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Broker-Dealers: Supervising Personnel Working Remotely in a Pandemic

March 24, 2020

As COVID-19 has spread across the globe, governments and businesses have implemented escalating policies designed to slow the spread of the virus. Many U.S. states, such as California, New York and Illinois, have issued stay-at-home orders, and the federal government has recommended that everyone should take steps to curtail social interactions. Consistent with these orders and guidance, many financial institutions, including broker-dealers, have temporarily closed their offices or otherwise activated remote or telework policies pursuant to their business continuity plans. In light of these operational changes and the quickly changing macro environment, firms should assess whether their supervisory policies and procedures for associated persons continue to comply with the Securities Exchange Act of 1934 (Exchange Act) and Financial Industry Regulatory Authority (FINRA) rules and are consistent with evolving regulatory guidance.

This notice provides a concise summary of a broker-dealer's supervisory obligations and regulatory guidance regarding supervision during a pandemic. As we explain, firms should confirm that their systems of supervision appropriately take into account how the firm is conducting business while its employees work remotely.

The Exchange Act and FINRA rules require broker-dealers to establish and maintain supervisory systems that are reasonably designed to promote compliance with the federal securities laws and FINRA rules. With certain exceptions, broker-dealers are generally provided with flexibility to design and implement a supervisory system appropriately tailored to its particular business and the environment in which it operates. During a pandemic, the securities regulators understand that brokerage firms may implement large-scale teleworking by associated persons. The Securities and Exchange Commission (SEC) and FINRA recognize that firms are structured differently and the need for flexibility to adopt procedures to suit their individual structure and business needs, but firms are still expected to establish and maintain a reasonably designed supervisory system for alternative work arrangements during a pandemic.

FINRA recently published guidance that addressed, among other things, the supervisory obligations of member firms that are using “remote offices or telework arrangements” in response to the spread of COVID-19. See FINRA Notice 20-08, Pandemic-Related Business Continuity Planning, Guidance and Regulatory Relief (Mar. 9, 2020).[1] These arrangements may result in registered representatives working in a different environment (e.g., at their homes instead of in the member's office), and supervising many remote locations can present significant challenges or unique considerations that do not exist when supervising non-remote locations. See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (Mar. 19, 2004). As a result, and as FINRA recently reminded, “the use of remote offices or telework arrangements during a pandemic may necessitate a member firm to implement other ways to supervise its associated persons who change their work locations or arrangements for the duration of the pandemic.” This recent notice echoes guidance that FINRA issued in 2009 following the H1N1 (swine flu) pandemic, where FINRA observed that “it is important that firm’s supervisory systems are adequately designed to provide reasonable supervision of employees’ activities (regardless of their functions) while working from remote locations.” FINRA Notice 09-59, Business Continuity Planning: FINRA Provides Guidance on Pandemic Preparedness (Oct. 12, 2009). Notably, FINRA’s recent guidance also advised that FINRA was “temporarily suspending the requirement to maintain updated Form U4 information regarding office of employment address for registered persons who temporarily relocate due to COVID 19.” Similarly, FINRA indicated that “member firms are not required to submit branch office applications on Form BR for any newly opened temporary office locations or space-sharing arrangements established as a result of recent events.”[2]

In light of FINRA’s guidance, broker-dealers should review their supervisory policies to confirm that they are reasonably designed to promote compliance by employees working remotely with the federal securities laws and FINRA rules, and that the appropriate personnel are performing supervisory functions.[3] Depending on the broker-dealer's particular lines of business, supervisory systems that were reasonably designed to supervise the activities of registered representatives in non-remote locations may need to be modified while employees are working from home or other remote locations. Determining whether a supervisory structure is reasonably designed will depend largely on the broker-dealer's particular business, and firms should consider whether their supervisory policies appropriately take into account the different functions of different employees. For example, it may be appropriate to use policies and procedures to remotely supervise traders that differ from the policies and procedures used to remotely supervise research analysts. For traders who are accustomed to working in highly customized work environments, separating operations may pose issues for desk communication and liquidity in the market. Therefore, firms should review their supervisory procedures regarding, among other things, capital and risk limits and desk communications and determine whether alternative supervisory systems are needed for oversight of trading operations. Firms may also consider the frequency of supervisory reviews in light of market events and changing conditions.

Firms should also assess whether their remote supervision procedures appropriately address concerns that may be more acute when employees are working remotely, such as those involving cybersecurity or the capture of communications or other records. For instance, firms that permit remote access to their systems should consider whether additional safeguards may be warranted given the circumstances to guard against cyber threats or to otherwise protect customer records and information. Likewise, employees working remotely may be more likely to use online collaborative or communication tools, including some tools that would not typically be used if the employees were not working remotely. Firms should accordingly consider whether during this period they are appropriately capturing and reviewing electronic communications and other records relating to their investment banking or securities business.

Similarly, firms should consider whether their supervisory systems appropriately account for areas that may present more regulatory or operational risk during this time. For example, the current environment could present a heightened risk that misconduct by associated persons may occur and remain unidentified for a period of time without a physical supervisor at the office or location. Customers may also be more likely to transfer funds between accounts or institutions, either as the result of decreasing market exposure or to meet liquidity needs. As such, firms should consider whether additional reviews or safeguards are needed regarding, among other things, unusual trading activity and frequent or questionable transfers of funds or securities between customer accounts or employee accounts. In addition, during this time, customer complaints may be high, and firms should review their supervisory process for reviewing the issues and nature of customer complaints received and how such complaints are being addressed.

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[1] FINRA's notice advises that a member "should use its best efforts to provide written notification to its FINRA Risk Monitoring Analyst as soon as possible after establishing a new temporary office or space-sharing arrangement, to include at a minimum the office address, the names of each member firm involved, the names of registered personnel, a contact telephone number and, if possible, the expected duration. The notification should also indicate whether the member firm's personnel will be sharing space with another entity, and if so, the type of business in which it is engaged (e.g., an affiliated investment adviser or an organization in the securities business)." Although not the focus of this notice, FINRA's recent guidance also recognizes that branch office exams may need to be temporarily postponed during the pandemic, and compliance with FINRA Rule 3110(c) in connection with conducting on-site inspections of branch offices this year may need to be reevaluated.

[2] As the industry largely shifts to teleworking, the North American Securities Administrators Association (NASAA) has adopted model guidance that allows a registered representative to work from a remote location during the pandemic without having to register in that state. State regulators are in the process of considering whether, or how to, implement this guidance.

[3] Under FINRA Rule 1210.04, individuals generally may not function in a principal capacity for more than 120 days without having passed the appropriate examination(s). Because examination centers have been closed in response to COVID-19, FINRA recently extended the relevant period of time so that "individuals who were designated to function as principals under Rule 1210.04 prior to February 2, 2020 will be given until May 31, 2020 to pass the appropriate examination(s)." FINRA, Frequently Asked Questions Related to Regulatory Relief Due to the Coronavirus Pandemic, https://www.finra.org/rules-guidance/guidance/faqs/coronavirus.

CONTACTS

We continue to closely monitor regulatory developments related to COVID-19 that may affect broker-dealers. If you have any questions concerning this alert, or regarding remotely supervising personnel during the COVID-19 pandemic, please contact the Sidley lawyer with whom you usually work or

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SEC Proposes Overhaul of Market Data Infrastructure

April 9, 2020

On February 14, 2020, the U.S. Securities and Exchange Commission (SEC) proposed amendments to the manner in which exchange market data is collected, consolidated and disseminated to the public (the Proposal). The Proposal would significantly expand the content of consolidated market data information to include, among other things, five levels of depth-of-book quotations and certain odd-lot quotes. The Proposal would also shift away from the current centralized model whereby designated "securities information processors" (SIPs) are responsible for collecting and disseminating consolidated market data from exchanges toward a decentralized model that allows newly registered "competing consolidators" to perform this function.

This marks the latest initiative from the SEC designed to modernize market data infrastructure, a core component of the U.S. national market system. Comments are due on or before May 26, 2020.

The purpose of the Proposal is to modernize the national market system and to address a number of issues relating to the distribution of market data. Specifically, the SEC believes that the collection and distribution of consolidated market data via the SIPs have not kept pace with technological and market developments and "are no longer satisfying the needs of many investors." SIP consolidated market data is meaningfully slower than most proprietary data products offered by the exchanges in a trading environment where speed matters significantly to many market participants. SIP consolidated market data also does not contain certain information that increasingly is needed by market participants, such as odd-lot data (i.e., quantities less than 100 shares are often a meaningful source of liquidity, especially for high-priced stocks) and opening and closing auction information from exchanges. Accordingly, the SEC believes the national market system may no longer be fulfilling its statutory goals of ensuring the broad availability of transaction and quotation data.

I. Background

In 1975, Congress adopted amendments to the Securities Exchange Act of 1934 (Exchange Act) charging the SEC with creating a "national market system" (NMS) including rules governing the collection and distribution of quotations and transaction information regarding securities.[4] With certain limited exceptions, the same security may trade on multiple different markets and at different prices in the U.S. Accordingly, to determine the best available price for a security at given time or the last sale price of a security, a consolidated view of market quotations and transactions across all markets is necessary.

