUITY MARKET ISSUANCE

Relevant Agencies

- CFTC
- FDIC
- Federal Reserve
- OCC
- SEC

Chapter 6 –
Promoting Equity Market Issuance

Capital raising in the United States is governed by a framework that was first put in place more than 80 years ago. While there have been occasional regulatory and legislative efforts to update the framework (e.g., Securities Offering Reform in 2005 and the JOBS Act in 2012), capital markets participants, including investors, issuers, selling security holders and intermediaries, operate in a regulatory structure that has not kept pace with the revolutions in information and communications technologies that have transformed nearly every other aspect of U.S. commercial activity in the last few decades. At the same time, requirements have accreted over the years that have increased the regulatory burden for companies without equivalent benefits for investors and the capital markets. The intense focus on the Dodd-Frank Act since 2010—coming on the heels of the bursting of the dot-com bubble in 2000, the corporate scandals that led to the Sarbanes-Oxley Act, the mutual fund scandals in 2003 and then the financial crisis—has left little time or regulatory resources to invest in other areas and has kept the United States from modernizing its approach to capital markets.

“A renewed analysis of securities markets—where we are today, how we got here, and whether we should shift course—is long overdue.”[1]

– Michael S. Piwowar, Commissioner, SEC

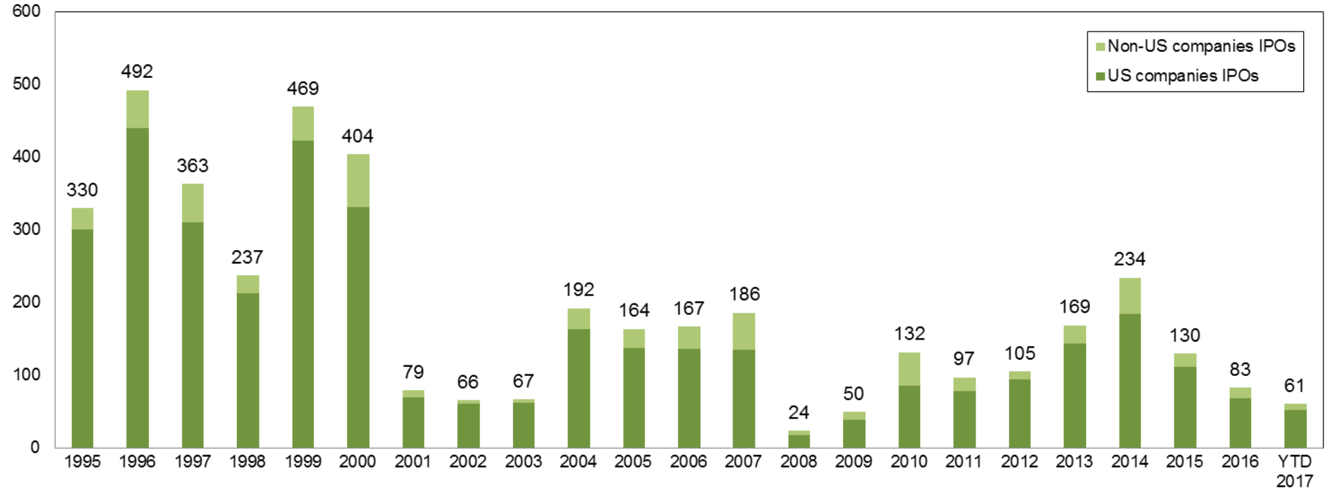
U.S. capital markets are a critical source of financing for businesses. Unfortunately, the number of publicly listed domestic companies in the United States has declined dramatically over the last 10 years, from 8,090 in 1996 to 4,331 in 2016.[2] Similarly, the number of IPOs has also significantly decreased in that period, from 492 in 1996 to 83 in 2016, and dollars raised has similarly declined.[3]

[1] Michael S. Piwowar, SEC, New Special Study of the Securities Markets: Keynote Address (Mar. 23, 2017) (link).

[2] World Bank, Listed Domestic Companies, Total (link).

[3] Dealogic.

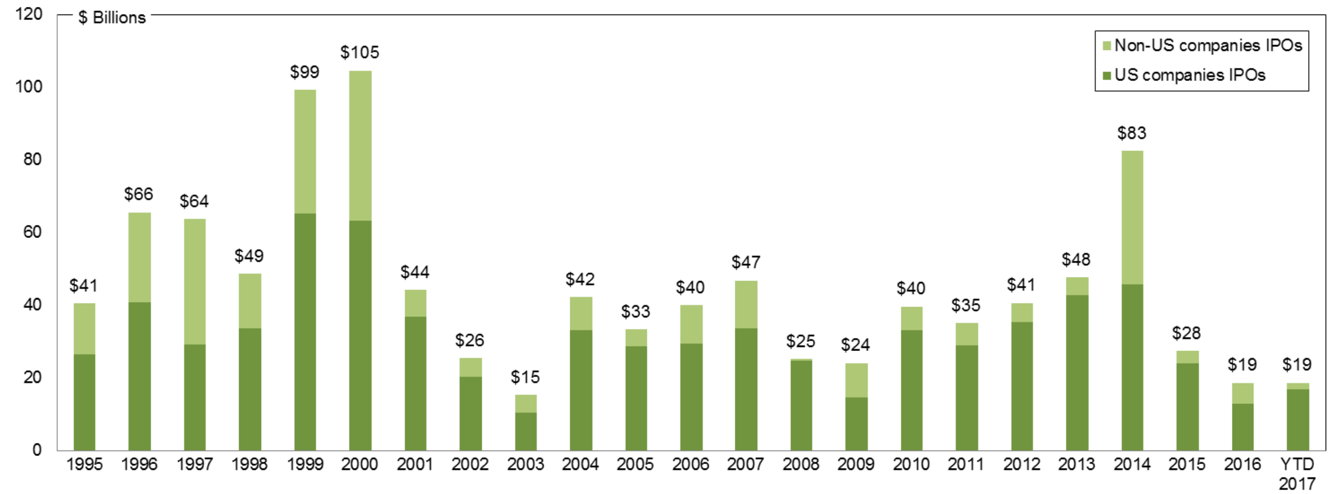
Figure 7 – U.S. Initial Public Offerings – Number of Deals (1995–2017 YTD, as of June 30)



***Note**: Includes SEC registered IPOs > $25 million; excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts.*

***Source**: Dealogic.*

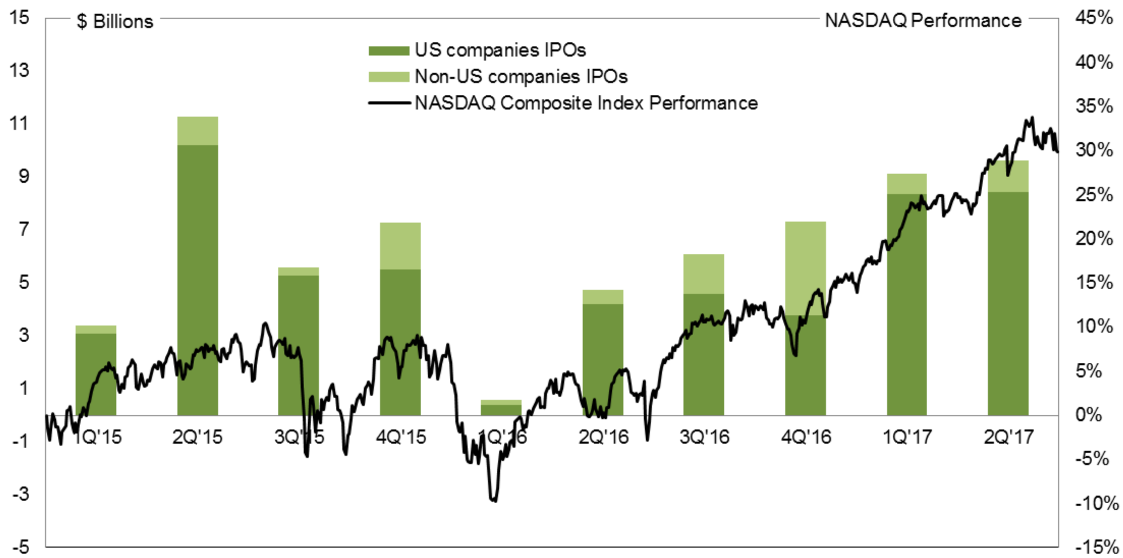
Figure 8 – U.S. Initial Public Offerings – Dollar Value Raised ($ Billions) (1995–2017 YTD, as of June 30)



***Note**: Includes SEC registered IPOs > $25 million; excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts.*

***Source**: Dealogic.*

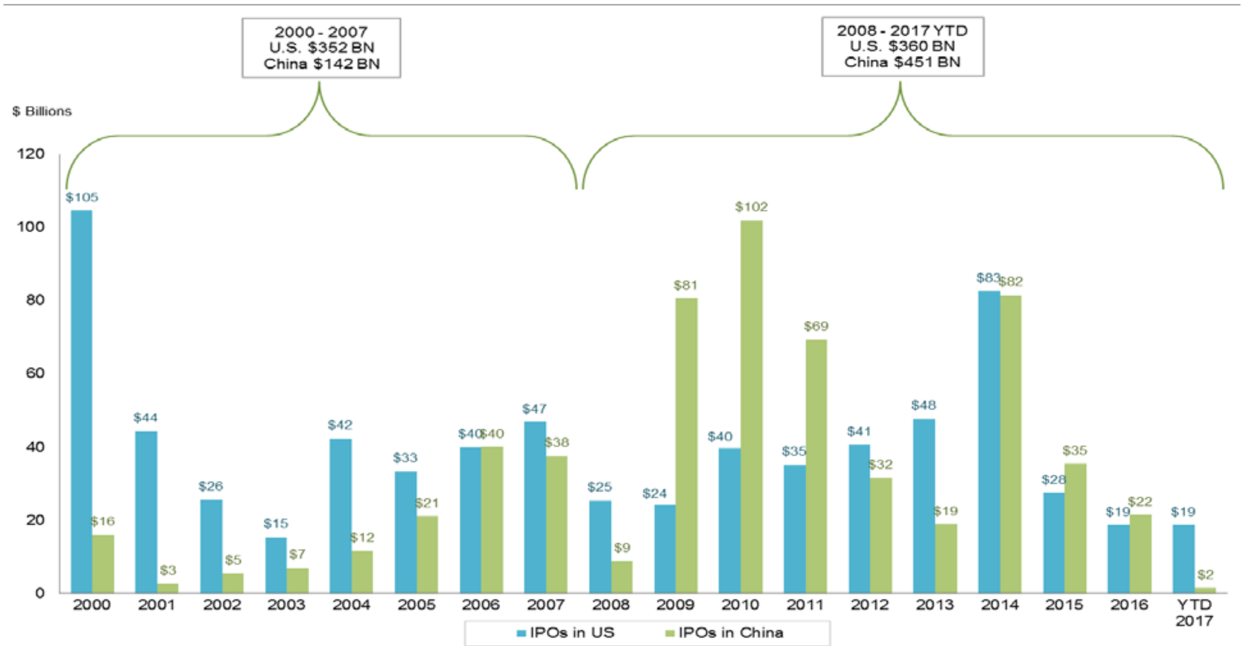
Figure 9 – U.S. IPOs vs. NASDAQ Performance (2015:Q1–2017:Q2)



Note: Includes SEC registered IPOs > $25 million; excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts. ***Source****: Dealogic.*

Chinese equity issuance had outpaced U.S. equity issuance in aggregate over recent years.

