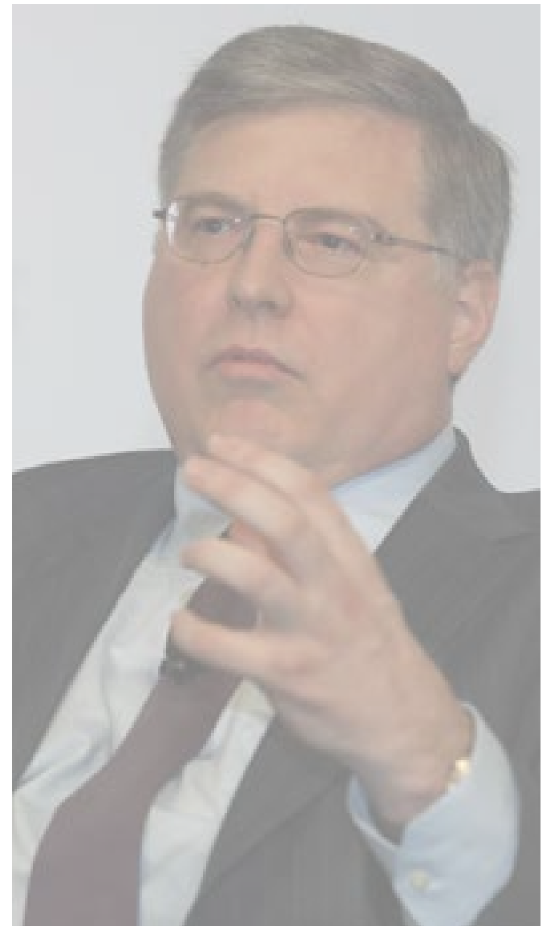

SIFMA Insights

C&L Annual Seminar Debrief

March 28, 2018

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SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit: http://www.sifma.org.

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Executive Summary

Recently, we hosted the 50th C&L Annual Seminar. With three days of presentations, events and meetings, and around 2,000 people in attendance, we gained insights into top-of-mind topics for market participants.

Carrying on a main theme from our co-hosted (with the Futures Industry Association) Asset Management Derivatives Forum in February, the industry remains focused on recalibrating regulations, both within our own borders and on the international stage. The goal is not to start the regulatory process over, but rather to ensure economic incentives and costs are calculatable and capital markets can run efficiently. Inside this note, we recap what was seen and heard, including: regulation harmonization and reformation, market structure updates and other hot topics.

Regulation Harmonization and Reformation

SEC Chairman Jay Clayton set the scene nicely to assist market participants in assessing regulatory reform. He indicated the Treasury reports point to the path forward, informing the agenda for the federal financial regulator community. Chairman Clayton indicated the need to simplify regulations and prevent regulator overlap by working with others and sharing information. This should make it easier to coordinate cross-jurisdictional policy. A few examples of regulatory overlap in need of reform include:

- **Volcker Rule** - This regulation has five regulators interpreting and implementing it, making it operationally challenging for banks. Chairman Clayton noted he was optimistic that the SEC and other regulators can move forward to simplify this. Of note, the House Financial Services Committee recently reported a bill to designate the Federal Reserve Board as the lead regulator for the Volcker Rule, with all rulemaking and interpretive authority.
- **SEC's Best Interest Standard** - An individual who has a 401(k) account, buys an annuity and holds a brokerage account with stocks in it will have a financial relationship with five regulators (plus a bank regulator if interacting with a bank, and the state AG). The SEC believes this is too many standards to comply with and is looking to simplify regulations for investors. Chairman Clayton indicated we should see something "soon" on this standard.

We also heard FINRA President and CEO Robert Cook discuss the need for regulators to streamline and simplify their own organizations. For example, firms have indicated that often have multiple divisions within FINRA request the same information. Through FINRA 360, now a year old, this regulator is looking to create consistent processes and eliminate redundancies (for example, consolidating its two enforcement divisions into one).

Perhaps a more complicated task will be harmonizing international regulations, and market participants need harmonization since financial markets are global. It was noted at the conference that while international groups are very important, U.S. capital markets are quite different to other regions and countries. U.S. regulators need to think about how to adapt international standards in manners that keep our capital markets running efficiently. There were around 300 recommendations on reform in the Treasury reports, with roughly two-thirds of them on prudential regulations. One panel discussed a path to move forward on this, beginning with Fed Chairman Jerome Powell's three principles:

1. **Efficiency** via a cost-benefit assessment;
2. **Transparency** through appropriate notifications and comment periods;
3. **Simplicity**; and
4. The panel added a fourth principle in **coherency** of regulations. For example, there are over 24 requirements just on capital and loss absorbency for banks, plus stress tests, TLAC, the SLR (which was meant to be a backstop but has created significant unintended consequences) and more.

The current regulatory regime has redundant and overlapping rules and exams, with multiple regulators adopting the same rule but wIth different interpretations of how to implement it. For example, market participants feel U.S. gold-plating of international standards undercuts the process of global harmonization. They also want to avoid international ring fencing, as capital then becomes trapped in the system, which could negatively impact recovery and resolution plans.