Today, the dissemination of this consolidated market data occurs through one of three exclusive SIPs, which consolidate exchange market data and are required to make it available to market participants.[5] The SIPs are governed by SEC-approved NMS plans that are designed to ensure that the SIPs provide the public with a comprehensive, accurate and reliable source of information for the prices and volume of any NMS stock at any time during the trading day on fair and reasonable terms. On January 8, 2020, the SEC proposed amendments related to the NMS plans governing the SIPs that would, among other things, consolidate the three existing NMS plans into a single plan (the NMS Plan) and require an independent administrator of the NMS Plan.[6] The consolidated NMS Plan would still play an important role under the Proposal despite the elimination of exclusive SIPs.

For many years the distribution of SIP consolidated market data has been criticized for being meaningfully slower than exchange's proprietary data feeds. Today's markets have evolved into high-speed electronic markets where even small degrees of latency in processing market data affect trading strategies, and many broker-dealers believe they must use exchange proprietary market data to compete effectively. The Proposal is designed to address that concern and other issues by enhancing the content and distribution means of consolidated market data.

II. Proposed Enhancements to Reg NMS

The Proposal primarily changes three things: (1) the displayed size of round lots depending on the price of the security, (2) the content of consolidated market data and (3) the means of distribution of consolidated market data (SIP vs. competing consolidator). The discussion below provides an overview and brief explanation of the significance of each of these items, as well as for core data, self-aggregators, requirements for exchanges distributing market data, and fees under the Proposal.

A. Round Lots

Under the Proposal, the applicable round lot size for a particular NMS stock would vary depending on the stock's average closing price of the stock during the previous month, as reported by its primary listing market.[7] For initial public offerings (IPOs), the IPO price would be used to determine the applicable round lot. The proposed round lots would be as follows:

Price Group	Round Lot Size
\$0.00 - \$50.00	100 shares
\$50.01 - \$100.00	20 shares
\$100.01 - \$500.00	10 shares
\$500.01 - \$1,000.00	2 shares

Under the Proposal, only where the best bid and the best offer are of at least 100 shares can those quotations be "protected" for purposes of the Order Protection Rule. [8] In other words, for a quotation to be protected, it must be the best bid or offer and have a quantity of at least 100 shares. Consequently, for stocks that have a lower round lot quantity, there may be bids and offers that are priced better than the best protected bid and protected offer available.[9]

This will result in frequent differences between the best protected bid and protected offer (PBBO) and the national best bid and national best offer (NBBO). Today, the PBBO and NBBO for a given stock are generally the same because all stocks have a uniform round lot size of 100 shares. As noted above, stocks that had an average closing price during the previous month above $50.01 per share will have a round lot of less than 100 shares.[10] Therefore, any time the best bid and best offer for such stocks is less than 100 shares each, the NBBO will be different than PBBO. For example, assume stock XYZ has a round lot size of 20 with the following quotes:

	Bid	Offer
NBBO	$75.00 x 20 shares	$75.05 x 20 shares
PBBO	$74.99 x 100 shares	$75.06 x 100 shares

The best bid and offer for XYZ are the highest buy order that is a round lot and the lowest sell order that is a round lot. Because XYZ has a round lot of 20 shares (i.e., its average closing price for the preceding month was between $50.01 and $100.00) and protected quotes must be for at least 100 shares, the NBBO differs from the PBBO.

Significance – What this means is that the NBBO quotations in the example above would not be "protected" from a trade-through under Rule 611 (Order Protection Rule) of Reg. NMS. [11] However, a broker-dealer could not ignore these quotes because the duty of best execution generally requires the execution of customer trades "at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price."[12] Given the duty of best execution to execute against any quotes that are better than the best protected quotation, a question arises whether the Order Protection Rule continues to be necessary at all.

Additionally, broker-dealers will need to ensure that customer limit orders that meet the applicable round lot size for the security are displayed, consistent with the Limit Order Display Rule.[13] For example, an order that previously may have constituted an odd lot for a security might be a round lot that must be displayed under the Proposal.

B. Consolidated Market Data

Under the Proposal, competing consolidators would be responsible for the distribution of newly defined "consolidated market data." Currently, consolidated market data produced by the SIPs generally consists of "core data," which is the price, size and exchange of the last sale; each exchange's highest bid and lowest offer (BBO) and the quantity available at those prices (also known as "top of book data"); and the NBBO. The SIPs also today provide certain regulatory information related to the NMS Plan to Address Extraordinary Market Volatility (aka the Limit-Up Limit-Down Plan) and short sale circuit breakers, such as information about when circuit breakers have been triggered.

The Proposal would expand the content of consolidated market data by expanding the components of core data, as well as by adding additional exchange-specific program data for exchange retail liquidity programs.[14] Specifically, under the Proposal, "consolidated market data" would mean data from all exchanges and Financial Industry Regulatory Authority (FINRA) (collectively self-regulatory organizations or SROs) that consists of the following:

a. <u>Core data</u> – as detailed further below, this would continue to contain top-of-book quotations and last sale data but would newly add (i) depth of book (DOB) data, (ii) odd-lot transaction data, and (iii) exchange auction information (e.g., opening auction)

b. <u>Regulatory data</u> – includes information for each stock relating to

i. *Short sale circuit breakers* – information regarding whether the short sale circuit breaker has been triggered[15]

ii. *Price bands* – relating to single-stock and market-wide circuit breakers under the Limit-Up Limit-Down Plan[16]

iii. *Halts* – trading halts and reopening notifications under the Limit-Up Limit-Down Plan

iv. *Opening and closing prices* – from the primary listing exchange

v. *Round lots* – indicator of the applicable round lot size for each stock

vi. *Other indications* – certain other messages such as subpenny and trade through exempt indicators

c. <u>Administrative data</u> – administrative, control and other technical messages that may be required by the NMS Plan[17]

d. <u>Exchange-specific program data</u> – data relating to exchange retail liquidity programs[18]

e. <u>Additional data</u> – as may be required pursuant to the NMS Plan

Significance – The most significant aspect of proposed definition of consolidated market data is the expansion of core data, discussed below.

C. Core Data

Although the term is currently undefined under Regulation NMS, "core data" provided by the SIPs currently consists of (i) the price, size and exchange of the last sale; (ii) top-of-book quotations from each exchange; and (iii) the NBBO. The Proposal would establish a new definition of core data to include all of these elements but would add to it the following:

a. <u>Best protected bid and protected offer (PBBO)</u> – As described above, under the Proposal, only where the best bid and the best offer are of at least 100 shares can those quotations be protected within the meaning of the Order Protection Rule. As a result, stocks with round lots of less than 100 shares (i.e., average closing price above $50.01 per share the previous month) may have better priced quotes that are not protected.

b. <u>Odd-lot data</u> – odd-lot quantities that when aggregated equal a round lot in the applicable stock shall be included as a bid or offer and disseminated at the least aggressive price of the aggregated odd-lot orders.

For example, assume stock XYZ has a round lot of 20 shares and the following quotes:

	Bid	Quantity	Lot Size
1	$75.00	5	Odd lot
2	$74.99	5	Odd lot
3	$74.98	10	Odd lot
4	$74.97	20	Round lot

In this example quotes 1, 2 and 3 when aggregated amount to a round lot (20 shares) and would therefore be displayed as a single quotation at the least aggressive of their prices ($74.98).

c. DOB data – would mean all quotation sizes at each exchange aggregated at each of the five price levels below a protected bid and above a protected offer. DOB data would also include any quotations between an exchange's best bid and its protected bid and its best offer and protected offer. For example, assume Exchange A is at the NBBO for stock XYZ and has the following bids on its order book:

	Bid	Quantity
NBBO	$75.00	20
	$74.99	20
	$74.98	20
PBBO	$74.97	100
	$74.96	20
	$74.95	40

Here, DOB data includes the quotes between the NBBO and the PBBO as well as each of the next five prices levels below the PBBO (i.e., $74.96, $74.95 and so on).

d. Auction information – would mean all the information specified by each exchange related to their auctions (e.g., opening, closing, reopening after a halt). This information would generally include, for example, estimated opening (or reopening) prices, the quantity of buy and sell orders during the preauction period and order imbalance indicators (e.g., more buys than sells).

Significance – Under the Proposal, core data would now include DOB data, odd-lot data and auction information, the majority of which is available today only through proprietary exchange data feeds. Given the enhancements to consolidated market data under the Proposal, many market participants could find that they no longer need to subscribe to proprietary market data products from exchanges. But, self-aggregators of proprietary market data feeds would still generally have a latency advantage over those acquiring consolidated market data from competing consolidators.

D. Competing Consolidators

As noted, competing consolidators would replace the exclusive SIPs for the distribution of consolidated market data. A competing consolidator would be required to register with the SEC on proposed Form CC pursuant to proposed Exchange Act Rule 614 using the SEC's EDGAR system in a manner similar to the requirements for NMS Stock ATSs.[20] The following provides an overview of competing consolidators under the Proposal:

a. Eligibility –both SROs and non-SRO entities, including broker-dealers and non-broker-dealers, would be eligible to operate as competing consolidators. An SRO, however, would not necessarily be required to complete Form CC to provide consolidated market data but would be subject to monthly reporting requirements.[21]

b. Form CC Requirements

i. *General information* – name, address, legal status (e.g., LLC) and affiliation with a broker-dealer

ii. *Control persons (Exhibits A and B)* – disclosure of persons owning more than 10 percent of the applicant or that otherwise directly or indirectly control the applicant as well as officers and directors of the applicant

iii. *Affiliates and organizational chart (Exhibits C and D)* – disclosure of affiliates of the applicant (i.e., entities that control, are controlled by or under common control with the applicant)[22] as well as an organizational chart for the applicant

iv. *Operational capability (Exhibit E)* – a narrative description of each consolidated market data service or function, including connectivity and delivery options, and all the procedures used for collecting and distributing consolidate market data

v. *Market data products (Exhibit F)* – a description of all market data products offered by the applicant; under the Proposal, competing consolidators may offer a variety of different market data products to suit subscribers' needs (e.g., providing full DOB data)

vi. *Fees/charges (Exhibit G)* – a description of fees for the applicant's services (e.g., subscription, connectivity) as well as variables affecting such fees and price differences among subscribers

vii. *Colocation and connectivity (Exhibit H)* – a description of any colocation and related services, including connectivity and throughput options offered as well as any other means to increase the speed of communication to the applicant's services

viii. *Specifications (Exhibit I)* – a narrative description or the functional specifications (e.g., FIX specs) for subscribers

c. SEC Review of Form CC – the SEC would review initial Form CC submissions pursuant to proposed Rule 614, which generally provides:

i. *Initial review* – the SEC has up to 90 days to review an initial Form CC submission. The SEC will make public effective Form CCs (or an order declaring a Form CC ineffective) by posting them on its website.