Figure 10 –U.S. vs. Chinese Initial Public Offerings – Dollar Value Raised ($ Billions)
(1995–2017 YTD, as of June 30)



Note: U.S. data includes SEC registered IPOs > $25 million and excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts; Chinese data includes rank eligible IPOs > $25 million and excludes business development companies, special-purpose acquisition companies, master limited partnerships, CLEFs, and real estate investment trusts. ***Source****: Dealogic.*

Modernization and rationalization of the U.S. regulatory framework would help to reverse these trends by expanding access to the capital markets for innovative businesses, both small and large, thereby stimulating economic growth and job creation.

With the continuing rapid development of capital markets in competing financial centers such as London and Hong Kong, it is critical to the long-term health of the U.S. financial markets, and therefore the U.S. economy as a whole, for the aging regulatory framework to be reassessed.

A. Access to Public Capital Markets

1. The Problem (Implicates Core Principle (c))

The JOBS Act relaxed the prohibition on pre-filing offers to certain sophisticated investors by emerging growth companies. Permitting companies to file registration statements confidentially allows them to take the time often needed during the SEC review process to consider whether to proceed with an offering without disclosing trade secrets to the market. Allowing companies to test the waters with investors decreases the risk of launching an unsuccessful offering. Reducing the burden associated with preparing additional financial statements, and obtaining an audit with respect to additional annual financial statements, decreases the cost to companies of doing a public offering. Emerging growth companies have since 2012 taken advantage of these accommodations provided by the JOBS Act with positive effect. Larger companies, however, experience many of the same frictions that can deter efficient and effective capital raising. Extending these provisions to a broader set of companies would encourage yet more companies to raise capital in the U.S. financial markets as a means to finance business investment, spur greater economic activity and facilitate job creation.

> "What we see clearly today . . . is that the JOBS Act had a positive impact on companies, particularly those that have been eager and ready to go public after the 2008 financial crisis and only needed a slight push."[4]
>
> *– Edward S. Knight, Executive Vice President, General Counsel and Chief Regulatory Officer, NASDAQ*

The U.S. securities registration system affords smaller companies accommodations to ease frictions associated with capital raising that can serve to discourage many companies from accessing the U.S. public capital markets, including certain burdensome disclosure-related and SOX 404

[4] The JOBS Act at Five: Examining Its Impact and Proposals to Further Enhance Capital Formation: Hearing Before the H. Subcomm. On Financial Services, 115th Cong. (Mar. 22, 2017) (statement of Edward S. Knight, Executive Vice President, General Counsel and Chief Regulatory Officer, Nasdaq, Inc.) (link).

requirements. The elimination of these same burdens for an expanded number of companies would have significant upside potential for the U.S. public capital markets and economy generally. Eliminating the requirements to use Forms S-3/F-3 will by facilitating subsequent public offerings make entering the U.S. public capital markets via an IPO more attractive for all issuers.

Business development companies also do not benefit from many of the accommodations afforded to smaller reporting companies, and in many cases other reporting companies more generally. Because business development companies generally facilitate capital formation for smaller companies, eliminating the many restrictions applicable to them would in turn benefit smaller companies by increasing the investment dollars available to them. Business development companies also create investment opportunities for retail investors. Lastly, only S-3/F-3 eligible issuers benefit from other accommodations not applicable to all reporting companies, including insulating securities analysts from liability for research coverage that might otherwise be deemed an offering of securities. Issuers and investors benefit from increased research, which provides greater access to information to facilitate more informed, and therefore more effective, capital raising and investment decisions.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should extend several JOBS Act accommodations that are available for emerging growth companies to all issuers of public securities:

    - Amend Section 5(d) of the Securities Act to permit all issuers, in the context of IPOs, to engage in oral or written communications with potential investors that are QIBs or institutional accredited investors to test the waters and determine whether such investors might have an interest in a contemplated IPO.

    - Amend Rule 163 under the Securities Act to allow prospective underwriters, authorized by the issuer, to make offers of WKSI securities in advance of filing any registration statement without those offers violating Section 5 of the Securities Act.

  - Amend Section 7(a) of the Securities Act and Section 13(a) of the Exchange Act to permit all first-time registrants to submit two rather than three years of audited financial statements in their Securities Act registration statements and to limit required selected financial data, including in subsequent Exchange Act reports, to the periods included in such registration statement.

  - Amend Section II.C in the General Instructions to Form S-1 and, when revised, the equivalent provision in Form F-1 to permit all issuers to omit from pre-marketing filings audited financial statements that will not ultimately be required at the time of marketing.

- The SEC should reduce burdens on issuers of accessing the public capital markets:

  - Amend the definition of smaller reporting company to raise the public float threshold from $75 million to $250 million.

  - Exempt all smaller reporting companies and give all first-time registrants a two-year annual report grace period from SOX 404 requirements.

  - Amend Forms S-3 and F-3 to permit all issuers to use Form S-3 or Form F-3 after their first post-IPO 10-K or 20-F and eliminate all other S-3/F-3 eligibility requirements except being up to date with all Exchange Act filings.

  - Permit business development companies to take advantage of a number of accommodations on the same basis as the other issuers to which they apply:

    - WKSI status and automatic shelf registration.

    - Rule 415 and shelf registration.

    - Incorporation by reference.

    - Research and communications safe harbors provided by Rules 134, 138, 139, 163, 163A, 164, 168, 169 and 433.

    - Access equals delivery provided by Rules 172 and 173.

- Prospectus and prospectus supplement provisions of Rule 424(b).
- Revise Rule 418(a)(3) to provide that business development companies meeting Form S-3 eligibility requirements are exempt from the requirement to provide the SEC with reports or memoranda relating to their business, operations or products for the past 12 months upon request.

B. Private Investment and Secondary Market Trading in Restricted Securities

1. The Problem (Implicates Core Principle (c))

While there is significant room to ease the burdens on companies seeking to raise money in the U.S. public capital markets, private companies equally should be able to more easily access capital from willing investors. Promoting capital formation at each stage of a company's life cycle creates the much-needed on-ramp to facilitate growth and job creation. Eliminating unnecessary roadblocks, such as certain elements of the bad actor prohibition in Regulation D, and expanding the potential universe of investors that can contribute capital to private companies would directly increase investment in the U.S. economy and would also allow companies to grow more quickly. In some cases, these changes will put companies in a position where, combined with the reform suggestions above, they may consider raising capital publicly at an earlier time. Promoting investment in private companies also fosters the development of technology and other productivity enhancing innovations that so many private companies deliver to the U.S. economy.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should promote private investment and secondary market trading in restricted securities:
  - Expand Rule 139 to provide that continuing coverage by research analysts of any issuer, as opposed to only those that qualify for Form S-3/F-3, would not be deemed to constitute an offer for sale of a

security of such issuer before, during or after an offering by such issuer.

- Amend the definition of accredited investor in Rule 501 under the Securities Act to include the following criteria which, if met, would qualify an investor as accredited as an alternative to the existing income net worth tests:
  - Any investor currently licensed or registered as a broker or investment adviser by the SEC, FINRA, or an equivalent self-regulatory organization, or a state division responsible for licensing or registration of individuals in connection with securities activities.
  - Require the SEC to develop additional objective standards based on education, job experience and professional knowledge or certifications, or alternatively develop such standards with the financial sector for draft legislation.
- Revise the substance and scope of bad actor disqualification to:
  - Limit the types of actions that cause disqualification to material violations of the securities laws.
  - Eliminate disqualifications based on actions of affiliates (other than subsidiaries), directors, officers and beneficial owners.

C. Secondary Market Public Resale Market Liquidity

1. The Problem (Implicates Core Principle (c))

Facilitating secondary market public resales provides a more liquid exit for investors in U.S. public companies. Secondary market liquidity also creates a positive feedback loop to help reduce an issuer's cost of capital. Amending Rule 144 to eliminate complex and unnecessary resale requirements would both encourage more investment in U.S. public companies, and early stage companies that wish to go public, and in turn encourage more companies to consider going public.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should amend Rule 144 under the Securities Act to:
    - Establish 20% ownership as the presumptive dividing line between non-affiliated and affiliated status for shareholders that may be deemed to be affiliates by virtue of their share ownership alone.
    - Eliminate three-month lag post-exiting affiliate status.
    - Reduce holding period for restricted securities of reporting issuers from six to three months.
    - Shorten period that must lapse after an issuer's IPO before Rule 144 becomes available to 30 or 60 days.

D. Investment in the Municipal Securities Markets

1. The Problem (Implicates Core Principle (c))

Municipal securities are a critical mechanism for state and local governments to finance their infrastructure needs and other obligations. Overhauling the nation's aging infrastructure is a priority of the current administration, and infrastructure investment will create new jobs both directly through construction and development and indirectly through its follow-on effects on economic output. S.828 would amend the FDIA and require federal banking regulators to treat certain municipal obligations as Level 2B liquid assets under their LCR rules.[5] By allowing these obligations to be treated as HQLA, increased bank investment in municipal securities can be encouraged, as discussed in Chapter 4.[6]

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[5] SIFMA also appreciates Treasury's recognition and thoughtful consideration of this problem in its first report on financial regulatory reform in June 2017 in expressing support for providing HQLA status to municipal securities.

[6] *See also* Chapter 3 of the May White Paper.

2. The Solution

Congress and the SEC should do the following:

- Congress should amend the FDIA to require the appropriate federal banking agencies to treat municipal bonds that are investment grade and liquid and readily marketable as 2B securities for the LCR Rule.

- The SEC should promote greater liquidity in municipal securities.

Chapter 7

RESEARCH RULES AND REGULATION

Relevant Agencies

- SEC
- FINRA

Chapter 7 – Research Rules and Regulation

In the capital markets, research generally refers to reports or other communications that are prepared by broker-dealer analysts that analyze equity or debt securities in order to help investors make informed investment decisions. The SEC has long acknowledged that "investment research is a fundamental element of the brokerage function,"[1] and the Supreme Court has recognized that the ability of research analysts to question corporate insiders and to "ferret out and analyze information" is necessary to the preservation of a healthy market.[2] Unsurprisingly, research was a critical issue addressed by the 2011 IPO Task Force[3] and, subsequently, by Congress in the JOBS Act. Research is also a central concern in all discussions about capital formation, including at meetings of the SEC Investor Advisory Committee and the SEC Advisory Committee on Small and Emerging Companies.

Despite this critical and central role of research, however, several recent developments risk impeding the provision of research and other valuable communications. This Chapter describes these developments and proposed solutions for each.

A. Implication on U.S. Broker-Dealers' Status under the Advisers Act of Research Payment Unbundling under MiFID II

1. The Problem (Implicates Core Principles (a), (c) and (f))

U.S. broker-dealers rely on an exclusion from the Advisers Act to provide research and other advice to clients without being required to register as investment advisers. Under the exclusion in Section 202(a)(11)(C) of the Advisers Act, a broker-dealer is not an investment adviser if the advice it provides, including research, is solely incidental to its brokerage business

[1] SEC, Future Structure of Securities Markets, 37 Fed. Reg. 5286, 5290 (Mar. 14, 1972) (link).