Yet, there was some optimism at our conference on the future of the regulatory environment. The long time frame for Basel IV - finalized December 2017, to be implemented by 2020 - provides a lengthy window to have international regulators work together to harmonize rules. The February decision by the U.S. Treasury Department to maintain the Orderly Liquidation Authority (OLA) process reaffirmed Dodd Frank Act Title II, which is embedded in international standards. Finally, the Senate recently passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (commonly known as the Crapo bill). This legislation is meant to provide regulatory relief for regional and community banks, which is viewed as critical to spur U.S. bank lending. Participants at our conference applauded this move, indicating it is important to differentiate regulations by type of bank as community banks differ significantly from large, multi-national banks.

Market Structure Updates

For those of us who enjoy a good market structure conversation, there was plenty to talk about at our recent conference. Some highlights of ongoing market structure debates include:

- **Best Execution** – In cash equities, best execution (best ex) has become less focused on meeting the national best bid and offer (NBBO), as regulators like FINRA have found firms are rarely outside of this requirement unless experiencing systems issues. Instead, market participants look to Price Improvement Information, or PII (not to be confused with the PII associated with the CAT!) such as: effective spread/ quote spread, amount of price improvement, number of orders price improved and other metrices that aim to show proof of high-quality execution. Panelists indicated orders on the fixed income side – which differs significantly from equities and can vary greatly depending on product – can be handled and executed differently and therefore reviewed less frequently than equities, suggested at least once per quarter.

  Payment for order flow (PFOF) was also discussed, with FINRA President and CEO Cook commenting that, while not illegal, they want to know how it benefits the customer, not just the firm. Market participants also want to ensure there is no conflict of interest with PFOF.

- **CAT** – The journey began in 2010, when the SEC proposed a rule to require the development of the Consolidated Audit Trail (CAT), a need which was emphasized after the May 2010 Flash Crash. The rule was finalized in July 2012, with Rule 613 of Reg NMS, which required a plan be developed to build the CAT. The self-regulatory organizations (SROs) then spent years developing operational policies and procedures, funding and governance models and implementation standards. The CAT Plan was approved on November 15, 2016, including the timeline as detailed in Rule 613.

  Based on the Rule 613 timeline, SROs should have begun reporting in November 2017, with large broker-dealers then required to comply by November 2018. Last fall, when market participants saw the initial draft version of the technical specifications (specs) for the CAT, concerns surfaced around how firms could comply with something whose specs have not yet been finalized. In light of this, and other concerns, the SROs did not begin reporting last November. However, the SEC declined to postpone the deadline for broker-dealers, meaning the November 2018 deadline is still in effect. The industry is very concerned about meeting regulatory requirements given there is no CAT and no completed specs. They deem it unrealistic to meet the November deadline.

  SIFMA and other market participants have identified several problems with the CAT, including: (a) the current plan requires collection of personally identifiable information (PII) which will be kept in a central place accessible by all SROs, creating concerns over the security of this data; (b) the plan calls for the elimination of duplicative systems (a prompt sunsetting of old systems), yet firms fear they could be in parallel run for years; and (c) SROs established the funding model at 25% SROs versus 75% broker-dealers, leaving these firms unhappy at having to shoulder the brunt of the costs. There is currently a working group in place to advise the SROs on the technical specs, and SIFMA has been called upon for input on the PII issue. One panelist indicated SROs are taking all the feedback under advice.

  SEC Chairman Clayton indicated he is "not happy and we need to fix it", further noting he is "confident the PII issue can be solved" by taking in 98% of what they need to monitor markets without taking in PII. Yet, the journey continues, with one panelist asking, "What is going to be completed first, the renovations at LaGuardia airport or the CAT"?

- **Market Data** – Market participants remain concerned about the rising costs of market data on U.S. cash equities, which are controlled by the SROs and security information processor (SIP) board without market input. There are several lawsuits outstanding regarding the costs of market data. Patomak Partners has asked for requirements increasing transparency into exchanges' activities related to the SIP, what their costs are and how they set fees, etc. The Healthy Markets Association has argued the SIP is a public feed and should, therefore, not be used to generate profit.

  In short, market participants expect challenges to market data pricing as related to the SIP.

- **SRO Reform** – Panelists noted that while market structure has evolved significantly since the 1970s, the rules for SROs remain the same. These rules were set when the SROs were owned by broker-dealers and other market participants, who also sat on the boards of these exchanges. Exchanges are now private, for-profit entities reporting to their shareholders. Yet, they maintain authority for their own and other stock exchanges. Market participants have questioned whether an SRO should maintain market-wide authority? Concerns also exist over SRO immunity from liability. Exchanges have a market function via its various exchanges, but also a regulatory function via its SRO. Should it be protected from all private liability? Some market participants say no. There is the City of Providence lawsuit, in which the court ruled that immunity covers regulatory activities, not an exchange's commercial activities (proprietary data feeds, co-location services, complex order types, etc.).