1. A Form CC will be declared ineffective if, after notice to the applicant and an opportunity for hearing, the SEC determines that declaring it ineffective is necessary and appropriate in the public interest (e.g., if the disclosures reveal noncompliance with applicable laws).

ii. *Material amendments* – a competing consolidator would be required to amend its Form CC prior to implementing a material change to the pricing, connectivity or products offered.

1. The SEC will make public any Form CC amendment within 30 calendar days from the date of filing.[23]

2. A change to these offerings is considered "material" if there is a "substantial likelihood that a reasonable market participant would consider the change important when evaluating the competing consolidator as a provider of market data."[24]

3. Notably, the Proposal does not contemplate (i) the SEC declaring a Form CC amendment effective or ineffective; (ii) any implementation delay after filing the amendment; (iii) any opportunity for public notice and comment on the amendment.

iii. *Annual report* – within 30 days after the end of each calendar year, a competing consolidator would be required to correct information that has become inaccurate or incomplete for any reason (e.g., a change to its organizational structure or its officers and directors) and indicate items that have been amended.[25]

iv. *Cessation* – a competing consolidator shall provide notice of cessation of operations at least 30 days prior to when it intends to cease operations. The SEC will post such notice publicly on its website.

d. <u>Responsibilities of Competing Consolidators</u> – the responsibilities of competing consolidators include[26]

i. *Consolidated market data* – collect and generate consolidated market data

ii. *Timestamp* – timestamp information upon (1) receipt from the exchange or FINRA, (2) receipt at its aggregation/consolidation mechanism and (3) dissemination to subscribers

iii. *Unreasonable discrimination* – make consolidated market data available to subscribers on "terms that are not unreasonably discriminatory" [27]

e. <u>Monthly Report of Performance Metrics</u> – within 15 calendar days of the end of each month, publish in a freely accessible manner on its website performance metrics, as defined by the NMS Plan, that include at least the following:[28]

i. *Capacity statistics* – e.g., system tested capacity, system output capacity, total transaction capacity and total transaction peak capacity

ii. *Message rate and total statistics* – e.g., peak output rates on the following bases: 1 millisecond, 10 millisecond, 100 millisecond, 500 millisecond, 1 second, and 5 seconds.

iii. *Network delay statistics* – e.g., quote and trade zero window size events, quote and trade retransmit events, and quote and trade message totals.

iv. *Latency statistics* – with distributions up to the 99.99th percentile, a competing consolidator must provide latency stats regarding

1. Exchange to CC (first leg) – when a SRO sends an inbound message to the competing consolidator and when it is received

2. CC to subscribers (second leg) – when the competing consolidator receives the inbound message from a SRO and when it sends a consolidated message to a subscriber

3. Exchange to subscribers (both legs) – when a SRO sends an inbound message to a competing consolidator and when the competing consolidator sends a consolidated message to a subscriber

f. <u>Monthly Report of Issues and Other Alerts</u> – within 15 calendar days of the end of each month, publish in a freely accessible manner on its website the following:

i. *Data quality issues* – e.g., delayed message publication, publication of duplicative messages and message inaccuracies

ii. *Systems issues* – e.g., processing, connectivity and hardware problems

iii. *Clock synchronization protocol* – to the extent such a protocol is used, it would have to be described

iv. *Clock drift averages and peaks* – for clocks used to generate timestamps, clock drift averages and peaks and the number of instances of clock drift greater than 100 microseconds

v. *Vendor alerts* – e.g., systems testing dates or market holiday reminders

g. <u>Recordkeeping</u> – competing consolidators would be required to keep and preserve records relating to its business for a period of no less than five years, the first two in an easily accessible place, and promptly furnish such records to the SEC upon request.

h. <u>Regulation Systems Compliance and Integrity (SCI)</u> – the SIPs are currently subject to Regulation SCI, which is designed to protect critical market infrastructure and address potential systems disruptions and intrusions.

Given that competing consolidators would replace the SIPs and perform the critical function of delivering consolidated market data to the public, competing consolidators would be subject to Regulation SCI under the Proposal, including SEC notification requirements relating to “SCI events.”

Significance – Competing consolidators would be newly registered entities designed to supplant the existing exclusive SIPs. The competing consolidator model is intended to reduce costs for consolidated market data relative to comparable proprietary market data products and reduce latency in the distribution of such data relative to the SIPs. Currently, SIPs receive market data from exchanges via fiber connections, making the resulting consolidated market data significantly slower than proprietary market data products. Under the Proposal, competing consolidators would be able to obtain the market data necessary to create consolidated market data from exchanges via faster wireless connections, reducing latency in delivery to subscribers.

E. Self-Aggregators

Under the Proposal, only a competing consolidator with an effective Form CC or a SRO may generate consolidated market data for dissemination to any person. However, broker-dealers that wish to use consolidated market data for internal purposes only could do so without registering as a competing consolidator.

The term "self-aggregator" would be defined in the Proposal as a broker-dealer that receives information with respect to transactions in NMS stocks, including data necessary to generate consolidated market data, "solely for internal use." [33] Only broker-dealers would be eligible to be self-aggregators and not other types of market participants, such as investment advisers.

Significance – In limiting self-aggregators to just broker-dealers, the SEC noted that while it was not requiring self-aggregators to register, broker-dealers are subject to the full broker-dealer regulatory regime, which includes inspections by the SEC and SROs. Accordingly, any expansion of possible self-aggregators would likely have to include voluntarily agreeing to audit rights to prevent consolidated market data from being shared with any other person. These provisions may affect some high-frequency trading investment advisers that currently maintain their own "ticker plants."

F. Distribution of Market Data by Exchanges

Under the Proposal, SROs would be required to provide equal access to their market data. Specifically, each SRO would be required to make available to all competing consolidators and self-aggregators its information regarding quotes and transactions in NMS stock "in the same manner and using the same methods, including all methods of access and the same format" as that data is made available to any person.

For example, if an exchange has more than one form of transmission for its proprietary data (e.g., via fiber connection and via wireless connection), then the exchange must offer competing consolidators and self-aggregators those same types of transmission for consolidated market data. Today, exchanges deliver market data to the SIPs via slower fiber connection, while offering proprietary market data through faster wireless connections. Any new form of access established by a SRO must also be offered to competing consolidators and self-aggregators.

Exchanges would still be permitted to sell proprietary market data products, though it seems likely that the value of such products relative to consolidated market data would be diminished given the equalized means of distribution and the inclusion of DOB data as part of core data.

Significance – The proposed requirement that all market data be distributed on equal terms appears to be designed to curb an exchange from favoring certain competing consolidators over others. For example, if an exchange operated a competing consolidator through an affiliate and there was no requirement to provide equal access to market data, an exchange might have incentives to provide latency or other advantages to its affiliated competing consolidator.

G. Fees

Pursuant to Section 11A of the Exchange Act and Rule 603 thereunder, consolidated market data must be offered on terms that are "fair and reasonable." [36] Fees for consolidated market data available through the SIPs have generally be shown to be fair and reasonable if they are reasonable related to costs.[37]

Under the Proposal, the NMS Plan governing the collection and dissemination of consolidated market data would be responsible for establishing and filing with the SEC the fees for the data used by competing consolidators and self-aggregators to generate consolidated market data.[38] However, the fees charged by competing consolidators for consolidated market data would not be subject to SEC review and approval.

Significance – Because there is no review process for the fees competing consolidators charge for consolidated market data obtained pursuant to the NMS Plan, these fees would not be subject to SEC review for being "fair and reasonable." The Proposal would therefore generally rely on competitive forces and fee disclosures via Form CC to help ensure that competing consolidator fees are fair and reasonable.

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[1] Exchange Act Release No. 88216, 85 FR 16726 (Mar. 24, 2020).

[2] Within the past year and a half, the SEC has, among other things, (i) adopted a transaction fee pilot, currently being challenged by several exchanges; (ii) issued a decision in an longstanding issued guidance on requirements related to fee filings; (iii) remanded 400 challenges to market data and market access fees; (iv) held a roundtable on market data and market access, which helped form the basis for some of the items in the Proposal; (v) issued comprehensive guidance on expectations for exchange fee filings. For a discussion of these updates, please see our client Update available here. The SEC also proposed amendments to the governance structure of the NMS plan governing the distribution of consolidated market data in January 2020. See infra note 5 and accompanying text. .