[2] Dirks v. SEC, 463 U.S. 646, 657 (1983) ("The SEC expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'") (quoting 21 SEC Docket 1401, 1406 (1981)).

[3] *See* SEC, IPO Task Force, Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth (Oct. 20, 2011) (link).

and the broker-dealer does not receive special compensation for providing the advice. Broker-dealers generally rely on this exclusion by providing research as part of full-service bundled brokerage services.

Starting on January 3, 2018, MiFID II will require EU investment managers to unbundle payments for research and execution services, and pay for research either from the investment manager's own money or through client funds specifically set aside in research payment accounts.[4] MiFID II takes an expansive view of the term research that could be interpreted to encompass sales and trading and other desk commentary not traditionally viewed in the U.S. as research.

U.S. broker-dealers are concerned that, by receiving separate payments for research from MiFID II-compliant EU investment managers, they might be considered to be receiving special compensation that would disqualify them from the exclusion in Section 202(a)(11)(C) of the Advisers Act. If the brokerage and research activities of U.S. broker-dealers become subject to the Advisers Act, the fiduciary framework of the Advisers Act—including restrictions on principal and agency cross trading—would apply in addition to the existing broker-dealer regulatory regime. This would create significant uncertainty and likely business disruption as broker-dealers try to assess the impact on their brokerage and research activities. Some U.S. broker-dealers have noted that the conflict between the EU and U.S. regulatory regimes has raised uncertainty as to whether they will be able to provide U.S.-produced research to those investment managers that are complying with MiFID II.

Adding to the complexity, EU regulators, with only months remaining before the MiFID II effective date, are *still* in the process of providing guidance on key aspects of these requirements, including cross-border implications. U.S. broker-dealers will have little time to review, comprehend, synthesize and implement the new MiFID II regime, including any new implementing guidance, while simultaneously piloting new business models.

Given the centrality of the U.S. capital markets to the global economy, any disruption caused as a result of broker-dealers trying to comply with the MiFID II requirements without simultaneously exposing their U.S.

[4] Research payment accounts cannot be linked to the volume or value of transactions executed on behalf of the clients, but may be funded through client charges imposed on a trade by trade basis along with commissions.

brokerage business to the requirements and obligations of the Advisers Act could have global consequences. To the extent that U.S. broker-dealers choose to solve this problem by not providing research to EU investment managers, EU investment managers will be less likely to transact with U.S. broker-dealers, harming U.S. capital market liquidity and capital formation.

2. The Solution

The SEC should do the following, which can be accomplished without statutory change:

- The SEC should provide U.S. broker-dealers, as soon as possible, with an exemption from the Advisers Act for the receipt of unbundled research compensation from investment advisers. The SEC can then carefully consider the permanent relief and regulatory framework necessary to address these regulatory conflicts.

B. Permissible Communications between Debt Research and Trading Desk Personnel

1. The Problem (Implicates Core Principles (a), (c) and (f))

FINRA's debt research rule (FINRA Rule 2242) is designed to address conflicts of interest relating to the publication and distribution of debt research reports. The rule, which became effective in July 2016, is based on FINRA's equity research rule (FINRA Rule 2241), although FINRA made adjustments to the debt research rule to reflect the significant differences between the fixed income and equity markets, as well as differences between the content of debt and equity research. One specific area where the debt research rule deviates from the equity research rule is with respect to potential conflicts between debt research analysts and sales and trading personnel on one hand and principal trading personnel on the other.

The debt research rule specifies the permissibility of certain interactions between debt research analysts and trading desk personnel, although the boundary of permitted and prohibited interactions is confusing, and FINRA's guidance does not go far enough to give firms comfort that certain communications are appropriate, thus discouraging debt research analysts from engaging in even permissible interactions.

The financial sector's uncertainty in this area has resulted in an erosion in the frequency and quality of interactions between debt research and trading desk personnel, which puts both at a significant information disadvantage. Given the relative complexity of the debt market and the breadth of debt security classes, debt research analysts need access to current market information from traders, and traders need research analyst input to accurately price positions for clients and manage firm risk.

> "A vibrant capital-raising process supports both large and small businesses, creates jobs, strengthens the economy and serves the interests of investors. Broker-dealers and FINRA both perform important roles in capital raising, but the process is evolving and it is essential that our approach also evolve where appropriate to ensure that important investor protections are preserved without needlessly interfering with capital formation."[5]
>
> *– Robert W. Cook, President and CEO, FINRA*

This issue is particularly acute when significant news stories or corporate events are announced, and the absence of guidance from an analyst can prejudice a trader's ability to price debt securities and manage risk in real time. Additionally, the absence of this information negatively affects investors' ability to make informed decisions on debt securities in their portfolios, constraining market liquidity in less liquid securities or during times of market stress.

2. The Solution

FINRA should do the following, which can be accomplished without statutory change:

- FINRA should revise the debt research rule or otherwise issue additional guidance to provide both clarity and greater flexibility with respect to the interactions between research and trading personnel.[6]

C. FINRA's Interpretation of Research Report and Proposed Desk Commentary Safe Harbor

1. The Problem (Implicates Core Principles (a), (c) and (f))

According to FINRA Rule 2241 and Rule 2242, a research report generally means any written (including electronic) communication that includes an analysis of securities of individual companies or issuers and that provides information reasonably sufficient upon which to base an investment decision. While the financial sector has historically understood the boundaries of that definition, FINRA has more recently questioned whether

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[5] Robert W. Cook, FINRA, Remarks From the 2017 FINRA Annual Conference (May 17, 2017) (link).

[6] *See* SIFMA, Letter to FINRA Regarding Request for Comment on FINRA Rules Impacting Capital Formation (June 6, 2017) (link).

certain desk commentary (e.g., material produced by sales and trading personnel to communicate market developments to clients) falls within that definition and should thus be subject to the conflicts of interest prohibitions and compliance framework under the research rules. The financial sector believes FINRA is unnecessarily taking an expansive view of the definition of research report, especially given that desk commentary is provided to sophisticated recipients who have not traditionally viewed such communications as objective research. In addition, by subjecting desk commentary to unreasonable constraints, FINRA risks impeding valuable market communications from sales and trading personnel.

In response to the financial sector's concerns and after dialogue with the financial sector, FINRA proposed amendments to Rule 2241 and Rule 2242 to create a limited safe harbor for certain written analysis that comes from sales and trading or principal trading personnel, but that may rise to the level of a research report under those rules (known as desk commentary).[7] The proposed safe harbor would be subject to conditions, including content standards and compliance with a number of the Rule 2241 or Rule 2242 provisions to mitigate research-related conflicts. In addition, the proposed safe harbor would require firms to include a health warning on desk commentary and to obtain negative consent from eligible institutional investors to receive such commentary.

SIFMA appreciates FINRA's recognition that, to the extent desk commentary technically falls within the research report definition, it should not be subject to the same restrictions and requirements that apply to communications prepared by research department personnel; however, SIFMA believes that some of the requirements that would apply to desk commentary under the proposed safe harbor could unnecessarily stifle valuable communication tools to the detriment of the marketplace.

In addition, although FINRA's stated objective of the safe harbor is to provide relief for desk commentary that may technically fall within the research report definition, as currently drafted, the proposed safe harbor appears to capture communications that would not fall within the definition of research report under any circumstances. This creates an implication that firms should comply with the safe harbor when disseminating such communications, even though such communications would not otherwise be

[7] These amendments are discussed in FINRA, Regulatory Notice 17-16 (Apr. 2017) (link).

subject to the research rules. This may result in firms further restricting the publication of valuable desk commentary.

2. The Solution

FINRA should do the following, which can be accomplished without statutory change:

- FINRA should modify the desk commentary safe harbor in a manner that takes into account the value of desk commentary in an environment that relies heavily on electronic communications and the necessary interactions among sales and trading personnel and with clients. Specifically, FINRA should consider the following modifications:[8]
  - Eliminate or modify certain conflict management provisions relating to investment banking that would preclude sales and trading personnel who author eligible desk commentary from engaging in many ordinary course activities. These restrictions may be particularly onerous for smaller firms that have limited resources and are less likely to have dedicated investment banking personnel with certain structuring expertise that exists in sales and trading.
  - Modify the description of content that is eligible to qualify for the desk commentary safe harbor to make clear that this content only includes communications that may technically fall within the definition of research report.
  - Provide clarity on certain content standards for desk commentary.

[8] These recommendations are further discussed in the comment letter SIFMA submitted to FINRA in response to FINRA's proposed desk commentary safe harbor. *See* SIFMA, Letter to FINRA Regarding Desk Commentary Safe Harbor from FINRA Equity and Debt Research Rules (May 31, 2017) (link).

Chapter 8

DERIVATIVES

Relevant Agencies

- CFTC
- FCA
- FDIC
- FHFA
- Federal Reserve
- OCC
- SEC

Chapter 8 – Derivatives

Title VII enacted beneficial reforms that have enhanced transparency and mitigated risks in the OTC derivatives market. The implementation of Title VII, however, was unduly complex, costly and over-engineered. Implementation issues have impeded U.S. access to global and regional markets, end-user access to funding and liquidity and efficient risk management. Addressing these issues can help promote U.S. competitiveness, job creation and economic growth, without undercutting Title VII's transparency and risk mitigation benefits.

Following the financial crisis, G20 members agreed to strengthen the regulation of OTC derivatives through five key reforms: clearing of standardized OTC derivatives through CCPs; reporting of OTC derivatives to trade repositories; where appropriate, trading of standardized OTC derivatives on exchanges or electronic trading platforms; higher capital requirements for non-cleared derivatives; and margin requirements for non-cleared derivatives.[1] Congress enacted these reforms in Title VII and charged the regulators listed in the sidebar with their implementation.

The regulators have now adopted rules implementing the vast majority of Title VII reforms:

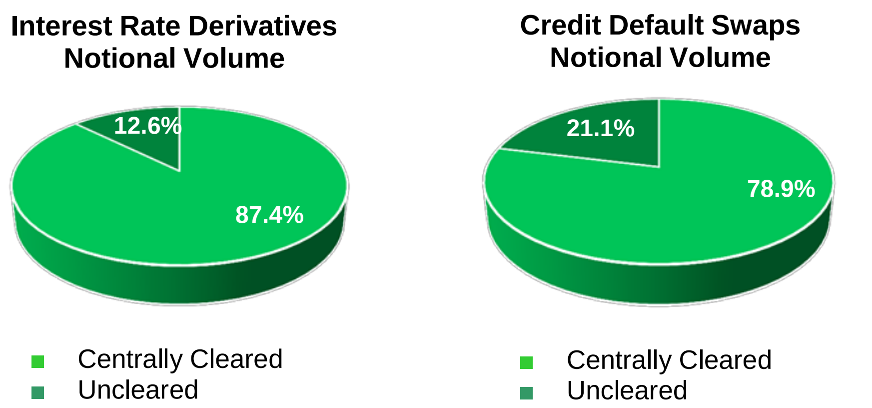
- All CFTC-regulated swaps, amounting to over 95% of the notional value of the OTC derivatives markets,[2] are now reported to trade repositories if a U.S. person or non-U.S. affiliate swap dealer is a party to the trade;
- 100% of all mandated interest rate and credit default swaps are centrally cleared, amounting to over 87% of the notional volume of OTC interest rate derivatives and over 78% of the notional volume of index credit default swaps;[3]

[1] G20 Pittsburgh Summit Declaration (Sept. 24, 2009) (link); G20, Cannes Summit Final Declaration (Nov. 4, 2011) (link).

