SIFMA Insights:

C&L Annual Seminar Debrief

April 2019

Key Takeaways

Recently, SIFMA hosted its C&L Annual Seminar. With two and a half days of presentations and events and over 2,000 attendees, we gained insights into top-of-mind topics for market participants. Inside this note, we recap just some of what was seen and heard, including: Markets Musings; Regulatory Recap; and Fintech's Future.

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behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. 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.

Markets Musings

U.S. capital markets are the largest and among the deepest, most liquid and most efficient markets in the world; they are the bedrock of our nation's economy. Efficient and resilient market structure is key to sustaining investor confidence and participation in markets. As such, we highlight key capital markets topics heard at the conference:

Equities

- Equity Market Structure – SEC Chairman Jay Clayton said, "In the last twenty years there have been substantial improvements for the long-term investor, but technological advances and globalization of markets have changed how people trade." What does this mean for proposals to change EMS? Clayton noted the comment files are still open from last year's round tables on market data and thinly-traded securities, and he said that the Commission has received both "complaints and constructive ideas". On market data in particular, he noted there are different data products with different speeds in this "trillions of dollars market" and they should review current practices, with a focus on the long-term investor.

  SEC Director of the Division of Trading and Markets Brett Redfearn also noted that their focus will remain on topics from the three roundtables: thinly traded securities; market data and access; and retail investor fraud. While the U.S. has a one-size-fits-all market structure, some stocks trade only 1-10 timer per day (versus millions for others) yet have the same rules. Redfearn indicated they are open to hearing about any innovations to address this issue. On market data, he noted they are asking questions about core data – should they increase the speed of the SIP or add more content (depth of book)? Should there be increased transparency on SRO data feeds? Should they review governance of the SIP by SROs (govern the SIP while selling competitive data offerings via proprietary feeds)? His main point was that broker-dealers need data for best execution (best ex) and markets need an evolving structure around market data.

- Access Fee Pilot – Do financial incentives lead to improved liquidity? The SEC has approved the access fee pilot to assess just this question. This will not be a simple operational lift. Market participants will have to build out technologies and reporting capabilities to enact the pilot, almost as if it were a new rule rather than a two-year test case. The preference by many market participants is for the SEC to judiciously implement pilots of this breadth/depth and use other means to test whether incentives lead to increased liquidity.[1]

- Best Ex – What is best ex in today's markets? Best ex is the best price under the circumstances around that trade. It is a process, not something that can be dictated by Reg NMS. Trading desks look at a multitude of different metrics, and they also account for order routing specifics. Clients – whether via the type of algo they have chosen for the trade or by directive to their broker-dealer – determine how they want their trade routed. Firms take all of these factors into account when assessing best ex, not just price.

[1] Of note, the SEC has granted a stay of the transaction fee pilot pending a decision by the court of appeals on the legal challenge to the pilot filed by Cboe, Nasdaq, and NYSE.

- CAT – Chairman Clayton indicated "they are concerned as anyone" about the collection and protection of PII and "they will get to a responsible place." He noted the current design of the CAT is to have two separate databases – one for trading data and the other to house customer information, including PII. The trading database would use unique customer IDs, rather than actual customer information. As to timing, a FINRA representative noted it is a "high priority to get the CAT up and running," but it will take longer to get to the initial reporting phase (for large and small firms), as they just picked up the mandate to operate the CAT.

- Market Data – In order to prove best ex, firms need market data. Market participants indicate meeting commercial best ex requirements cannot be done through only the SIP. Firms need to use proprietary (prop) feeds to get depth of book – they need the fastest, most detailed market data to prove best ex. Many market participants indicate the SIP itself and the governance around the SIP need improvements, although latency (or the delay) to prop feeds has decreased over the last few years. But can it ever be truly substitute for prop feeds? Since the SIP aggregates data feeds, there will always be a delay, and speed matters in trading, even if the difference in speeds is tiny.