[3] Proposal at 16729. The exchanges that are participants in the NMS plans to distribute consolidated market data via the SIPs also face conflicts of interests insofar as they sell proprietary data products that compete with market data from the SIPs. As a result, the exchanges have not been incentivized to ensure that consolidated market data is delivered as efficiently and effectively as their proprietary market data products.

[4] 15 U.S.C. 78k-1(c)(1)(B).

[5] 15 U.S.C. 78k-1. Some market participants buy proprietary data products from exchanges for their own use rather than using the consolidated feeds.

[6] For an overview of the proposed changes to the governance structure of the NMS Plan governing the collection, consolidation, and dissemination of consolidated market data, please see our client Update here.

[7] Proposal at 16741; Proposed Rule 600(b)(81).

[8] 17 CFR 242.611.

[9] Proposal at n.117.

[10] Currently, the NBBO might differ from the PBBO where an exchange might have a manual quotation (e.g., from an exchange floor) that is priced better than the best electronically displayed quotation. In such case, because the manual quotation is not readily accessible in the same manner that an electronic quotation is, market participants are permitted to trade through the better priced manual quotation. Manual quotations are rare as most equity exchanges have moved to automated trading.

[11] 17 CFR 242.611.

[12] Internal citations omitted. Exchange Act Release No. 51808, 70 FR 37495, 37538 (June 29, 2005) (Reg NMS Adopting Release). The Order Protection Rule was originally designed to be a "backstop" to a broker's duty of best execution. Id. at 37508. Accordingly, the Proposal will generally rely more on the duty of best execution to prevent trade-throughs than the current market structure currently does.

[13] 17 CFR 242.604.

[14] Under the Proposal, market data related to the overt-the-counter bulletin board ("OTCBB") that is currently provided through the exclusive SIPs would not be included as part of consolidated market data.

[15] 17 CFR 242.201.

[16] Under the Proposal, the exchange with the greatest number of listing of S&P500 stocks would be responsible for determining whether a Level 1, Level 2, or Level 3 decline has occurred under the Limit-Up Limit Down Plan. For an overview of some of the key aspects of the Limit Up Limit Down Plan, please see our client update here.

[17] Proposed Rule 600(b)(2).

[18] Proposed Rule 600(b)(32). Exchange retail liquidity programs are designed to attract orders from retail customers to exchanges (rather than executing against a wholesale broker-dealer or on an alternative trading system (ATS)).

[19] Proposed Rule 600(b)(20).

[20] For a discussion of the filing regime for NMS Stocks ATS, please see our client Update here.

[21] Proposal at n537.

[22] Proposed Form CC defines affiliate to have the meaning provided in Exchange Act Rule 12b-2. 17 CFR 240.12b-2.

[23] Proposed Rule 614(b)(2)(iii).

[24] Proposal at 16780.

[25] Proposed Rule 614(b)(2)(ii); Proposal at 16781.

[26] Proposed Rule 614(d).

[27] Proposed Rule 614(d)(3).

[28] Proposed Rule 614(d)(5)

[29] Proposal at 16873.

[30] Proposed Rule 614(d)(6).

[31] Proposed Rule 614(d)(7) and (8).

[32] 17 CFR 242.1000 et seq. For an overview of the requirements of Regulation SCI, please see our client Update here.

[33] Proposed Rule 600(b)(82).

[34] Proposed Rule 603(b).

[35] Proposal at 16770.

[36] 15 U.S.C. 78k-1; 17 CFR 242.603.

[37] Proposal at 16770.

[38] Proposal at 16792.

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SIDLEY UPDATE

OCIE Announces Plans to Assess Compliance With Reg BI and Form CRS as Scheduled

April 8, 2020

On April 7, 2020, the U.S. Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations (OCIE) released two risk alerts regarding Regulation Best Interest (Reg BI) and Form CRS. This follows SEC Chairman Jay Clayton's announcement that the SEC will not extend the compliance date for Reg BI and Form CRS (discussed here).

Notably, while Reg BI applies only to broker-dealers, Form CRS is a requirement for investment advisers as well, making these risk alerts relevant to both types of firms. As reflected in the risk alerts, OCIE will begin examinations to assess firms' compliance with Reg BI and the rules governing the completion of Form CRS within the first year after these requirements take effect on June 30, 2020. According to the risk alerts, these initial examinations are designed primarily to evaluate whether firms have made a "good faith effort" to establish policies and procedures reasonably designed to achieve compliance with Reg BI and the rules governing the completion of Form CRS. OCIE also will evaluate whether firms have made reasonable progress in implementing the Reg BI policies and procedures as necessary or appropriate.

Although the risk alerts acknowledge the unique circumstances under which firms are currently operating because of COVID-19, OCIE expects firms to have such reasonably designed policies and procedures in place.

Background

The SEC released Reg BI on July 12, 2019. Reg BI establishes a "best interest" standard of conduct for broker-dealers when making recommendations to retail customers. This standard will apply to recommendations involving securities transactions, investment strategies and types of accounts. The SEC also adopted new rules and forms that require broker-dealers and investment advisers to deliver to new and existing retail customers a summary of the relationship between the customer and the firm, known as Form CRS. Firms are required to deliver Form CRS to existing customers by July 30, 2020.

We previously discussed the releases adopting Reg BI and Form CRS and the related SEC guidance here.

Risk Alert Highlights

OCIE identified several areas that its exam teams may focus on as part of the Reg BI review. These key areas include the firm's compliance with the following:

- *The Disclosure Obligation*, which requires broker-dealers, prior to or at the time of the recommendation, to provide retail customers, in writing, full and fair disclosure of
    - all material facts relating to the scope and terms of the relationship with the retail customer
    - all material facts relating to conflicts of interest that are associated with the recommendation
- *The Care Obligation*, which requires broker-dealers to exercise reasonable diligence, care and skill when making a recommendation to a retail customer
- *The Conflict of Interest Obligation*, which requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers
- *The Compliance Obligation*, which requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole

Importantly, the risk alert provides a summary of how OCIE may assess how firms are complying with each of these obligations, including a list of documents it may request and review as part of its review. The risk alert also includes an appendix listing information OCIE may request when conducting its examinations of broker-dealers regarding Reg BI.

To test compliance with the rules governing Form CRS, OCIE will

- confirm that the firm has filed the Form CRS with the SEC and posted the Form CRS on its website
- evaluate whether the firm timely delivered the Form CRS to existing and new retail customers
- assess whether the firm's Form CRS is formatted in accordance with the instructions (e.g., it includes particular wording where required, it uses text features where required and it is written in plain English)
- review the firm's written policies and procedures, recordkeeping processes and delivery processes and dates in light of the obligations imposed by Form CRS

Although OCIE identified these as the primary focus areas, the OCIE Staff may select additional risk-based areas for review identified through the course of the exam.

The risk alerts provide firms with additional visibility into how OCIE may review a firm's Reg BI program and the documents it may request as part of its review. Firms should consider using this information to assess their implementation plans for Reg BI and Form CRS and whether they are prepared to meet OCIE's requests.

Also, although not addressed in this announcement, firms should expect the Financial Industry

Regulatory Authority examiners as well as state regulators and exam teams to be similarly focused on firms' compliance with these requirements.

The risk alerts are available [here](#) (Reg BI) and [here](#) (Form CRS). Sidley will continue to monitor developments from the SEC in light of COVID-19 and the upcoming deadlines related to Reg BI and Form CRS.

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SIDLEY UPDATE

Trading Halts and Suspensions for Securities and Derivatives

March 18, 2020

Given the significant volatility in the financial markets, Sidley Austin LLP is providing this summary of existing trading halts and suspensions and the authority of U.S. regulators to potentially institute broader trading halts and suspensions. This includes (i) market-wide circuit breakers and individual stock circuit breakers under the "Limit-Up Limit-Down Plan;" (LULD Plan) and (ii) trading suspension authority of the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), exchanges and Financial Industry Regulatory Authority (FINRA).

Market-Wide Circuit Breakers

As evidenced by recent market events, trading in U.S. equities may be halted temporarily pursuant to the national market system (NMS) Plan to Address Extraordinary Market Volatility, also known as the LULD Plan, as described below.[1] There are no corresponding market-wide circuit breakers for derivatives, although at least some designated contract markets (DCMs) cease trading upon the triggering of the LULD Plan and have certain price limit controls.[2]

National Market System Plan to Address Extraordinary Market Volatility: The LULD Plan sets forth certain parameters that trigger a pause in trading or suspend trading for the remainder of the day to address market-wide volatility, as described below.

- *Market-Wide Circuit Breakers* — To halt trading across the entire market, a market decline at one of three price levels must have occurred, meaning a decline in the price of the S&P 500 index during regular trading hours as compared to the previous day's closing price for the index:
    - Level 1 Market Decline – 7 percent
        - If triggered, causes a 15-minute halt during 9:30 a.m.-3:25 p.m. ET (no halt after 3:25 p.m. ET) and only one halt per trading day.
    - Level 2 Market Decline – 13 percent
        - If triggered, causes a 15-minute halt during 9:30 a.m.-3:25 p.m. ET (no halt after 3:25 p.m. ET) and only one halt per trading day.
    - Level 3 Market Decline – 20 percent

- If triggered at any time during the trading day, causes a halt in all trading for the remainder of the trading day.