[2] The OTC credit and equity derivatives regulated by the SEC as security-based swaps comprise less than 3% of outstanding notional amounts in the OTC derivatives markets. Bank for International Settlements, OTC Derivatives Statistics at end-June 2016 (Nov. 2016) (link). Unless otherwise stated, references to swaps in this Chapter also refer to security-based swaps.

[3] International Swaps and Derivatives Association, Swaps Info Weekly Analysis (Apr. 7, 2017) (link). Interest rate derivatives and index credit default swaps make up over 80% of outstanding

Figure 11 – Interest Rate Derivatives and Credit Default Swaps Notional Volume



Source*: ISDA, SwapsInfo Weekly Analysis (Apr. 7, 2017).*

- Trading on CFTC-registered SEFs amounts to over 56% of the notional volume of OTC interest rate derivatives and over 74% of the notional volume of index credit default swaps;[4] and

- By September 1, 2017, new non-cleared swaps between financial entities will be secured by daily mark-to-market, or variation margin, preventing the buildup of unsecured exposure over time and thereby significantly mitigating systemic risk.

In addition, the SEC has proposed rules addressing each of the key Title VII reforms and finalized rules governing the reporting of security-based swaps and the registration and regulation of security-based swap dealers.

With Title VII's reforms largely in place, it is now possible to evaluate the implementation of those reforms with a view to preserving aspects that have proved beneficial while minimizing rules that have unnecessary and undesirable consequences.

Addressing the issues described does not require Congress to roll back Title VII or U.S. regulators to abandon G20 principles. It will, however, require regulators to focus on how Title VII rulemaking affects economic growth,

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notional amounts in the OTC derivatives markets. Bank for International Settlements, Statistical Release: OTC Derivatives Statistics at end-June 2016 (Nov. 2016) (link).

[4] International Swaps and Derivatives Association, Swaps Info Weekly Analysis (Apr. 7, 2017) (link).

jobs, and competitiveness, in addition to risk mitigation and market transparency.

SIFMA sets forth recommendations in this Chapter for how best to achieve these objectives without necessitating legislative action. The regulators should act expeditiously on these recommendations. The SEC should also re-propose its Title VII rules, both already final rules and those still only proposed, to take into account new rules and guidance from the other regulators. The SEC should also adopt permanent relief tailoring the application of existing securities laws to security-based swaps.

A. Cross-Border Application of Title VII

1. The Problem (Implicates Core Principles (c) and (d))

The OTC derivatives markets were historically among the most globally integrated of our financial markets. Before Title VII, U.S. firms traded abroad on a level playing field with non-U.S. competitors, and a diverse range of non-U.S. firms were willing to provide liquidity in the United States, often as part of their lending to U.S. firms. This global integration helped promote liquidity, reduce costs, and limit concentration of risks.[5]

> "As predicted, the CFTC's flawed swaps trading implementation has caused numerous harms, foremost of which is driving global market participants away from transacting with entities subject to CFTC swaps regulation. It has fragmented global markets into a series of distinct liquidity pools that are less resilient to market shocks and less supportive of global economic growth. It has unnecessarily impeded banks' financial risk hedging activities necessary for healthy extension of credit to the private sector."[6]
>
> *– J. Christopher Giancarlo, Chairman, CFTC*

Accordingly, international harmonization of derivatives reforms was a key objective of Congress, U.S. regulators, and their G20 counterparts. Despite this consensus, however, legislatures and regulators often did not agree on the details of implementation. Even in cases where regulators achieved a detailed agreement on a harmonized approach, different implementation schedules have created competitive disparities unfavorable to U.S. firms and markets.

The adverse impact of disparate rules has been exacerbated by the regulators' decision to apply Title VII extraterritorially. As enacted by Congress, Title VII does not apply extraterritorially except where non-U.S.

[5] Derivatives end-users and investors have routinely emphasized the importance of global integration of the OTC derivatives markets. European Association of Corporate Treasurers and Coalition for Derivatives End-Users, Letter to Financial Stability Board, International Organization of Securities Commissions and OTC Derivatives Working Group Regarding Derivative End-Users (July 11, 2013) (link), Investment Company Institute and ICI Global, Letter to SEC Regarding Cross-Border Security-Based Swap Activities (Aug. 21, 2013) (link); Coalition for Derivatives End-Users, Letter to CFTC Regarding Cross-Border Application of the Registration Threshold and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants (Dec. 19, 2016) (link).

[6] J. Christopher Giancarlo, CFTC Chairman, Transforming the CFTC (Mar. 30, 2017) (link).

activities present a direct and significant risk to the United States. But, as implemented by regulators, Title VII frequently applies extraterritorially to U.S. firms' foreign branches and affiliates and the non-U.S. market participants with whom they transact without meeting the direct and significant standard.

For example, if the foreign branch or guaranteed affiliate of a U.S. bank seeks to trade on a local swaps trading platform, then that trading platform typically must register with the CFTC as a SEF. The trading platform would then need to satisfy CFTC rules prescribing what execution methods it offers, even for trading that does not involve the U.S. bank. These extraterritorial U.S. requirements have generally been unacceptable to non-U.S. firms, leading most non-U.S. trading platforms to deny access to U.S. banks' foreign branches and guaranteed affiliates.[7] Implementation of the SEF registration requirement in October 2013 thus led to a sharp drop in U.S. dealers' share of trading in Europe of euro-denominated interest rate swaps from over 25% to less than 10%.[8]

Similar dynamics have been observed in reaction to other rules. For example, non-U.S. firms are often reluctant to trade with U.S. banks' foreign branches or affiliates lest those counterparties become subject to Title VII's margin rules—which apply even to trading between two non-U.S. persons, neither of which has a U.S. guarantee, if one of the parties happens to be swap dealer with a U.S. parent company.[9] Similarly, extraterritorial application of CFTC registration requirements has led most non-U.S. CCPs to limit or no longer permit U.S. participation.[10]

The resulting market fragmentation harms the U.S. economy and job creation, which is inconsistent with Core Principle (c)—fostering economic growth and vibrant financial markets. As noted by a broad coalition of

[7] Only two non-U.S. trading platforms have registered as SEFs and only one additional non-U.S. trading platform has elected to rely on the CFTC's relief for qualifying non-U.S. trading platforms.

[8] International Swaps and Derivatives Association, Cross-Border Fragmentation of Global Interest Rate Derivatives: Second Half 2015 Update (May 2016) (link). PricewaterhouseCoopers found that this liquidity fragmentation led to price divergence between U.S. and European markets equal to as much as four times the typical bid-ask spread. PricewaterhouseCoopers LLP, Global Financial Markets Liquidity Study, at 43–44 (Aug. 2015) (link).

[9] Extraterritorial application of Title VII's clearing rules has also been problematic. For example, clients in Australia and Hong Kong have curtailed their trading with U.S. banks' Australian and Hong Kong branches since the CFTC expanded its clearing mandate to cover local foreign currency-denominated interest rate swaps.

[10] For example, except in Singapore, no Asian CCP permits clearing by U.S. customers.

corporate end-users of derivatives in response to a recent CFTC proposal, market fragmentation can "ultimately raise prices for Main Street consumers who rely on reasonably priced products and services and . . . hurt the standing of U.S. companies with foreign operations to compete globally."[11]

"U.S. entities could be at a competitive disadvantage if non-U.S. entities determine that the burden and costs for obtaining permission for substituted compliance or having to comply with CFTC rules for which there are no foreign counterpart requirements outweigh the benefits of engaging in transactions with U.S. registered funds or non-U.S. funds that are deemed U.S. persons."[12]

– The Investment Company Institute and ICI Global

In principle, regulators could address these competitive disparities by allowing firms to comply with U.S. rules through substituted compliance with comparable non-U.S. rules. U.S. regulators stated their intention to take an outcomes-based approach to making the comparability determinations that are necessary to permit substituted compliance. In practice, however, they have failed to make these determinations in many key areas,[13] or they have imposed limitations that are antithetical to the very goal of substituted compliance, such as a stricter-rule-applies condition that effectively requires firms to satisfy both sets of rules.[14] Regulators' burdensome substituted compliance framework has not prevented the emergence of competitive disparities.

Regulators have adopted or proposed to adopt additional requirements on non-U.S. firms doing business in the United States that extend U.S. regulation beyond those firms' trading with U.S. clients. For example, under CFTC staff guidance and SEC rules, a non-U.S. firm that trades with a non-U.S. client through personnel located in the U.S. must comply with a wide range of Title VII requirements. These personnel arrangements are important to the maintenance of global market liquidity across multiple time zones. Temporary relief or delays of these rules have been necessary so that

[11] Coalition for Derivatives End-Users, Letter to CFTC Regarding Cross-Border Application of the Registration Threshold and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants (Dec. 19, 2016) (link).

[12] Investment Company Institute and ICI Global, Letter to SEC Regarding Cross-Border Security-Based Swap Activities (Aug. 21, 2013) (link).

[13] The only instance where regulators have recognized other jurisdictions' implementation of the G20 clearing, trading, margin or reporting mandates is the CFTC's recognition of Japanese margin rules. The CFTC has also recognized certain foreign regulations outside of the G20 mandates (e.g., EU documentation, portfolio reconciliation and portfolio compression requirements).

[14] For example, the CFTC and European Commission agreed to a stricter-rule-applies approach, where exemptions from mandatory clearing exist in one jurisdiction but not in the other. CFTC, Cross-Border Regulation of Swaps/Derivatives: Discussions Between the CFTC and the EU – A Path Forward (July 11, 2013) (link).

non-U.S. firms do not face further disincentives from creating jobs, investing and providing liquidity in the United States.[15]

2. The Solution

The CFTC, SEC, Federal Reserve, OCC, FDIC, FHFA and FCA should do the following, which would modify Title VII's cross-border framework to reverse market fragmentation by creating a level playing field for U.S. and non-U.S. firms and which can be accomplished without statutory change:

- Tailor the extraterritorial application of Title VII to foreign branches and affiliates so that U.S. firms can effectively compete in non-U.S. markets.

- Do not apply Title VII extraterritorially to U.S. firms' foreign branches or affiliates where existing regulation already protects against significant risk flowing back to the United States:

  - Swap dealer registration should not apply to a U.S. firm's non-U.S. affiliate on the basis of trading with non-U.S. counterparties if the U.S. firm's non-U.S. affiliate is regulated in a G20 jurisdiction or otherwise subject to Basel-compliant capital standards, regardless of whether the affiliate is guaranteed by its U.S. parent. This approach would promote U.S. competitiveness abroad while still ensuring that U.S. firms cannot use offshore affiliates to conduct unregulated swaps trading.

  - Non-U.S. swap counterparties, trading platforms and CCPs should not be required to register as swap dealers, SEFs or derivatives clearing organizations, respectively, as a result of doing business with a U.S. firm's foreign branch or affiliate (guaranteed or not).[16] This approach would remove the incentives for foreign liquidity

[15] Notably, end users have indicated that they would generally seek to avoid trading with non-U.S. dealers using U.S. personnel if doing so would subject them to duplicative regulatory requirements. Coalition for Derivatives End-Users, Letter to CFTC Regarding Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of Non-U.S. Swap Dealers Located in the United States (Mar. 10, 2014) (link).