- Reg ATS-N – Twenty years after the first ATS regulation, the SEC has overhauled it and adopted amendments to enhance operational transparency and regulatory oversight of ATSs. This includes filing detailed public disclosures on Form ATS-N. While market participants respect the objectives, the result is a cumbersome document which could have the unintended consequence of decreasing transparency by becoming unwieldly. Perhaps perfect transparency should not be the goal, rather a balance of increased transparency with reporting forms which may not be 100% comparable across all ATSs.

Fixed Income

- Fixed Income Market Structure – The SEC's Director of the Division of Trading and Markets noted the agency's focus on fixed income market structure will continue to be around the FIMSAC's five recommendations: pilot program for block-size trades in corporate bonds; review the oversight framework of electronic trading platforms; ETP classification scheme; investor education and data on ETFs; and establish a new issue reference data service for corporate bonds.

- Best Ex – Panelists noted best ex is becoming a priority for the SEC and FINRA. The SEC standard is that firms should seek to obtain for customer orders the most favorable terms reasonably available under the circumstances. Yet, price is not the only factor. Firms should consider order size, execution speed, trading characteristics of the security, availability of accurate information on competitive markets, availability of access to competing markets and cost of access as well. What is important is that best ex is viewed from the customer perspective, and price is not always the key factor to the customer.

- LIBOR Transition – The development of sufficient liquidity in SOFR futures and swaps markets is essential to a smooth transition away from LIBOR, and the build out of SOFR futures contracts is "one of CME's most successful futures launches ever". CME has traded over 2.8 million SOFR futures contracts since the launch in May 2018. YTD, SOFR futures ADV was over 29,000 contracts ($49B notional), and volumes increased in March 2019 to over 42,000 ADV ($73B notional). March saw, new records – 82,727 contracts traded ($130B notional) on 3/22/19; 151,444 OI ($479B notional) on 3/20/19.

	SOFR	Eurodollar	Fed Funds
Launch Date	5/7/18	12/9/81	10/3/98
AD OI First 200 Days	38,431	8,084	2,710
OI on Day 200	132,072	17,803	1,823
ADV First 200 Days	9,250	1,042	294
Total Volume First 200 Days	1,850,054	208,399	58,804
Latest Month ADV at Day 200 (Days 180-200)	22,336	1,907	237

Source: CME Group

Note: AD = average daily; ADV = average daily volume; OI = open interest, an indicator of future volumes represented by the total number of long/short futures contracts that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery.

- TMPG – The TMPG provides best practice recommendations for conduct in the UST, agency and agency MBS markets. For example, they put out recommendations last year on information handling, i.e. the use and protection (and more) of confidential information. While, the recommendations are guidelines, not rules or regulations, panelists indicated clients are now asking them to confirm that they adhere to the practices. Additionally, the Fed requires primary dealers to attest annually that they are following the practices. The adherence by these major market participants creates an expectation throughout the market that participants will adhere.

Reg BI: Raising the Bar on Investor Protection While Preserving Choice

"One thing I don't think has gotten through in discussions about Reg BI is where is disclosure required and where is mitigation or elimination of conflict required."

--Kenneth E. Bentsen, Jr.; President and CEO, SIFMA

Ensuring investors are protected in their dealings with financial professionals is a universal goal. Regulation Best Interest, the SEC proposed best-interest standard goes a long way to accomplishing that goal by clearly raising the bar on investor protection, while preserving choice.

By any measure, the SEC's proposed standard materially exceeds the existing FINRA suitability standard to the benefit and for the protection of retail customers. Specifically, it enhances broker-dealer conduct standards by adding new and heightened care, disclosure, and conflicts-of-interest obligations. For example, under Reg BI, recommendations must not only be suitable but in the retail customer's "best interest." This means broker-dealers cannot put their interests ahead of the interests of the retail customer. In addition, broker-dealers must more heavily weigh the cost of a security or strategy in determining whether to recommend the security or strategy.

Coupled with the far more frequent regulatory exam rate for broker-dealers, SEC and FINRA enforcement and oversight, and the private right of action afforded to retail customers through FINRA arbitration, the new SEC proposal represents a true best-interest standard with real teeth. The best way to protect investors and avoid investor confusion is to allow the SEC – the primary federal regulatory agency – to finalize the new nationwide standard.