- *OTC Trading* — These market-wide circuit breakers apply to both exchange and over-the-counter (OTC) trading in NMS stocks.[3]
- *Individual Stock Circuit Breakers* — The LULD Plan provides for additional trading limits and trading pauses for individual securities whose prices cross certain price bands relative to their average price over the preceding five minutes of trading, causing the stock to enter a "Limit State." These price band percentage parameters vary depending on the type of security, its previous closing price and the time of day the circuit breaker is triggered.
- *Securities Options* — Securities options are not subject to the LULD Plan. However, options exchange rules typically provide that trading will be halted upon the occurrence of a market-wide trading halt under the LULD Plan.[4]

Futures Circuit Breakers: DCMs have certain price limits that were originally adopted in response to historic market declines in October 1987.

- *Varies by Contract Type* — Different futures contracts have different price limits and rules governing what occurs when triggered (e.g., some markets temporarily halt trading, while others may stop trading for the entire day).
- *Price Limit Bands* — Price limits are determined daily and can have multiple levels (e.g., certain equity index futures have a three-level expansion on the downside of 7 percent, 13 percent and 20 percent, and a 5 percent limit up and down in overnight trading).[5]

Trading Suspensions

The SEC and CFTC as well as the self-regulatory organizations that they regulate, have certain authority to halt or suspend trading, as described below.

SEC: The SEC has authority to suspend trading pursuant to Section 12(k) of the Securities Exchange Act of 1934 (Exchange Act)[6] as follows:

- *Ten-Day Suspension* — suspend trading in any security, other than exempted securities[7], for up to 10 days
- *Ninety-Day Suspension* — suspend trading on all exchanges or otherwise in securities, other than exempted securities, for up to 90 days provided the President is notified and does not disapprove[8]
- *Emergency Order* — for up to 10 days, in an "emergency," the SEC may suspend, restrict or take other actions (other than for exempted securities) it believes are necessary in the public interest and to protect investors to:
    - maintain or restore fair and orderly markets,
    - ensure prompt, accurate and safe clearance and settlement or
    - mitigate the substantial disruption of securities markets, investment companies, segments of markets or the processing of transactions

    - *Extensions* — The SEC has authority to extend an Emergency Order up to 30 days if the emergency still exists.
    - *Emergency* — an emergency in this context generally means
        - (i) a major market disturbance (or threat of disturbance) with "sudden and excessive fluctuations of securities prices
        - (ii) a substantial disruption (or threat of disruption) of the "safe or efficient operation" of the national system for clearance and settlement and
        - (iii) a major disturbance that substantially disrupts (or threatens to substantially disrupt) the function of securities markets, investment companies, segments of markets, or the processing of transactions[9]
- *Security Futures* — The SEC's authority extends to security futures as well, provided the SEC consults with and considers the views of the CFTC.
- *Presidential Override* — The President has authority to terminate a 90-day suspension or an Emergency Order (or extension thereof).

Securities Exchanges: Pursuant to Exchange Act Rule 12d2-1, an exchange is authorized to suspend trading in any listed security in accordance with its rules provided the exchange promptly notifies the SEC of the effective date and reasons for suspension.[10]

- *Duration* — Such suspension may continue indefinitely until the SEC believes that the exchange is seeking to evade certain delisting requirements.
- *FINRA* — FINRA also has broad authority under its rules to suspend OTC trading in any NMS stock whenever the primary listing exchange halts trading or in response to certain "extraordinary market activity." [11]

CFTC: The CFTC has broad authority to direct a registered entity (e.g., a designated contract market)[12] when it has reason to believe that an emergency exists to take action it believes is "necessary to maintain or restore orderly trading in or liquidation of futures contracts" pursuant to an "emergency," which means

- an actual or threatened market manipulations and corners,
- any act of the U.S. or a foreign government affecting a commodity or
- any other major market disturbance that prevents the market from accurately reflecting the forces of supply and demand.[13]

Designated Contract Markets: DCMs have broad authority to halt trading in contracts in the interest of fair and orderly markets.[14] Pursuant to CFTC regulations, DCMs are required to have controls in place that pause or halt trading to address market disruptions and emergencies.[15]

- *Duration* — CFTC and DCM rules do not generally restrict the DCM in how long it may initiate a trading halt.[16]
- *Security Futures* — DCMs generally halt trading in broad-based index futures contracts when

the LULD Plan has been triggered to halt trading in all equity securities.[17]

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[1] The LULD Plan is available at http://www.luldplan.com/plans.html.

[2] See, e.g., Cboe Futures Exchange (CFE) Rule 417A (providing that the exchange shall halt trading upon the triggering of a market-wide circuit breaker under the LULD Plan).

[3] See FINRA Rule 6121 (Trading Halts Due to Extraordinary Market Volatility). FINRA will also halt trading in OTC Equity Securities whenever it has halted trading in all National Market System stocks for the duration of the halt. FINRA Rule 6440.03.

[4] See, e.g., Cboe BZX Rule 20.5.

[5] See, e.g., Chicago Mercantile Exchange (CME) Rule 358.

[6] 15 U.S.C. 78l.

[7] The term “exempted securities” generally includes government securities (e.g., U.S. treasuries), municipal securities and certain other securities excluded from the definition of an “investment company” (15 U.S.C. 80a-3(c)) under the Investment Company Act of 1940. 15 U.S.C 78c(a)(12).

[8] The SEC is also required to consult with and consider the views of the Secretary of the Treasury, the Board of Governors of the Federal Reserve System and the CFTC unless such consultation is impracticable in light of the emergency. 15 U.S.C. 78l(k)(6).

[9] 15 U.S.C. 78l(k)(7).

[10] 17 CFR 240.12d2-1.

[11] FINRA Rules 6120 (Trading Halts). FINRA may also initiate trading halts in OTC equity securities. FINRA Rule 6440 (Trading and Quotation Halt in OTC Equity Securities).

[12] Registered entities include designated contract markets, derivatives clearing organizations, boards of trade, swap execution facilities and swap data repositories. 7 U.S.C. 1a(40).

[13] 15 U.S.C. 12a(9). This authority includes (i) setting temporary emergency margin levels on any futures contract; (ii) fixing limits that may apply to a market position acquired before the emergency.

[14] See e.g., Nasdaq Futures Exchange (NFX) Rules, Section 13; CME Rule 579A.

[15] 17 CFR 38.255.

[16] See *id.*

[17] See e.g., NFX Rules, Section 16 (Regulatory Trading Halts); CME Rules 35300 (halting trading in the E-mini S&P 500 where the LULD Plan is triggered or the New York Stock Exchange declares a trading halt); CFE Rule 417.

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SIDLEY UPDATE

Massachusetts Promulgates Broker-Dealer Fiduciary Rule

March 4, 2020

On February 21, the Massachusetts Securities Division (the Division) became the first state regulator to finalize a rule to hold broker-dealers and their agents to a fiduciary standard of conduct when making recommendations and providing investment advice to their customers. To meet this fiduciary duty, broker-dealers and their agents must adhere to duties of utmost care and loyalty to the customer. Breaches of the duty could be deemed "unethical or dishonest conduct or practices" and could result in potential enforcement remedies, including fines or registration revocation, and thereby could give rise to other collateral consequences under the federal securities laws.

The Division first proposed a uniform fiduciary standard for both broker-dealer agents and investment advisers in June 2019[1] and revised that proposal in the fall of 2019 following a period of public comment. The final amended uniform fiduciary standard adopted on February 21, 2020 (hereinafter, the Massachusetts Final Regulations),[2] reflects further comment and public hearings and differs significantly from the initial proposal as discussed in more detail below. The Massachusetts Final Regulations will become effective on March 6, 2020, and enforcement will commence on September 1, 2020.

Other states, including New Jersey and Nevada, are working on their own fiduciary rules; however, neither state has adopted fiduciary legislation. Maryland's proposed fiduciary rule was rejected last year by the state senate's finance committee.

Who Is a "Customer"?

In the Adopting Release, Amendments to Standard of Conduct Applicable to Broker-Dealers and Agents – 950 Mass. Code Regs. 12.200 (Feb. 21, 2020) (hereinafter, the Adopting Release),[3] the Division noted that several commenters requested that the definition of "customer" be limited to "retail investors with a legal address in Massachusetts or who reside in Massachusetts."[3] The Massachusetts Final Regulations define a "customer" to include both current and prospective customers, but to exclude institutions, including banks, savings and loans associations, insurance, trust and registered investment companies, registered broker-dealers and investment advisers, and certain other institutional buyers. See 950 CMR 12.207(3). The Division did not make any changes to the Massachusetts Final Regulations in response to these comments. The Division stated that "[t]he Massachusetts Uniform Securities Act is clear on the scope and applicability of the Final Regulations and does not need further clarification."[3]

Critically, the Massachusetts Final Regulations differ in scope from the U.S. Securities and Exchange Commission's Regulation Best Interest (Reg BI) in their definitions of covered customers. Reg BI applies to "retail customers" defined as

> A natural person, or the legal representative of such natural person, who: (i) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) Uses the recommendation primarily for personal, family, or household purposes.

17 CFR § 240.151-1(b)(1). This creates a potential gap between the scope of customers encompassed by the Massachusetts Final Regulations and Reg BI. For example, Reg BI applies only to natural persons and therefore excludes all non-natural persons regardless of size. On the other hand, customers under the Massachusetts Final Regulations could include non-natural persons that do not qualify as institutional buyers as defined in 950 CMR 12.205(1)(a)6. and 950 CMR 14.401. Firms must be mindful of this distinction when making recommendations and providing investment advice to their customers.

Comparison to SEC's Regulation Best Interest

In issuing the Massachusetts Final Regulations, Massachusetts' Secretary of the Commonwealth (the Secretary) suggested in a statement that the SEC's Reg BI did not go far enough to ensure that investors' interests are protected. Not surprisingly, the Massachusetts Final Regulations are more stringent than Reg BI in a few material respects.