[16] Also, like in the futures markets, U.S. customers should be permitted to access non-U.S. swaps trading platforms and CCPs through U.S. brokers or comparably regulated non-U.S. brokers without subjecting the trading platform or CCP to U.S. registration. Regulation of their brokers would serve to protect U.S. customers, while allowing them to access liquidity abroad.

providers, trading platforms, and CCPs to refuse access to U.S. firms, while allowing existing prudential regulation to address any risks faced by U.S. firms trading abroad.

- Since they are already subject to comprehensive U.S. prudential supervision at the legal entity or consolidated level, or both, U.S. firms' foreign branches and affiliates, guaranteed or not, should not be subject to Title VII's mandatory clearing, mandatory trading, margin, or reporting rules when they trade with non-U.S. firms, at least in other G20 or similarly highly regulated jurisdictions. This approach will help ensure that U.S. firms' foreign branches and affiliates can transact on a level playing field with local competitors and each other.

- At a minimum, if these rules continue to apply to U.S. firms' foreign branches or affiliates outside such highly regulated jurisdictions, a limited exception should apply to foreign branch or affiliate trading activity with non-U.S. firms that does not exceed a *de minimis* proportion of the U.S. group's overall trading activity. This exception would build on an existing CFTC exception, which recognized that, although trading in emerging market branches is not a significant source of risk, it is an integral component of U.S. banks' global businesses.

- Promote cross-border market access through more robust substituted compliance.

  - In any remaining instances where U.S. rules overlap with rules of another jurisdiction that has a comprehensive regulatory framework for derivatives consistent with G20 or other internationally recognized principles, then the transacting parties—including U.S. firms and their foreign branches and affiliates—should be able to transact under the rules of that other jurisdiction, without any stricter rule—applies condition or other limits on substituted compliance. This more robust approach to substituted compliance would help reverse market fragmentation.

- Remove undue impediments to the position of the United States as a global financial center.

- The CFTC and SEC should undo Title VII guidance and rules that discourage non-U.S. firms from investing, trading or creating jobs in the United States:

  - To encourage firms to hire U.S. front office personnel and promote global market liquidity, Title VII rules should not apply to a swap between non-U.S. firms or between a non-U.S. firm and a foreign branch or affiliate of a U.S. firm on the basis that U.S. located personnel arrange, negotiate or execute the swap. The participation of U.S. personnel does not create risks justifying the imposition of Title VII requirements to these otherwise non-U.S. swaps.

  - The SEC intends to require a non-U.S. security-based swap dealer to provide a certification and legal opinion regarding SEC access to its books and records and ability to conduct on-site examinations. The SEC also intends to require all security-based swap dealers to conduct background checks regarding non-U.S. employees. These rules cover more than just the business that these firms conduct in the United States, which results in conflicts with foreign laws. To encourage non-U.S. firms to trade in the U.S. markets, the SEC should limit or eliminate these requirements.[17]

  - If a non-U.S. dealer registers with the CFTC or SEC because it enters into swaps with U.S. persons, it also becomes subject to U.S. reporting rules for its swaps with non-U.S. persons. Those swaps have a very limited U.S. nexus, but reporting them to U.S. regulators often violates foreign laws. While the CFTC has granted relief from these reporting rules for a non-U.S. swap dealer that is part of a non-U.S. corporate group, the CFTC should expand this relief to all non-U.S. swap dealers and make it permanent. The SEC should adopt the same relief. This relief would encourage non-U.S. firms to trade in U.S. markets.

[17] The CFTC adopted an exception to its parallel certification for instances where blocking, privacy or secrecy laws apply. The CFTC has also provided relief from background check rules for non-U.S. employees who do not trade with U.S. counterparties.

B. Margin Requirements for Non-Centrally Cleared Swaps

1. The Problem (Implicates Core Principle (c))

"I am very concerned by recent press reports of remarks by unnamed Fed officials that the 10-day coverage period may be intentionally 'punitive' in order to move the majority of trades into a cleared environment. Any punitive or arbitrary squeeze on non-cleared swaps will surely have consequences—mostly negative—for American businesses and their ability to manage risk. With tens of millions of Americans falling back on part-time work, it is not in our national interest to deter American employers from safely hedging commercial risk to free capital for new ventures that create full-time jobs. It is time we moved away from punishing U.S. capital markets and move toward rules designed to revive American prosperity."[18]

– J. Christopher Giancarlo, Commissioner, CFTC

Title VII's mandatory clearing requirements have quite successfully increased central clearing. In addition, higher capital requirements now apply to non-cleared swaps, which provide a significant incentive for central clearing.

Nonetheless, the regulators, as part of an international regulatory working group, designed margin requirements for non-cleared swaps so as to further promote central clearing beyond what has occurred as a result of these already extensive measures.[19] In particular, they established initial margin[20] requirements for non-cleared swaps at levels required to address potential adverse market movements over a 10-day period, rather than the 5-day period typically required for cleared swaps—resulting in roughly 40% higher margin requirements. No rigorous empirical analysis informed this difference, even though market participants had raised significant concerns with the 10-day requirement.[21]

It is not obvious why these punitively higher margin requirements are necessary to incentivize central clearing, since Title VII already includes mandatory clearing requirements for suitable swaps. The only firms who are exempt from mandatory clearing are also exempt from margin requirements for non-cleared swaps. For firms subject to both requirements, the higher margin requirements for non-cleared swaps impose unnecessary costs, particularly since many non-cleared swaps are too customized or thinly traded to be clearable.

[18] J. Christopher Giancarlo, CFTC Commissioner, Opening Statement at Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities (Sept. 17, 2014) (link).

[19] Basel Committee and International Organization of Securities Commissions, Margin Requirements for Non-Centrally Cleared Derivatives (Mar. 2015) (link). The SEC has not yet finalized its margin rules for non-cleared security-based swaps.

[20] Initial margin is intended to collateralize the potential change in value of derivatives with a counterparty in default after the default occurs but before the non-defaulting counterparty can replace those derivatives. Under current rules, when a firm collects initial margin, it cannot reuse it to fund other aspects of its business.

[21] Objections were raised by asset managers commenting on a previous version of these rules in 2011, but ultimately were not addressed by the regulators. BlackRock, Letter to CFTC on Proposed Margin Requirements for Uncleared Swaps (July 11, 2011) (link); PIMCO, Letter to CFTC on Issues Arising from Margin Requirements for Covered Swap Entities as Proposed by the Prudential Regulators and Commodity Futures Trading Commission (July 11, 2011) (link).

These costs are quite significant, requiring U.S. firms to lock up an estimated $315 billion in high-quality assets,[22] even with a $50 million threshold before initial margin requirements apply to a pair of counterparties together with their affiliates.[23] Much of these costs are ultimately borne by end-users.[24] These costs are in addition to the costs of increased capital and liquidity reserves U.S. banks must now hold for non-cleared swaps. These rules should instead be complementary, so that the aggregate amount of capital, liquidity reserves and margin requirements is well-calibrated against the risks of non-cleared swaps.[25]

U.S. regulators have exacerbated the adverse impact of this flawed margin regime by expanding the scope of firms subject to it relative to parallel non-U.S. rules. In particular, regulators in other jurisdictions recognized exceptions from both initial and variation margin requirements for firms that do not trade a significant amount of OTC derivatives. Such firms do not contribute to significant risk through their OTC derivatives activity but U.S. regulators have not recognized any such exception. This difference places U.S. firms at a competitive disadvantage when they attempt to trade with non-U.S. clients in this category. It also makes it difficult for smaller U.S. investment firms to invest or hedge using swaps[26] and inhibits the use of swaps to hedge exposures in connection with securitization activities.

U.S. regulators have also adopted stricter deadlines for when firms must collect required margin than the deadlines that apply in foreign jurisdictions. This difference also puts U.S. firms at a competitive disadvantage, since it

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[22] OCC, Federal Reserve, FDIC, FCA, FHFA, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74891 (Nov. 30, 2015) (link).

[23] This threshold was adopted by an international regulatory working group on the basis of a quantitative impact study that had serious methodological flaws and was misunderstood and inconsistently construed by firms contributing data to the study. SIFMA provided detailed comments on the study at the time, but regulators failed to address them. SIFMA, Letter to Bank for International Settlements and International Organization of Securities Commissions Regarding Margin Requirements for Non-Centrally-Cleared Derivatives (Mar. 15, 2013) (link).

[24] Coalition for End-Users, Letter to CFTC (Dec. 2, 2014) (link).

[25] There has generally been a failure to analyze the cumulative impact of Title VII and enhanced prudential requirements. Consequently, these rules frequently work at cross-purposes (e.g., leverage ratio requirements increase the cost of central clearing, and margin requirements reduce the availability of HQLA) or are duplicative (margin requirements for non-cleared swaps and heightened capital requirements for those same swaps). SIFMA's further comments on capital and liquidity requirements are set forth in Chapters 2 and 3 of the May White Paper.

[26] The Impact of G-20 Clearing and Trade Execution Requirements: Hearing Before the H. Subcomm. On Commodity Exchanges, Energy and Credit, 115th Cong. (June 14, 2016) (statement of Luke Zubrod, Director, Chatham Financial) (link).

makes it more difficult for non-U.S. clients to post non-cash collateral or trade with U.S. firms across multiple time zones.

Financial institutions use inter-affiliate swaps to facilitate centralized group-wide risk management. When appropriately documented and variation margined, these internal risk management transactions do not present risk to the financial system. Nonetheless, the U.S. bank regulators have imposed initial margin requirements on inter-affiliate swaps, in addition to variation margin requirements. Doing so locks up significant amounts of high-quality assets without corresponding risk mitigation benefits. Although the CFTC has exempted inter-affiliate transactions from initial margin and mandatory clearing requirements, it requires the affiliates relying on these exemptions to collect initial margin or centrally clear their swaps with third parties, even in non-U.S. jurisdictions where Title VII's cross-border framework would not otherwise require them to do so. While the CFTC's exemptions provide some relief, these conditions have proved problematic in certain instances for firms that transact with their U.S. affiliates. Further, the U.S. banking regulators' not providing similar relief unnecessarily complicates the U.S. regulatory landscape and disadvantages those not solely regulated by the CFTC.

Required initial margin levels are also higher because existing standards for imposing mandatory clearing and trading rules to amended or new swaps unnecessarily inhibit measures to reduce bilateral credit risk. For example, amendments to extinguish current market credit exposure or new swaps executed to reduce potential future credit exposure often trigger these rules, which effectively prohibits these risk-reducing trades.

Recalibrating margin and clearing rules to be more risk-sensitive and work in tandem with enhanced prudential requirements would unlock significant resources for U.S. lending, investment and job creation, without exposing the U.S. financial system to undue risk. During the 2003–2012 period before these rules were implemented, derivatives are estimated to have boosted U.S. real GDP by about $3.7 billion each quarter.[27]

[27] Apanard Prabha, Keith Savard and Heather Wickramarachi, Milken Institute, Deriving the Economic Impact of Derivatives: Growth Through Risk Management (Mar. 2014) (link).