Please see more details on Reg BI here: https://www.sifma.org/resources/news/reg-bi-raising-the-bar-while-preserving-choice/

Regulatory Recap

After global financial markets adopted an unprecedented volume of new regulations since the crisis, various policymakers acknowledge some changes may have gone too far, adversely impacting market efficiency and liquidity at the expense of economic growth. As such, we highlight key regulatory topics heard at the conference:

- SA-CCR – The industry supports the shift from CEM to SA-CCR. However, as a main concern under SA-CCR is the inability of firms to offset IM in the PFE calculation, panelists discussed potential changes on this front. The FSB has acknowledged that the leverage ratio has detrimentally impacted client clearing firms, and they mean to reexamine adequate incentives to clear derivatives. The Basel Committee has recognized the issue and might look to change it but needs "strong" evidence to do so. We expect them to review the alpha factor in 2020. The U.S. is in the odd position that a markets regulator actually sent in a comment letter to a prudential regulator explaining the negative implications of SA-CCR on market efficiency. We will continue to press these points in subsequent rule makings which incorporate SA-CCR.
- What's Next for Banks – On the horizon for bank regulations, stress testing is becoming the binding constraint for many financial institutions, particularly because of the GMS. Panelists indicated there could be further capital charges to absorb, such as the FRTB, which essentially increases capital held against the trading book.
- Fragmentation – On regulatory fragmentation, a panelist indicated "the world is getting more complicated rather than less so." EU regulations, such as MiFID II and GDPR, have creeped into the U.S., causing significant operating and various compliance issues. Global financial institutions have to deal with prudential and market regulations across multiple agencies and jurisdictions. In the U.S., they must deal with federal versus state laws, in addition to multiple global regulators for the larger firms. Firms indicate they have multiple and frequently overlapping regulatory exams – which is costly from both a monetary and employee time perspective – and they hope regulators will increase coordination efforts.

"WHILE THE SEC'S OCTOBER 2017 NO-ACTION RELIEF WAS CRITICAL TO MINIMIZE DISRUPTION FROM THE MIFID II DIRECTIVE, SIFMA URGES THE SEC TO TAKE ACTION NOW TO PROVIDE PERMANENT AND BROADER RELIEF. ALLOWING BROKER-DEALERS TO CHARGE SEPARATELY OR RECEIVE CASH PAYMENTS FOR RESEARCH PROVIDED TO BOTH INVESTMENT MANAGERS AND INSTITUTIONAL INVESTORS WITHOUT BEING SUBJECT TO THE ADVISERS ACT CREATES AN EVEN PLAYING FIELD FOR INVESTMENT MANAGERS, INSTITUTIONAL INVESTORS, AND THEIR UNDERLYING CLIENTS AND INVESTORS, WHILE ENSURING EXISTING PRESSURES ON RESEARCH ARE NOT EXACERBATED." --KENNETH E. BENTSEN, JR.; PRESIDENT AND CEO, SIFMA

- Volcker – The proposal for Volcker 2.0 was a significant start towards reform but some elements of the proposal raised concerns with market participants. The accounting prong, which replaced the short-term intent prong, actually brings more transactions into scope, particularly those which are clearly not short-term, speculative transactions. For example, Treasury departments invest in bonds and record them as available for sale and under the accounting prong as proposed these long-term holdings would be subject to the Volcker rule even though the firm may plan to hold the position for years. Firms remain concerned with the continued uncertainty around the direction key elements of the proposal will take and have noted the lack of specific proposals in Volcker 2.0 for the covered funds portions of the rule. While firms spent four years building systems and procedures to comply with the original rule, changes will be required for reporting and compliance regimes although the timing of a final rule remains unclear. Additionally, the proposal does nothing to address the five agency problem, meaning regulatory guidance and compliance remains burdensome and complex.