- **Tick Size Pilot** – The tick size pilot, which began in October 2016, added nickel increment trades for small cap stocks (market cap less than $3 billion, less than 1 million shares ADV and stock prices under $2). The pilot ends in October 2018, and market participants do not expect an extension. SEC Chairman Clayton further noted the tick size pilot is "getting there with the information they hoped to get out of it," i.e. it does not need to be extended. While we should see data in April 2018, market participants do not believe the results will show much impact on liquidity. However, they do note it is important to keep trying to find the right incentives for market makers to provide liquidity for small cap companies.

- **Transaction Fee Pilot** – Last week, the SEC released its proposal on a transaction fee pilot (commonly referred to as the access fee pilot), intended to gather data on the impact of transaction fees and rebates on order routing behavior and execution quality. Reg NMS set a $0.30 per 100 share cap on protected quotes, and exchanges charge essentially full price to the takers of liquidity and provide rebates to those who provide liquidity (known as the maker-taker model; vice versa is the taker-maker model, where the liquidity taker is paid for facilitating the trade). There will be three buckets in the pilot, with 1,000 stocks in each bucket: (1) $0.15 fee cap; (2) $0.05 fee cap; and (3) no rebates. The pilot will be for stocks trading over $2, and there will be no overlap with stocks already in the tick size pilot. There will be a 60-day comment period until around Memorial Day. This is a two-year pilot with an automatic one-year sunset. SEC Chairman Clayton noted he believes they will gather all of the data they need within one year.

Other Hot Topics

- **DOL Fiduciary Rule: What Now?** - The 5th Circuit's Court of Appeals decision to vacate the DOL fiduciary rule right before our conference set up panelists with lots to discuss. The DOL can appeal to the 5th Circuit, or they can take the appeal to the Supreme Court. If there is no appeal, the rule goes away on May 7. The DOL has not yet commented on the decision.

  However, this is not the end of the conversation, as there are activities from other regulators and groups. Panelists expect the SEC to move quickly on its best interest standard with some suggesting it could be introduced by the end of the second quarter. This is expected to include additional disclosure, along with language clarifying standards of conduct for advisors. The Certified Financial Planning Board is proposing to expand fiduciary duty beyond financial planning, looking to have their rule finalized by the first quarter of next year. Panelists believe this is an attempt to get ahead of the SEC, which will have to provide a notice and comment period. Finally, panelists expect more activity from state legislators.

  While SIFMA and other market participants are pleased with the 5th Circuit's decision, compliance teams of many market participants had already adopted procedures to comply with the rule. Many firms have already changed contract language and updated policies and procedures. These teams will now need to go back to review and potentially make further changes.

- **Latest Developments Affecting Research** - With MiFID II in full effect, firms continue to work through issues around payments for research. MiFID II seeks to increase transparency and indicate best execution by unbundling payments for execution and research, requiring firms to set an explicit price for research. As the buy side historically paid with commissions, and many are now paying through they're P&L, it is not surprising that some firms have asked for discount pricing or free trials. Panelists believe discount pricing can be managed within the rules and could be appropriate for super users of research, with some banks offering new consumers of their research 90-day free trials. (Free trials are not permitted for existing users under MiFID II.) Outside of pricing, challenges exist on the operations side. Firms need to have controls in place to ensure they are not blasting research to clients who have declined to receive it.

  Another topic was on hard dollar payments for research. In the U.S., a firm must register their research activities as an investment adviser (IA) to receive hard dollar payments. The SEC granted firms a 30-month no-action on this rule to help firms navigate through MiFID II rules. Regardless, a few firms decided to register their research department as an IA. This requires separate policies and procedures for research analysts, and firms must be careful to not provide clients with tailored advice (this is in violation of U.S. regulations, if the broker-dealer performs principal trading). Similar to payment strategies, firms appear to be taking varied approaches on their operational structures, a balance of complying with MiFID II and continuing to serve clients.

Appendix: Terms to Know

Basel IV	Changes agreed to the Basel Accords
DFA	Dodd-Frank Wall Street Reform & Consumer Protection Act
MiFID II	Markets in Financial Instruments Directive (revised)
OLA	Orderly Liquidation Authority
SLR	Supplemental Leverage Ratio
TLAC	Total Loss-Absorbing Capacity

DOL	Department of Labor
Fed	Federal Reserve System
FINRA	Financial Industry Regulatory Authority
SEC	Securities and Exchange Commission

AG	Attorney General
C&L	Compliance & Legal
IA	Investment Advisor

ADV	Average Daily Trading Volume
Bese Ex	Best Execution (in trading)
CAT	Consolidated Audit Trail
NBBO	National Best Bid and Offer
PFOF	Payment For Order Flow
PII	Price Improvement Information (associated with best ex)
PII	Personally Identifiable Information (associated with CAT)
Reg NMS	Regulation National Market System
SIP	Security Information Processor
SRO	Self-Regulatory Organization

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