2. The Solution

The CFTC, SEC,[28] Federal Reserve, OCC, FDIC, FHFA and FCA, working together and with their international counterparts as appropriate,[29] should do the following, which would recalibrate margin and clearing requirements to unlock resources for lending and investment by focusing the requirements solely on what is appropriate to mitigate risk, and which can be accomplished without statutory change:

- Adjust the level of required initial margin to be risk-sensitive and appropriate to the reduction of systemic risk.
  - Initial margin levels for non-cleared swaps should be made consistent with initial margin levels for similar cleared swaps, and all appropriate risk offsets should be recognizable when calculating initial margin.[30]
- Remove impediments to effective risk management by exempting inter-affiliate swaps.
  - Inter-affiliate swaps should be exempt from initial margin, mandatory clearing and mandatory trading requirements, so long as they are part of a centralized risk management program and remain subject to variation margin requirements.
- Increase the $50 million maximum initial margin threshold.
  - Regulators should conduct a further review to consider increasing the $50 million initial margin threshold.
- Tailor the scope of covered market participants to focus on the most significant sources of risk.

[28] While the SEC has not finalized its requirements for non-centrally cleared security-based swaps, the Commission should address these issues in a similar manner, as appropriate for entities and products subject to its jurisdiction.

[29] Since certain problematic aspects of the margin rules are incorporated into international standards, the regulators should seek to modify those standards.

[30] U.S. regulations increase initial margin requirements unnecessarily by preventing firms from recognizing offsetting risks across derivatives that happen to be regulated by a different regulator (the CFTC, SEC or Prudential Regulators). This basis for not recognizing *bona fide* risk offsets lacks a rational policy justification and imposes unnecessary costs on U.S. firms. Regulators should remove these artificial limits so that firms have a greater ability to portfolio margin non-cleared transactions with related risk profiles.

- Margin requirements should only apply to dealers and the most significant non-dealer market participants—not all firms engaged in investing or trading activity. An appropriate *de minimis* exception should also apply to trading with counterparties located in jurisdictions lacking legally enforceable netting regimes, so that U.S. firms are not blocked from doing business in those jurisdictions.

- Set realistic deadlines for collecting margin.

  - The deadline for collecting margin should be revised to account *for* logistical and operational considerations that impact the margin transfer process.[31]

- Permit efforts to reduce bilateral credit risk.[32]

  - The CFTC should not apply mandatory clearing and trading requirements when firms enter into or amend non-cleared swaps to reduce their credit risk to each other, either bilaterally or through multilateral exercises.

C. The Title VII Implementation Transparency, Accountability and Coordination

1. The Problem (Implicates Core Principle (g))

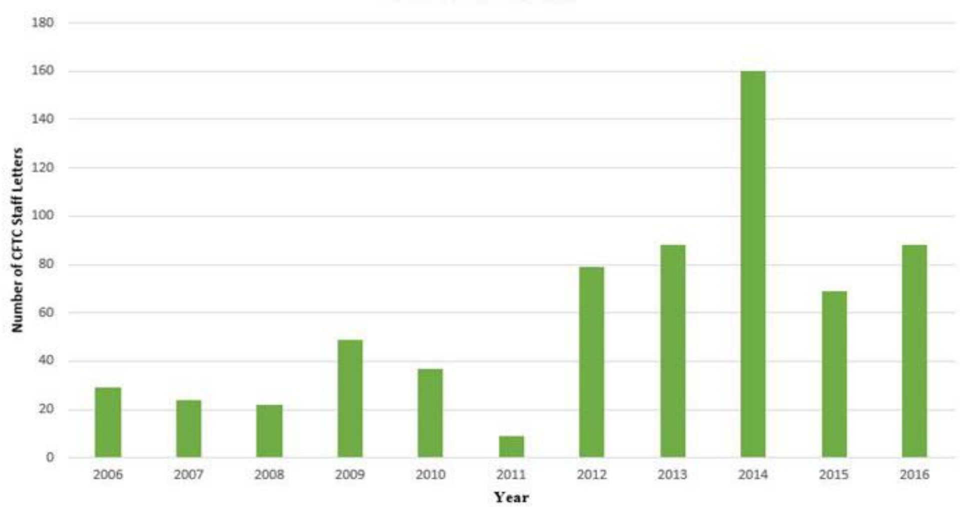
The Title VII implementation process was rushed and chaotic. The rule rollout was punctuated by significant problems created largely by the CFTC's unnecessarily accelerated and inadequately deliberative rulemaking process. The CFTC routinely resorted to guidance and staff no-action letters to modify problematic new rules and delay unachievable compliance dates. As shown in Figure 12, in the six years preceding Title VII implementation (2006-2011), CFTC staff averaged approximately 30 letters

[31] Separately, to avoid exacerbating a potential crisis, counterparties should have additional time to satisfy increases in initial margin resulting from a recalibration of margin requirements during a period of increased market stress.

[32] While the SEC has not finalized its requirements for the clearing or trading of security-based swaps, the Commission should address these issues in a similar manner, as appropriate for entities and products subject to its jurisdiction.

per year, while in 2014 alone CFTC staff issued 160 letters, mostly to address issues occasioned by the CFTC's Title VII rollout.

Figure 12 – CFTC Staff Letters



***Source**: CFTC, Letters Archive (link).*

The CFTC staff often released these letters at the very last minute, and, as staff actions, the letters did not follow rulemaking processes.[33] The resulting regulatory patchwork lacked a cohesive policy framework and had no foundation in meaningful cost-benefit analysis.

As a result of its inadequate deliberation, not only did the CFTC adopt flawed cross-border rules and margin rules but it also adopted:

- SEF trading rules that codify particular incumbent trading practices and lack consistency with the statutory framework for SEF regulation;
- Trade reporting rules that are highly complex and inconsistent with other U.S. and non-U.S. reporting rules, which lead firms to report data that is often not useful or, at times, impairs market liquidity; and
- Extensive swap dealer risk management and governance rules, including for firms already subject to OCC and/or Federal Reserve oversight.

Despite efforts to harmonize, CFTC and SEC business conduct requirements will require counterparties to use different documentation for economically similar products, without providing any meaningful additional

[33] Hester Peirce, Mercatus Center, Regulating through the Back Door at the CFTC (Nov. 2014) (link).

protections. The SEC also will require firms to report additional data fields that no other regulator, including the CFTC, requires. Proposed CFTC and SEC capital requirements continue to incorporate differences from each other and other regulators' capital requirements in ways that are not warranted by differences in circumstances or other considerations.

2. The Solution

CFTC Chairman Giancarlo has begun a new initiative to conduct an agency-wide review of CFTC rules, regulations and practices to make them simpler, less burdensome and less costly, which SIFMA strongly supports. SIFMA also commends recent steps taken by the CFTC to undertake a review of its swaps reporting framework and rules regarding chief compliance officer duties and recordkeeping rules.[34] In line with these efforts, SIFMA encourages the CFTC to identify opportunities to simplify, harmonize and streamline SEF trading, business conduct and capital requirements.[35] The SEC should engage in a similar initiative before implementing its parallel rules.[36]

[34] CFTC Letter 17–33, Division of Market Oversight Announces Review of Swap Reporting Rules in Parts 43, 45, and 49 of Commission Regulations (Jul. 10, 2017) (link); CFTC, Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants, 82 Fed. Reg. 21330, 21337 (May 8, 2017) (link); CFTC, Recordkeeping, 82 Fed. Reg. 6356, 6367 (Jan. 19, 2017) (link).

[35] Specific rule areas the CFTC should examine are: required execution methods on SEFs; treatment of block trades and package trades; the "made available to trade" process; SEF impartial access requirements; SEFs' treatment of swaps rejected from clearing; confirmation data reporting; block trade thresholds and delays; pre-trade mid-market marks; scenario analysis; daily marks; pre-trade recordkeeping requirements (particularly voice recording requirements); requirements relating to the format and searchability of records; clearing/trading conflicts of interest requirements; CFTC-specific risk management and business continuity rules applicable to swap dealers subject to oversight in those areas by other U.S. regulators; and CFTC capital, liquidity and recordkeeping requirements applicable to swap dealers subject to Federal Reserve, SEC or foreign capital supervision.

[36] The SEC's rules also raise some unique issues not raised by the CFTC's rules, such as a requirement for the non-reporting party to obtain and provide unique identifier codes and a requirement for data repositories to publish data to the public immediately upon receipt, even for block trades.

Chapter 9

THE ROLE OF SELF-REGULATORY ORGANIZATIONS

Relevant Agencies

- SEC
- FINRA
- National Securities Exchanges

Chapter 9 – THE ROLE OF SELF-REGULATORY ORGANIZATIONS

Public confidence in the financial markets starts with investors being secure that their intermediaries are well-regulated, governed by rules that protect investors and ensure fair and orderly markets, and that the rules are being enforced. Market regulation historically has been accomplished through a combination of government oversight, in conjunction with SROs that impose rules and examine their members for compliance. This model strikes a mutually beneficial balance between the public and interests of the regulated industry. The public benefits by limiting the expenditure of government funds through leveraging the resources of SROs, while the regulated industry benefits from being supervised by SROs familiar with the nuances of their operations.

In the securities markets, SROs include national securities exchanges and FINRA, a national securities association.[1] The roles of these SROs have changed over time, however. National securities exchanges have privatized and adapted a more commercial focus, retaining the benefits of SRO status while outsourcing the regulatory functions to FINRA, which is not affiliated with a market. Further, with FINRA taking on a greater role as the key regulator of the securities industry, it no longer has as close a connection to the financial sector as the self-regulatory model was originally intended to maintain. This Chapter describes these concerns and proposed solutions for each.

A. The Status of Exchanges as SROs

1. The Problem (Implicates Core Principles (f) and (g))

Historically, securities regulation has been accomplished through a combination of government regulation and self-regulation. Even before the adoption of the Exchange Act in 1934, stock exchanges developed formal rules to govern conduct on their markets. Congress, in passing the Exchange Act and later the Maloney Act of 1938 and the Securities Acts Amendments of 1975, maintained this model, and additionally incorporated

[1] Of course, dual oversight by government regulators and SROs exists in other industries as well, such as the futures and swaps market. This Chapter focuses on SROs in the securities market and does not address the structure or role of other SROs.

another SRO, now FINRA, originally to focus on firm's off-exchange activity.

Each national securities exchange and FINRA is a separate SRO, responsible for promulgating and enforcing rules that govern a variety of the aspects of their members' business, including those related to financial condition, operational capability, and qualifications of those that they employ. SROs are required to enforce their members' compliance with the SRO's rules, as well as the federal securities laws generally. This is achieved through routine examinations, monitoring cross-market trading activity, and where necessary, disciplinary proceedings in response to rule violations.

> "[T]he current self-regulatory structure is outdated and in great need of rethought and reform. . . . An overhaul of the self-regulatory model would address the significant conflicts of interest in having one group of for-profit commercial entities—the exchanges—act as regulators of the commercial competitors—broker-dealers."[2]
>
> *– Jeff Brown, Senior Vice President, Charles Schwab*

Today's exchanges, however, bear little resemblance to the member-owned cooperatives of 1934. Following the wave of demutualization that began in the early 2000s, today's exchanges act as for-profit, publicly-traded companies with obligations to their shareholders, while simultaneously acting as regulators to the companies that they list and the member firms (broker-dealers) with whom they compete. Focusing on their commercial interests, exchanges have outsourced and delegated a substantial majority of their member regulatory functions to FINRA.