Fintech's Future

The industry continues to analyze how fintech solutions can increase efficiencies in the back office, serve clients, manage risk or meet regulatory reporting requirements. While much of a firm's technology spend is on ways to increase operational efficiencies and decrease costs (for the firms and also their customers), many firms also sponsor investments for fintech innovations. As such, we highlight key fintech topics heard at the conference:

- Regulator Commentary – Several regulators spoke about fintech on their panels. A FINRA representative said some fintechs and other new comers to financial services have expressed concerns that it is not easy to work new ideas through an existing regulatory framework. In light of this FINRA, is considering opening an office of innovation to help innovators learn how to navigate the agency's rules and procedures. On sandboxes, the FINRA rep noted they received comments from market participants that they did not need a formal sandbox, rather a path guiding firms through FINRA's processes.

- Digital Advice – Panelists began by detailing the path of innovation in the digital advice space: 2010-2014, the startup/disruptor phase; 2015-2016, the incumbent response phase; 2017-2018, the broad adoption (by clients/investors) phase; and 2019+, the next wave. What will be the next wave of innovation and differentiation? Noting the important role of the financial advisor, hybrid models was the focus of the discussion. The old model was an advisor constantly on the phone speaking with clients, a phone glued to his/her hand. Then robo platforms – interestingly, a panelist pointed out a platform is not robo if you do not have an algo picking the stocks, i.e. if you have human intervention around stock picking – were originally designed as if you never had to speak to a human. Now firms of all types are looking at hybrid platforms, which can be more sophisticated in asset allocation and offer access to advisors to help clients ensure they are making the right investment decisions to meet their financial goals.

- Cyber – Panelists indicated cyber security is no longer just about bad actors stealing data that can be quickly and easily monetized, the scope has expanded. Bad actors are now also looking to disrupt businesses via malware that corrupts critical data, and players involved in the Western financial infrastructure remain key targets. So how does a firm bake in security? Firms cannot just add security measures in later, instead firms must integrate all business operations with security from the beginning. Otherwise firms leave doors open for bad actors to get in. Panelists noted security practitioners have five critical assets to protect – information, data, facilities, personnel and cyber – and firms' security strategies should integrate all pieces to provide the best defense.

Appendix: Terms to Know

Fed	Federal Reserve System
FINRA	Financial Industry Regulatory Authority
SEC	Securities and Exchange Commission
FSB	Financial Stability Board

EMS	Equity Market Structure
Algo	Algorithm (algorithmic trading)
ATS	Alternative Trading System
Best Ex	Best Execution
CAT	Consolidated Audit Trail
PII	Personally Identifiable Information
Reg ATS-N	Regulation of NMS Stock Alternative Trading Systems
Reg NMS	Regulation National Market System
SIP	Security Information Processor (aggregates all exchange's best quotes into one feed)
SRO	Self Regulatory Organization

FIMS	Fixed Income Market Structure
FIMSAC	Fixed Income Market Structure Advisory Committee
ETP	Exchange-Traded Product
ETF	Exchange-Traded Fund
ETN	Exchange-Traded Note
ETC	Exchange-Traded Commodity
ETI	Exchange-Traded Instrument
LIBOR	London Interbank Offered Rate
SOFR	Secured Overnight Financing Rate
ADV	Average Daily Trading Volume
OI	Open Interest
TMPG	Treasury Market Practices Group
UST	U.S. Treasury Securities
MBS	Mortgage-Backed Security
Agency	Federal Agency Securities (FNMA, FHLMC, FAMC, FHLB, FCS, TVA, etc.)

CEM	Current Exposure Method
FRTB	Fundamental Review of the Trading Book
GDPR	General Data Protection Regulation
GMS	Global Market Shock
IM	Initial Margin
MiFID II	Markets in Financial Instruments Directive (revised)
PFE	Potential Future Exposure
SA-CCR	Standardised Approach for measuring Counterparty Credit Risk
SCB	Stress Capital Buffer
Volcker	The Volcker Rule

Fintech	Financial Technology
Reg BI	Regulation Best Interest

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