Reg BI, which goes into force on June 30, 2020, is designed to raise the broker conduct standard above the current suitability requirement. Under Reg BI, broker-dealers, among other things, cannot put their interests ahead of the customer's interests and are required to mitigate or, in certain instances, eliminate conflicts of interest. See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019). However, the Massachusetts Final Regulations require broker-dealers and their agents to provide investment advice and recommendations "without regard to the financial or any other interests of any party other than the customer." 950 CMR 12.207(2)(b)3. Indeed, "[d]isclosing conflicts alone does not meet or demonstrate the duty of loyalty." 950 CMR 12.207(2)(c). Broker-dealers and their agents also have a duty to "make all reasonably practicable efforts to avoid conflicts of interest, eliminate conflicts that cannot reasonably be avoided, and mitigate conflicts that cannot reasonably be avoided or eliminated." 950 CMR 12.207(2)(b)2.

In addition, Reg BI only prohibits sales contests that are product-specific or limited to particular time periods, while the Massachusetts Final Regulations prohibit all sales contests. See 950 CMR 12.207(2)(d).

Notable Concessions

In response to concerns expressed by the financial industry during the comment period, the Division did end up excluding or clarifying various provisions in its proposed amendments to the Regulations (the Proposal). The concessions made by the Division in the Massachusetts Final Regulations include the following:

1. Removed Investment Advisers and Investment Adviser Representatives as Regulated Persons

Section 12.207 of the Proposal included broker-dealers, agents, investment advisers and investment adviser representatives. The Division excluded investment advisers and investment adviser representatives from the scope of the Massachusetts Final Regulations, noting that they are already subject to a fiduciary duty.[3] The Division explained that the Massachusetts Final Regulations "will continue to make broker-dealers and agents subject to a fiduciary duty when they make recommendations or provide advice with respect to securities." See *id*.

2. Removed Presumption That Use of Certain Titles, Purported Credentials or Professional Designations Imposed an Ongoing Fiduciary Duty

Section 12.207(1)(c) of the Proposal imposed obligations, including to monitor the customer's or client's account or portfolio on an ongoing basis, for broker-dealers or agents who use certain titles, credentials or professional designations (e.g., financial adviser; financial consultant).[3] Given the other protections provided under the Massachusetts Final Regulations, the Division stated that it had removed the presumption that such titles imposed an ongoing duty from the Massachusetts Final Regulations. See *id*.

3. Clarified When Broker-Dealers and Their Agents Have an Ongoing Fiduciary Duty

In response to various commenters raising concerns about whether the Proposal was imposing an ongoing duty on a broker-dealer or agent where one otherwise would not exist, the Division clarified the scope of the fiduciary duty.

The Division clarified that in Section 12.207(1)(a) of the Final Regulations, "the duty runs during the period in which incidental advice is made in connection with the recommendation of a security to the customer."[3] The Division also clarified that Section 12.207(1)(b) of the Final Regulations will further extend the duty beyond the recommendation period under certain circumstances "based upon ancillary factors that occur outside the traditional broker-dealer customer relationship." See *id*. The Division explained that an ongoing fiduciary duty exists if (i) the broker-dealer or agent has discretionary authority over the customer's account (unless the discretion relates solely to the time and/or price for the execution of the order); (ii) there is a contractual obligation that imposes a fiduciary duty; or (iii) there is an agreement to monitor the customer's account on a regular or periodic basis. See *id*.; see also 950 CMR 12.207(1)(b)1-3. The Division stated that it had amended the Massachusetts Final Regulations with respect to this third prong to clarify that "the duration of the fiduciary duty is determined by the agreement with the customer."[3]

Section 12.207(1)(b)4. of the Proposal "imposed a fiduciary duty during any time in which the broker-dealer or agent received ongoing compensation or provided investment advice to the customer in connection with other non-brokerage financial advice." See *id*. Section 12.207(1)(b)5. of the Proposal also imposed a fiduciary duty when the broker-dealer or agent engaged in any act, practice or course of business that resulted in the customer's having a reasonable expectation that their accounts would be monitored on an ongoing basis. See *id*. In response to commenters' concerns, chiefly, that these extended duties would result in broker-dealers and their agents falling outside the scope of the incidental" exemption in the Investment Advisers Act of 1940, the Division stated that it had removed both provisions from the Massachusetts Final Regulations. See *id*.

4. Removed Commodities and Insurance Products

Sections 12.207(1)(a) and 12.207(2)(d) of the Proposal included references to commodities and insurance products. In response to multiple commenters reasoning that the Proposal should be limited only to securities, the Division stated it had removed the express language regarding advice on commodities and insurance products from the Massachusetts Final Regulations.[3] Insurance lobbyists remained concerned that Massachusetts considered variable annuities to be securities that would fall under the fiduciary rule, based on documents on the Division's website and the fact that the Division has taken enforcement action against broker-dealers who sell variable annuities. Following adoption, a spokeswoman for the Secretary stated in an email that "[u]nder Massachusetts law, variable annuities are not securities" and "[t]he [Final] [R]egulations cover securities."

Furthermore, recommendations to sell a security and buy a nonsecurities product (or vice versa) could be subject to the fiduciary rule with respect to the entire transaction.

5. Clarified That Broker-Dealers and Agents Have a Duty to "Reasonably" Eliminate and Mitigate Conflicts of Interest

Section 12.207(2)(b)2. of the Proposal addressed the obligations of a broker-dealer or agent when facing conflicts of interest or potential conflicts of interest.[3] In response to several commenters voicing concerns that this section of the Proposal was ambiguous and hard to meet, the Division revised the Massachusetts Final Regulations to clarify that "not all conflicts must be avoided or eliminated." See *id*. The Division stated that "conflicts that arguably could be avoided or eliminated do not need to be if it would not be reasonable for a broker-dealer or agent to do so." See *id*.

Examples of conflicts of interest that cannot reasonably be avoided or eliminated include (i) receiving compensation in connection with making a recommendation, (ii) making a recommendation or sale of proprietary products and (iii) making a recommendation or sale in a principal transaction.[3] The Division explained that such conflicts may be mitigated by "ensuring that the fee earned for the recommendation is reasonable and complying with the remainder of the fiduciary duty." See *id*.

6. Excluded Municipal Securities and Government Securities From Duty of Loyalty Provision

Although the Proposal did not specifically address municipal securities, the Division excluded municipal securities and government securities (i.e., securities issued by U.S. federal, state and municipal governments) from the duty of loyalty provision in the Massachusetts Final Regulations pursuant to Section 12.207(2)(e).[3] The Division explained that "[r]ecommendations and advice provided in connection with these securities continue to be subject to the duty of care under Section 12.207(2) of the [Massachusetts] Final Regulations, as well as provisions of Section 12.204 of the [Massachusetts] Final Regulations." See *id*.

Key Takeaways

Concerns with the Massachusetts Final Regulations remain on both sides of the aisle. Advocates for investor protection think the Massachusetts Final Regulations represent only a slight upgrade on Reg BI. They expressed dismay over the Division's retreat from what the Proposal had required with respect to ongoing monitoring of accounts, as well as the Division's removal of recommendations of annuities and other insurance investments from the Massachusetts Final Regulations.

Industry representatives have said that the Massachusetts Final Regulations could negatively affect investor choice. They stated that more investors may have to rely on fee-based advisory accounts rather than potentially more suitable commission-based brokerage models. Additionally, they noted that the asset minimums often associated with advisory accounts could result in individuals with moderate to low incomes having to manage their money on their own. Furthermore, the differences between Reg BI and the Massachusetts Final Regulations will complicate broker-dealer compliance efforts. The possibility that additional states may also enter into this area is another concern, particularly for firms with substantial customer bases across multiple states.

Ultimately, the broker-dealer industry will have a difficult decision over whether to comply with Massachusetts' fiduciary rule or challenge its legality in court on federal preemption and other grounds.

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[1] "Massachusetts Securities Division Proposes Uniform Fiduciary Standard; Could Create Patchwork of Obligations Across State Lines," Sidley Update, July 2, 2019

[2] Amended Regulations

[3] Adopting Release

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SIDLEY

SIDLEY UPDATE

SEC Commissioner Peirce Proposes Blockchain Token Safe Harbor

February 13, 2020

On February 6, 2020, U.S. Securities and Exchange Commission (SEC or Commission) Commissioner Hester M. Peirce (Commissioner Peirce) gave a speech describing the need for more clarity on application of the securities laws to the offer and sale of blockchain tokens or digital assets. As part of the speech, she proposed a safe harbor (Proposal or Safe Harbor) exempting certain tokens from the registration requirements of the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act), including an exemption for persons engaging in certain transactions with respect to such tokens from the definitions of "exchange," "broker" and "dealer" under the Exchange Act. The Proposal is of significance to any existing or future blockchain development team considering the distribution of tokens, as well as any digital asset exchange or over-the-counter desk that facilitates transactions in digital assets, blockchain tokens or virtual currencies.