Though outsourcing many of their regulatory *obligations*, exchanges have generally maintained the *benefits* of their favored status as SROs, such as their role in NMS Plans, their ability to charge regulatory fees, and limits on their liability not available to other private businesses.

As discussed in Chapter 1, exchanges retain the ability to set market policy through NMS Plans, a regulatory device that the SEC has leveraged frequently in recent years to require SROs to design and implement market structure changes. However well-intentioned, SROs have used their authority as SROs under the NMS Plan structure to implement market structure changes in ways that benefit their business interests or mitigate their costs at the expense of their broker-dealer members. For example, the public market data feed provided through the SIPs is operated by the exchanges and FINRA, while the exchanges also produce their own competing proprietary data products. Not surprisingly, the SIP data feeds are slower and contain less information than the more expensive data the exchanges sell directly.

[2] Jeff Brown, Senior Vice President, Charles Schwab, Written Testimony on Behalf of SIFMA Before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment (June 27, 2017) (link).

Historically, broker-dealers have paid fees to SROs to help fund regulation of the markets. While they operate now as commercial entities, exchanges nevertheless continue to use their SRO authority to charge fees to their members to help offset their own regulatory expenses. Broker-dealers pay membership fees to exchanges, along with trading activity fees, testing fees, personnel fees and branch fees along with various regulatory fees. Broker-dealers are concerned that existing regulatory fees collected by exchanges become part of their baseline revenue and contribute to exchanges' regularly anticipated profit margins. Therefore, whenever new regulatory requirements are imposed, the exchanges pass on the new cost to their members as a new or increased regulatory fee rather than looking to existing regulatory fees. When this occurs, for-profit exchanges are effectively able to shift these ordinary overhead costs of their business onto the broker-dealers with whom they compete. Because of the role of exchanges as SROs, ordinary market dynamics that constrain pricing do not limit exchanges' ability to impose additional fees, so long as they are nominally regulatory in nature.

Two examples in particular demonstrate how the exchanges have used their fee authority to generate revenue from, or shift their own expenses to, broker-dealers through unreasonable regulatory fees:

- **Options Regulatory Fees**. The Options Regulatory Fee ("ORF") was introduced to replace registered representative fees as a regulatory funding mechanism. Since its inception, the ORF has been charged on all customer transactions that a firm executes, regardless of the exchange on which the transactions occur, not just on the exchange charging the ORF. The options exchanges have claimed that charging ORF for transactions on other exchanges prevents firms routing to exchanges solely to avoid regulatory fees. 14 of the 15 options exchanges now charge an ORF, however, accounting for more than 99% of total market share. Accordingly, there is no regulatory gap to justify an exchange charging an ORF based on a firm's trading on other exchanges.

- **CAT Fees**. The SEC has required the SROs to design and develop a CAT to enhance their regulatory capabilities. In turn, the SROs have attempted to use their fee authority to impose more than 75% of the

SROs' costs of building and operating the CAT to broker-dealers. Even the SEC has questioned this use of SRO fee authority as improper.[3]

Exchanges also benefit from their SRO status to insulate themselves from private liability for damages they cause, based on both a judicially-created doctrine of absolute immunity and limitations on liability codified in their rules. Courts have adopted a theory that an exchange has absolute immunity from liability for activities relating to their regulatory functions—as though it were a government entity—on the theory that an exchange steps into the shoes of the SEC. As exchanges have converted to for-profit enterprises, however, most, if not all, of their activities have become commercial in nature and should not be entitled to immunity.[4]

The SEC has also permitted each exchange to adopt rules (to which every exchange member has no choice but to agree) that codify additional limitations on the exchange's liability in any circumstance. These limits are set at levels that bear no relation to the substantial costs that an exchange could impose on the public. By law, an exchange and its members must comply with the exchange's rules. As a result, these rules legally prohibit an exchange from accepting greater liability, absent SEC approval.

2. The Solution

The SEC should conduct a comprehensive review of the self-regulatory status of exchanges, and ultimately propose potential amendments that Congress should adopt to the securities laws. This review should consider ways to overhaul the self-regulatory model to address the changed nature of exchanges, including:

- Eliminating the self-regulatory status of exchanges;
- Eliminating the applicability of common law immunity and rules-based limitations of liability enjoyed by exchanges; and

[3] *See* SEC, Joint Industry Plan, 82 Fed. Reg. 35005 (July 27, 2017) (link) (summarily abrogating the fee structure set by the SROs for the CAT NMS Plan on the basis that the SROs did not adequately justify why shifting 75% of the costs of the CAT to non-ATS operator industry members was not unfairly discriminatory or an undue burden on competition); *see also* SEC, Self-Regulatory Organizations, 82 Fed. Reg. 31656 (July 7, 2017) (link) (suspending the SRO fee structure for the CAT and instituting proceedings to determine whether to approve or disapprove the fee structure).

[4] The SEC has taken the very sensible view that absolute immunity should be narrowly applied only to SROs' member regulatory functions, such as proceedings to discipline members, not to other activities that merely relate to their market operations. *See* Brief of the SEC as Amicus Curiae (Nov. 28, 2016) (link); City of Providence v. Bats Global Markets, Inc. (2d Cir. No. 15-3057) (link).

- Centralizing self-regulatory functions in a single SRO.[5]

B. The Role and Functioning of SROs

1. The Problem (Implicates Core Principles (f) and (g))

Under the Exchange Act, registered broker-dealers generally must become a member of a registered national securities association—of which there is currently only one, FINRA. FINRA and each national securities exchange separately are obligated to enforce their members' compliance with their rules and the federal securities laws. Over time, this SRO model has resulted in inefficiencies due to overlap among the multiple SROs, as well as with the SEC. There have been attempts to address this in the past. FINRA—responsible for oversight of the activities of 3,800 broker-dealers and 632,740 individual brokers selling securities in the U.S.—itself was formed in 2007 to address inefficiency and duplication between the National Association of Securities Dealers and the New York Stock Exchange. The inefficiencies persist, however.

In addition, certain benefits of the SRO model, described in more detail below, have been lost because of the expansive undertakings by FINRA, as the primary regulator of the securities industry. FINRA has assumed many of the regulatory responsibilities of the securities exchanges and it (and not the SEC) has become the primary regulatory examiner of broker-dealers. With this dramatic expansion of its governing power, certain benefits of the SRO model, such as accessibility, transparency, and familiarity with securities industry operations, have diminished. The result is that many in the securities industry now view FINRA less as an SRO than as a government regulator that has subsumed many of the SEC's responsibilities. The self in self-regulation is no longer apparent to the financial sector.

1.1. *Accessibility and Transparency*

Being accessible and transparent are fundamental principles of self-regulation. An important method of accessibility is levering member

[5] *See* Committee on Capital Markets Regulation, U.S. Equity Market Structure Report (July 27, 2016) (link) ("The surveillance and enforcement regulatory responsibilities currently assigned to SROs should be centralized to the extent practicable. . . . Exchange legal immunity should only be available for exchange regulatory functions unique to exchanges that cannot be effectively centralized.")

expertise through, for instance, committees composed of members and other stakeholders that provide feedback on rule proposals, regulatory initiatives, and securities industry issues. Member firms should be able to readily lend their expertise and input to an SRO through the committee process, including on the rulemaking process, the development of regulatory initiatives, and resolution of securities industry issues.

Unfortunately, today's member committees are not sufficiently used or empowered in the functioning of SROs. SROs provide little information about how their various member committees are formed and participants selected, or often even their membership. Such a lack of information makes it difficult for members to effectively communicate their views and share their expertise. Further, even when committees do function, their role is often overly limited and it remains unclear what, if any, of their input is ultimately considered by the SRO.

In addition, the functioning of SROs is often unnecessarily opaque to their members, creating the perception that SROs are primarily more government regulators than self-regulators. For example, there is little transparency into the magnitude of regulatory and related fees collected by SROs and how those are spent on regulatory activities. The lack of transparency makes it difficult for members to evaluate whether the fees are reasonable.

1.2. ***Rulemaking and Regulatory Guidance***

Another fundamental principle of self-regulation is that regulation should be based on information and expertise from members gleaned through the formal rulemaking process or regulatory guidance consultations. To achieve this goal, engagement with, and accessibility to, member firms is crucial.

It is not always apparent, however, that SROs, while engaging members, are actually considering *and* integrating member input provided on regulatory matters. In particular, it is not always clear that a proposal's cost effectiveness, including consideration of alternative means of regulation, has been adequately considered, or that a rigorous economic impact assessment has been conducted based on input provided by key stakeholders.

Like other regulators, SROs also suffer from the practice known as regulation by enforcement, which is particularly contrary to the idea of self-regulation. Member firms often find themselves subject to SRO enforcement actions or examination findings that are based not on specific regulatory requirements developed through the formal rulemaking process, or even through official guidance, but rather on unofficial legal positions taken by SRO staff. For example, the SRO enforcement staff may extrapolate from a position taken in a settlement with a particular member and then apply it as an official interpretation to all members. In other cases, SRO enforcement staff base their interpretations on informal statements made in speeches, or on outdated guidance. Regulation by enforcement is extremely troublesome because it creates legal standards and imposes retroactive regulatory requirements and legal liability without conducting the formal rulemaking process or considering member expertise and input.

1.3. *Coordination with Other Regulators*

Another goal of the SRO model is efficiency, by bringing the regulator closer to the regulated parties. This efficiency is lost, however, where there are multiple SROs or SROs and governmental regulators that do not coordinate, resulting in duplication and overlap of regulatory efforts in rulemaking, examination and enforcement. Far too often, firms experience multiple enforcement actions by different regulators for the same conduct, and multiple examinations covering the same areas. This hampers the benefits of the SRO model and results in unfair piling on when it comes not only to fines, but also to enforcement defense costs.

1.4. *Focus on Mission*

The missions of SROs, broadly construed, is to provide investor protection and promote market integrity. However, SROs have often failed to maintain their focus on these goals. They expand their mission and allocate resources away from core investor protection and market integrity considerations such as sales practices, market manipulation, and customer harm, to examine whether members have the appropriate culture, or comply with all technical specifications of rules, the failure of which result in no harm to investors. Similarly, the penalties imposed by SROs often are not appropriately commensurate with the severity of the conduct, and do not take into consideration the extent to which the alleged conduct actually harmed investors or market integrity.

Unfortunately, the SEC generally has failed to constrain or properly focus the SROs. SEC oversight has traditionally been limited to considering the extent to which the SROs are appropriately examining their members, and evaluating SROs' formal rule proposals, rather than considering whether the SROs are focusing on core investor and market protection, consistent with their mission and the SRO model.