Commissioner Peirce explained that in the course of building decentralized blockchain networks, development teams need to get blockchain tokens into the hands of network users so that users can participate and use the tokens as intended on the network. She notes that the SEC's current approach to digital assets, a combination of settled enforcement actions and nonbinding guidance related, has made it extremely difficult to distribute blockchain tokens without implicating the federal securities laws. Most recently, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) released guidance on how to apply the *Howey* Test to determine whether a transaction is an "investment contract" and thus a security. [1] As first described by the U.S. Supreme Court in *SEC v. W.J. Howey & Co.*[2] (*Howey* Test), the court determined that the sale of portions of orange groves, together with an arrangement for caring for the trees and getting the fruit to market, was a security. Commissioner Peirce notes that in applying the *Howey* Test to digital assets "some commentators have pointed out that [the SEC has] elided the distinction between the token and the investment contract." Whether a digital asset itself is an investment contract remains the subject of ongoing litigation in various federal courts. In one pending high-profile case, the central issue is the nuanced question of whether digital assets distributed pursuant to an exempt securities transaction are also securities.[3] However, Commissioner Peirce notes that the Proposal is unlikely to affect the approach taken to date in SEC enforcement actions addressing digital assets.

The exemption from registration provided by Commissioner Peirce's nonexclusive Safe Harbor is for a three-year period from the date of first token sale, effectively shifting the application of the *Howey* Test from the initial token sale to a future date. The grace period is intended to provide the blockchain network sufficient time to become functional or decentralized (defined in the Proposal as "network maturity") such that the offer and sale of the blockchain tokens would not satisfy the *Howey* Test at the end of the three-year period. The definition of network maturity "is intended to provide clarity as to when a token transaction should no longer be considered a security transaction but, *as always, the analysis will require an evaluation of the particular facts and circumstances*." (*Emphasis added*.) If, at the end of the three-year period, a blockchain network had not reached network maturity, the development team would no longer be able to rely on the Safe Harbor and would need to consider the application of the federal securities laws to the offer and sale of the tokens.

A few additional elements of the Safe Harbor are as follows:

- *Public Disclosure*. The development team is required to make substantial disclosures on a freely accessible public website. As opposed to traditional securities disclosures that relate to the securities issuer, this information would be specifically tailored to the development team, blockchain network operations and token economics.
- *Liquidity*. Secondary trading is recognized as a necessary component in developing a mature network. The development team would need to make a good faith and reasonable effort to create liquidity by seeking trading platforms that will support the token. The Safe Harbor provides that such trading platforms and other intermediaries would be exempt persons from the definition of "exchange," "broker" or "dealer" under the Exchange Act. The trading platforms must demonstrate compliance with other applicable federal and state laws, as well as regulations related to money transmission, anti-money laundering and consumer protection.
- *SEC Filing Requirement*. Within 15 days of the first sale of tokens, the development team would be required to file with the SEC a notice of reliance on this Safe Harbor.
- *Bad Actor Disqualification and Antifraud Protections*. The Proposal seeks to balance fostering innovation with investor protection by making the Safe Harbor unavailable to development teams with a member that is a "bad actor" as defined by the federal securities laws. The Safe Harbor also preserves the SEC, state regulators and private purchasers' rights of action under the securities laws' antifraud provisions.

In terms of next steps, Commissioner Peirce welcomed feedback on the draft Proposal. However, she acknowledged that an actual safe harbor proposal will require approval by vote of the full Commission and be subject to the SEC's formal rulemaking process, including publication in the *Federal Register* and an open comment period for public input. Given the impact of the Proposal on blockchain development teams and trading platforms, industry participants should consider the potential impact to its existing business model and actively engage in providing feedback to the SEC in advance of formal rulemaking.

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[1] See our previous Sidley Update SEC FinHub's Digital Asset Framework: A Guide for Issuers and Secondary Trading Markets.

[2] 328 U.S. 293 (1946).

[3] *SEC v. Telegram Group Inc. and Ton Issuer Inc.*, Case No. 1:19-cv-09439-PKC (S.D.N.Y.). See also Brief for the Chamber of Digital Commerce Amicus Curiae, available here.

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SIDLEY UPDATE

SEC Proposes Amendments to Governance of Market Data Plans

January 23, 2020

On January 8, 2020, the SEC issued a proposed order to improve the governance of National Market System (NMS) plans that produce public consolidated equity market data and trade and quote data (Proposed Order)[1]. The Proposed Order would unify the three NMS plans that currently provide such information into a single consolidated data plan (New Consolidated Data Plan), would allocate one-third of the voting representation to new representatives not affiliated with a self-regulatory organization (SRO) and would require independent administration of the New Consolidated Data Plan.

This proposal is the latest in a series of recent initiatives under Chairman Jay Clayton relating to market data, exchange fees and other enhancements to market structure.[2] The deadline for comments on the proposal is February 28.

Background

The NMS plans governing market data are designed to consolidate "core data" [3] from each of the SROs to an exclusive securities information processor (SIP), which consolidates this market data and makes it available to market participants.[4] The purpose is to provide the public with a comprehensive, accurate and reliable source of information for the prices and volume of any NMS stock at any time during the trading day.

Today, there are three NMS plans governing the dissemination of core data for equities, two of them administered by New York Stock Exchange LLC (NYSE) and one administered by Nasdaq Stock Market LLC (Nasdaq).[5] The participants in these NMS plans consist of equities exchanges that facilitate or previously facilitated trading in NMS stocks as well as FINRA. All voting authority with respect to the NMS plans rests with SRO participants, though each of the NMS plans has a nonvoting advisory committee consisting of broker-dealers, a market data vendor and an investor.

Impetus for the Proposed Order

The primary concerns relating to the current governance of the NMS plans and the operation of the SIPs that led to the Proposed Order are conflicts of interest, latency concerns and efficiency. First, the SRO participants in the NMS plans, as national securities exchanges, sell their own propriety market data products, which typically include more detailed quote information and compete with core market data available from the SIPs.[6] Since the time of the initial creation of the NMS plans in the early 2000s, the exchanges have shifted from member-owned, not-for-profit organizations to publicly held companies seeking to maximize shareholder value. These two facts create a significant conflict of interest that incentivizes the exchanges to maximize the viability of their proprietary market data products at the expense of the core data distributed through the SIPs.

Second, many market participants rely on processing market data as quickly as possible to facilitate their trading. The core data distributed through the SIPs is slower than proprietary market data feeds received directly from the exchanges because core data must be aggregated and consolidated by the SIP before distributed to market participants. While the NMS plans have taken steps in recent years to improve the speed of the SIPs, many market participants still believe that the current speed of core data is not sufficient for them to trade competitively.

Third, each of the three NMS plans today must be separately maintained and operated, which is unnecessary and less efficient than a consolidated NMS plan. In addition, the current governance structure of the NMS plans does not provide the primary consumers of the market data with a voting interest in the operation of the NMS plans.

The Proposed Order

The key aspects of the Proposed Order are set forth below:

- *Consolidate NMS Plans* — As noted, the Proposed Order would consolidate the three NMS plans to a single New Consolidated Data Plan for efficiency reasons.
- *Exchange Groups Assigned One Vote* — Currently, each SRO has one vote. The Proposed Order would modify the voting structure to provide that each exchange group would be entitled to a single vote rather than each individual exchange. If an exchange group maintains a consolidated market share of 15 percent or more for at least four of the preceding six calendar months, the exchange group would be entitled to a second vote.
    - The SEC believes that providing each SRO a single vote under the current NMS plan provides exchange groups with disproportionate influence on the governance of the plans. Currently, three exchange groups (Cboe BATS, NYSE and Nasdaq) control 14 of 17 votes.
- *Non-SRO Members Provided One-Third Voting Power* — The Proposed Order would establish five new positions for non-SRO voting representatives that would be provided a one-third voting interest in aggregate on the operating committee. The non-SRO representatives would consist of (i) an institutional investor (e.g., an asset management firm), (ii) a broker-dealer with a predominately retail customer base, (iii) a broker-dealer with a predominately institutional investor customer base, (iv) a securities market data vendor, (v) an issuer of NMS stock and (vi) a retail investor.[7]
    - The SEC believes that the governance of the New Consolidated Data Plan would benefit from a broader constituency having voting rights, in particular consumers of the equity data plans.
    - The Proposed Order provides that non-SRO voting representatives would serve

(e.g., discussing a matter that exclusively affect the SROs), (ii) where it is included on the written agenda with a clearly stated rationale for the executive session and (iii) where the proposed executive session is approved by a majority vote of the SRO members of the operating committee.

- *Conflicts of Interest Policy* — The Proposed Order provides that the New Consolidated Data Plan should include a comprehensive conflicts of interest policy applicable to all members of the operating committee and that address dual roles that some members may have (e.g., as a SRO offering proprietary market data while simultaneously responsible for operation of the New Consolidated Data Plan).
- *Other Policies* — The Proposed Order provides that other policies within the existing NMS plans that are "necessary for the operation and oversight" should be adopted as part of the New Consolidated Data Plan. In addition, the Proposed Order calls for a robust confidentiality policy to ensure that participants do not use information for their commercial or proprietary benefit as well as a policy to govern an orderly transition from the existing NMS plans to the New Consolidated Data Plan.

What's Next

After considering comments on the Proposed Order, the SEC may issue a final order that would require the plan participants to propose a New Consolidated Data Plan in accordance with the final order, which would then be published for public comment. Notably, the two Democratic Commissioners (Robert Jackson and Allison Herren Lee) dissented from the Proposed Order, noting concerns that the proposed reforms did not go far enough and arguing that the SEC should take a more active approach to implementing these reforms. Both Commissioners cited the NMS plan governing the Consolidated Audit Trail(CAT), which remains unfinished after nearly a decade, as evidence regarding the lengthy delays that often accompany coordinated NMS plans.