2. The Solution

As noted above, the SEC should conduct a comprehensive review of the regulatory structure of SROs. This review should also consider the self-regulatory model more broadly and amendments to SEC rules and recommendations to Congress for amendments to the Exchange Act to reinvigorate the *self*-regulatory nature of those entities that remain SROs. These amendments would seek to rebalance the activities and conduct of SROs to facilitate greater transparency, cooperation and coordination between SROs, member firms, and other regulators, particularly in the context of rulemaking, examination and enforcement, including:

- Ensuring that SRO committees are empowered with a greater role in the rulemaking process, development of regulatory initiatives, and resolution of securities industry issues by enhancing transparency and accountability concerning committee operations and deliberations.
- Requiring that SRO fee structures are transparent and align the level of fees charged to the actual cost of regulation.
- Requiring each SRO to adopt and publicly release a strategic plan to review and update its rules and guidance on a periodic basis, and consider the application of those rules to new industry practices, while prohibiting the adoption of new regulatory interpretations through enforcement or other unofficial means.
- For any enforcement action taken, requiring SROs to provide a rationale for the type, nature, and size of a sanction, including why it deviates from stated guidelines (if applicable).
- Requiring that SROs have in place policies for communication and coordination:
    - Before undertaking enforcement action to confirm with other SROs and government regulators (federal and state) that the activity would not be unnecessarily duplicative, and

    - Internally within the SRO, to ensure that all employees of the SRO adopt consistent messages and regulatory interpretations.

- Requiring that the SEC conduct closer oversight and examination of SROs to ensure that they are operating within their mission and consistent with the SRO model.

Chapter 10

DOL FIDUCIARY REGULATION

Relevant Agencies

- DOL
- SEC

Chapter 10 – DOL Fiduciary Regulation

The Employee Retirement Income Security Act of 1974 was enacted to protect employee benefit plan participants and their beneficiaries. Under authority granted by ERISA, the DOL promulgated its first regulation defining fiduciary investment advice with a five-part test in 1975. The test required that both the advisor and the plan mutually understood that fiduciary investment advice was being provided along with intent on the part of the plan to rely on that advice.

This Chapter describes SIFMA's concerns with the DOL's fiduciary regulation and proposed solutions for each.

A. The Problem (Implicates Core Principles (a), (c), (f) and (g))

In 2010, the DOL released a proposal to revise that five-part test with a solution in search of a problem. The proposed rule, however, was heavily criticized for being overbroad and was ultimately withdrawn in response to strong opposition from members of both parties of Congress and the financial services sector. In 2015, the DOL reproposed the rule and it was finalized in 2016, expanding the definition of an investment advice fiduciary. The new rule, which went into effect on June 9, 2017, more broadly defines who is a fiduciary by reason of giving investment advice, and brings into the scope of fiduciary advice most communications with individual retirement account owners and plan participants, unless an exception is met.

A presidential memorandum was issued in February 2017 directing the DOL to examine the rule to ensure that it does not adversely affect the ability of Americans to gain access to retirement information and financial advice. The study anticipated by the President's memorandum could very well lead to changes to the rule itself, so SIFMA has encouraged the DOL to delay all other aspects of the rule to a later date to allow this review to occur.

Since the final rule has come into place, SIFMA has already seen the negative impacts, as illustrated by a study conducted by Deloitte with SIFMA's member firms. SIFMA submitted this study by Deloitte to the DOL with some comments on the rule on August 9, 2017.

> "The [DOL] Fiduciary Rule dismisses disclosure as ineffective, in stark contrast to the Commission's long experience with the regulation of conflicts of interest."[1]
>
> *– Michael S. Piwowar, Commissioner, SEC*

The final rule created a complicated new structure for investment advice through the best interest contract prohibited transaction exemption which includes an unprecedented and burdensome list of operational and compensation-related conditions that firms and advisors must follow. The exemptions rely on private plaintiffs to enforce the rules, which significantly increases the likelihood of litigation. This will likely lead to even further increases to the costs of products and services to retirement investors to reflect the risk of, and expense associated with, defending potentially disruptive class actions that have become a hallmark in the 401(k) plan arena.

In addition, financial services and insurance are among the most comprehensively regulated industries in the United States. These regulations are rigorously enforced by the SEC and other government agencies, fifty state regulators and self-regulatory organizations such as FINRA. The DOL's fiduciary regulation fails to account for the many existing laws and regulations already governing financial advice and services.

B. The Solution

For over eight years and counting, SIFMA has strongly supported enhancing investor protections by establishing a heightened and more stringent broker-dealer best interest standard. The SEC and DOL should do the following, which can be accomplished without statutory change:

- The DOL should delay any further implementation of related aspects of the rule at least until a full study is completed as anticipated by the President's memorandum.
    - The SEC should establish a best-interest standard of conduct for broker-dealers that builds upon their existing regulatory structure and that applies when they are providing personalized investment advice about securities to retail customers.

[1] Michael S. Piwowar, SEC, Comment Letter in Response to the Department of Labor's Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (July 25, 2017) (link).

- The SEC should apply the best-interest standard across *all* securities recommendations made to retail customers in *all* broker-dealer accounts, not just to IRA accounts.

- The SEC should fit the best-interest standard within the existing and long-standing securities regulatory regime for broker-dealers.

- There should be a requirement to conduct rigorous examination, oversight and enforcement by the SEC, FINRA and state securities regulators.

■ If, after the study required by the President's memorandum, DOL adopts a final fiduciary regulation, SEC and DOL coordination should ensure that the conduct standards for broker-dealers remain high, consistent, and harmonized across all regulatory regimes.

GLOSSARY

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Term / Acronym	Definition
Advisers Act	Investment Advisers Act of 1940
ATS	Alternative Trading System
Banking organization	A bank holding company, bank, savings association or savings and loan holding company subject to the U.S. Basel III capital rules, or a U.S. bank holding company or intermediate holding company of a foreign banking organization
Basel Committee	Basel Committee on Banking Supervision
Basel III	The Basel III Framework for Capital Adequacy
CAT	Consolidated Audit Trail
CCAR	Comprehensive Capital Analysis and Review
CCP	Central Counterparty
CFTC	Commodity Futures Trading Commission
CLO	Collateralized Loan Obligations
CMDA	Competing Market Data Aggregator
Core Principles	Core Principles for Regulating the United States Financial System, set forth in Presidential Executive Order from February 3, 2017
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DOL	U.S. Department of Labor
EMMA	MSRB's Electronic Municipal Market Access
ERISA	The Employee Retirement Income Security Act of 1974
eSLR	Enhanced Supplementary Leverage Ratio
EU	The European Union
Exchange Act	The Securities Exchange Act of 1934
Fannie Mae	Federal National Mortgage Association
FCA	Farm Credit Administration
FDIA	The Federal Deposit Insurance Act of 1950
FDIC	Federal Deposit Insurance Corporation

Term / Acronym	Definition
Federal Reserve	The Board of Governors of the Federal Reserve System
FHFA	Federal Housing Finance Agency
FICC	Fixed Income Clearing Corporation
FINRA	Financial Industry Regulatory Authority
FOCUS	Financial and Operational Combined Uniform Single
Freddie Mac	Federal Home Loan Mortgage Corporation
G20	An international forum for the governments and central bank governors from 20 major economies
GAO	U.S. Government Accountability Office
GDP	Gross Domestic Product
GFMA	The Global Financial Markets Association
GSE	Government-Sponsored Entity
G-SIB	Global Systemically Important Bank
HQLA	High-Quality Liquid Assets
HUD	U.S. Department of Housing and Urban Development
IPO	Initial Public Offering
IPO Task Force	Task force of venture capitalists, entrepreneurs, securities attorneys, academicians, public investors and investment bankers that arose independently from working group conversations at Treasury's Access to Capital Conference in March 2011
IRA	Individual Retirement Account
IRS	Internal Revenue Service
ISDA	The International Swaps and Derivatives Association
JOBS Act	Jumpstart Our Business Startups Act of 2012
LCR	Liquidity Coverage Ratio

Term / Acronym	Definition
Level 1	Category of assets including as excess reserves held at a Federal Reserve Bank, U.S. government securities and the sovereign debt of certain foreign government entities assigned a 0% risk weight under the U.S. Basel III standardized approach that are counted as HQLA without any haircuts or quantitative caps
Level 2A	Category of assets including claims on U.S. GSE's and certain sovereign entities that are assigned a 20% risk weight under the U.S. Basel III standardized approach that can be counted as HQLA, subject to haircuts and caps
Level 2B	Category of assets such as corporate bonds that, under certain circumstances, can be counted as HQLA, subject to haircuts and caps more stringent than those for Level 2A assets
Maloney Act	The Maloney Act of 1938
May White Paper	SIFMA's "Rebalancing the Financial Regulatory Landscape," submitted to Treasury in May 2017
MiFID II	The EU's Markets in Financial Instruments Directive, effective January 3, 2018
MSRB	Municipal Securities Rulemaking Board
NASDAQ	The Nasdaq Stock Market
NMS	National Market System
NMS Plan	A plan jointly entered into among SROs in connection with the planning, development, operation or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof, or the development and implementation of procedures and/or facilities designed to achieve compliance by SROs and their members with any section of Regulation NMS and the rules promulgated under Section 11A of the Exchange Act
NMS Stocks	Stocks listed on a national securities exchange
OATS	Order Audit Trail System
OCC	Office of the Comptroller of the Currency

Term / Acronym	Definition
OPR	Order Protection Rule, Rule 611 of Regulation NMS
ORF	Options Regulatory Fee
OS	Official Statement
OTC	Over-the-Counter
PTF	Principal Trading Firm
QE	Quantitative Easing
QIB	Qualified Institutional Buyer
Regulation AB II	The SEC's Regulation AB II
Regulation ATS	The SEC's Regulation ATS
Regulation D	The SEC's Regulation D
Regulation NMS	The SEC's Regulation NMS
Regulation SCI	The SEC's Regulation SCI
Regulation SHO	The SEC's Regulation SHO
RMBS	Residential Mortgage-Backed Securities
RPA	Research Payment Account
Rule 144A	The SEC's Rule 144A under the Securities Act
S.828	115th Congress Senate bill to amend the Federal Deposit Insurance Act to require the appropriate Federal banking agencies to treat certain municipal obligations as Level 2B liquid assets, and for other purposes
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
SEC	Securities and Exchange Commission
Securities Act	The Securities Act of 1933
Securities Acts Amendments of 1975	Securities Acts Amendments of 1975, amending the Securities Act and Exchange Act
Securities Offering Reform	The SEC's Securities Offering Reform rules of 2005
SEF	Swap Execution Facility
SIP	Securities Information Processor
SLR	Supplementary Leverage Ratio
SMMP	Sophisticated Municipal Market Professionals

Term / Acronym	Definition
SOX 404	Section 404 of the Sarbanes-Oxley Act
SRO	Self-Regulatory Organization
SSFA	Simplified Supervisory Formula Approach
Sub-Penny Rule	Rule 612 of Regulation NMS
TBA	To Be Announced Trade
Title VII	Title VII of the Dodd-Frank Act
Tower Amendment	Section 15B(d) of the Exchange Act
TRACE	Trade Reporting and Compliance Engine
Treasury	U.S. Department of the Treasury
Treasury Report	The U.S. Department of the Treasury's report, "A Financial System that Creates Economic Opportunities: Banks and Credit Unions," of June 12, 2017
TRF	Trade Reporting Facility
TRID	TILA-RESPA Integrated Disclosures Rule, combining certain disclosures required by the Truth in Lending Act of 1968, or TILA, and Real Estate Settlement Procedures Act of 1974, or RESPA
VaR	Value at Risk
Volcker Rule	A rule issued by the CFTC, FDIC, Federal Reserve, OCC and SEC implementing Section 13 of the Bank Holding Company Act of 1956, which was added in 2010 by Section 619 of the Dodd-Frank Act
WKSI	Well-Known Seasoned Issuer