The Proposed Order, if implemented, would address a number of the equity market structure initiatives outlined by Chairman Clayton and Division of Trading and Markets Director Brett Redfearn in a March 2019 speech.[10] The current SEC leadership might next consider further changes to equity market structure such as (i) re-examining the regulatory authority and responsibility of for-profit exchanges, (ii) expanding data disseminated under the SIPs to include streaming or depth of book data or even (iii) establishing a competing consolidator model in which any number of market data vendors or broker-dealers could aggregate market data and distribute it without the need for any SIP. The looming 2020 election and any potential leadership changes at the SEC, however, might portend a more limited reform agenda in the coming months.

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[1] Securities Exchange Act of 1934 Release No. 87906 (January 8, 2020), 85 FR 2164 (January 14, 2020).

[2] For a discussion of some of these past initiatives and what may yet be on the horizon, see our August 2019 client alert Increasing SEC Scrutiny of Exchange Fees and What May Come Next.

[3] "Core data" consists of (1) the price, size and exchange of the last sale; (2) each exchange's current

highest bid and lowest offer, and the shares available at those prices and (3) the national best bid and offer (i.e., the highest bid and lowest offer currently available on any exchange).

[4] Section 11A of the Securities Exchange Act of 1934 directs the SEC to, among other things, prescribe rules providing for the “prompt, accurate, reliable, and fair collection, processing, distribution, and publication of information with respect to quotations for and transactions in such securities and the fairness and usefulness of the form and content of such information.” 15 U.S.C. 78k-1(c)(1)(B). Section 11A further authorizes the SEC, by rule or order, to authorize or require the SROs to act jointly with respect to matters as to which they share authority, including the NMS plans governing the dissemination of core market data. 15 U.S.C. 78k-1(a)(3)(B).

[5] The three NMS plans that govern the distribution of core data are (1) the Consolidated Tape Association Plan (CTA Plan); (2) the Consolidated Quotation Plan (CQ Plan); and (3) the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation, and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis (UTP Plan). There is also a fourth NMS plan for options exchanges governing the collection, consolidation and dissemination of last sale and quotation information for listed options, known as the Limited Liability Company Agreement of Options Price Reporting Authority, LLC (OPRA Plan). The SEC states in the Proposed Order that it is proposing to take an “incremental approach” to addressing NMS plan governance issues and may consider future amendments to the OPRA Plan.

[6] For example, the exchange proprietary market data feeds typically in “depth of book” market data, which show quotations beyond just the best available bid or offer at a given time.

[7] The non-SRO representatives could not be affiliated with an SRO or a broker-dealer to serve as the representative of an issuer, market data vendor or retail investor.

[8] 15 U.S.C. 78k-1.

[9] The SEC noted that a number of industry representatives have called for greater transparency regarding the revenue allocation formula, including a “plain language version.”

[10] Chairman Jay Clayton and Director Brett Redfearn, *Equity Market Structure 2019: Looking Back & Moving Forward*, remarks at Gabelli School of Business, Fordham University (March 8, 2019) available at https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019.

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SIDLEY UPDATE

SEC and FINRA Issue 2020 Examination Priorities for Broker-Dealers and Investment Advisers

January 17, 2020

The U.S. Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) and the Financial Industry Regulatory Authority (FINRA) recently published their examination priorities (together, the Examination Priorities) for the 2020 calendar year.[1] In general, the 2020 Examination Priorities continue recurring themes from recent prior years.

OCIE's 2020 Examination Priorities for broker-dealers and investment advisers include the protection of retail investors (including compliance with new standard of care requirements and interpretations), cyber and information security risks, anti-money laundering compliance, firms engaging in the digital asset space and the provision of electronic investment advice.

FINRA's 2020 Examination Priorities for member firms include those generally identified by OCIE for registered broker-dealers, as well as cash management and bank sweep programs, initial public offerings, liquidity management, trading authorizations and order routing and vendor display rule requirements, among others.

This Sidley Update summarizes selected aspects of the Examination Priorities that may be of particular interest to broker-dealers and investment advisers. As always, firms should use the 2020 Examination Priorities to review their compliance and supervisory procedures carefully and make any necessary revisions. Firms also should be prepared to explain their compliance and supervisory policies in these areas in their upcoming SEC and/or FINRA examinations, as applicable, and provide documentation of relevant reviews.

HIGHLIGHTS OF THE SEC'S EXAMINATION PRIORITIES FOR BROKER-DEALERS AND INVESTMENT ADVISERS

Following are the highlights of OCIE's 2020 Examination Priorities for broker-dealers and investment advisers.

Focus Areas for Both Broker-Dealers and Investment Advisers

The following core areas of focus are common to both SEC registered broker-dealers and SEC registered investment advisers (RIAs), although the specifics of what OCIE examines for will depend on a firm's registration status and the nature of its business.

Protection of Retail Investors

For both broker-dealers and investment advisers, OCIE will continue to emphasize the protection of retail investors, particularly seniors and those saving for retirement. In particular, firms can expect OCIE examinations to focus on the following core areas with respect to retail investors (which may include retail customers, clients and fund investors):

- *Fraud, Sales Practices and Conflicts of Interest*
  OCIE will look for compliance with requirements regarding disclosures to investors (including those relating to fees and expenses, conflicts of interest and employees' outside business activities), as well as the implementation of supervisory systems and controls designed to oversee activities and ensure that required disclosures are timely and accurate.

  OCIE also will focus on recommendations and advice provided to retail investors, with a particular emphasis on seniors, retirees, teachers and military personnel, as well as products that the SEC considers higher risk (e.g., products that carry higher fees and expenses, are complex or nontransparent, and situations in which the issuer is affiliated with the firm making the recommendation).

  In addition, for **RIAs**, OCIE will continue to examine for fulfillment of a firm's duties of care and loyalty under the Investment Advisers Act of 1940, as amended (Advisers Act), with a particular focus on whether a firm's advice is in the best interest of its clients and whether the firm has eliminated or at least appropriately disclosed all conflicts of interest.

- *Retail-Targeted Investments*
  OCIE will continue to focus on investment products marketed and sold to retail investors, including mutual and exchange-traded funds, municipal and other fixed income securities and microcap securities.

  Among other things, examiners will look for financial incentives that may influence the selection of particular mutual fund share classes and will seek to ensure that investors are receiving fee discounts consistent with applicable requirements, including a firm's policies, contractual commitments and disclosed breakpoints.

  Broker-dealers can also expect to have their trading activity in municipal and corporate bonds examined for compliance with (i) best execution obligations, (ii) fair pricing, commissions and mark-ups/mark-downs, and (iii) confirmation disclosure requirements.

  With respect to microcap securities, OCIE will seek to identify **broker-dealers** that may be engaged in, or aiding and abetting, pump and dump or other market manipulation schemes, as well as illegal distributions of securities of smaller cap companies. Broker-dealers may be selected for examination based on their market making or other significant trading activity in unlisted securities, as well as employing registered personnel with disciplinary history. Focus areas for such examinations will include sales practices, supervision of high-risk personnel and compliance with key regulatory requirements (including Rule 15c2-11 under the Securities Exchange Act of 1934, as amended (Exchange Act), the locate requirement of Regulation SHO and the obligation to file suspicious activity reports (SARs)).

- *Standards of Care (Including New Regulation Best Interest and Form CRS)*
  OCIE examiners will focus on firms' preparedness for, and compliance with, applicable standard of care requirements.

  Regulation Best Interest. Prior to the June 30, 2020 compliance date for new Regulation Best Interest (Regulation BI), OCIE will engage with **broker-dealers** regarding their preparedness to comply with the new requirements.[2] After the compliance date, OCIE will examine for implementation of the new requirements, including for policies and procedures regarding conflicts of interest and the content and delivery of Form CRS.[3]

  Interpretation Regarding Standard of Conduct for Investment Advisers. As previously noted, OCIE will continue to examine **RIAs** for compliance with their fiduciary obligations. This will include reviewing firms' conduct in light of the SEC's 2019 Interpretation Regarding Standards of Conduct for Investment Advisers, as well as the content and delivery of Form CRS.[4]

Information Security

OCIE will continue to focus on information security, including with respect to governance and risk management issues (particularly with respect to oversight of third-party service providers), retail trading and compliance with Regulations S-P and S-ID, the configuration of network storage devices and the proper disposal of retired hardware to protect client and firm information. OCIE will also continue to focus on **broker-dealers'** controls surrounding mobile and online access to customer brokerage account information, as well as **RIAs'** protection of their clients' personal financial information (with respect, for example, to access controls, data loss prevention, training, and incidence response and resiliency).

Financial Technology (FinTech) and Digital Assets

One notable addition to OCIE's Examination Priorities this year is a focus on FinTech and innovation. The addition of FinTech to the 2020 priorities highlights OCIE's commitment to keep up with the rapid pace of developments in the FinTech space and with the attendant risks to investors. Specifically, OCIE will continue to assess the effectiveness of compliance and controls related to firms' use of alternative data and technologies.

The digital asset market, which includes cryptocurrencies, coins and tokens, has grown rapidly and continues to be an area of focus for OCIE. Areas of exam focus will include investment suitability, portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance programs and controls, and supervision of employees' outside business activities.

Firms Registered as Municipal Advisors

OCIE will continue to examine municipal advisors (including **broker-dealers** and **RIAs** dually registered as municipal advisors) for compliance with registration, professional qualification and continuing education requirements. OCIE will also focus on municipal advisors' fulfillment of applicable standards of care and the management and disclosure of conflicts of interest.

Additional Focus Areas Specific to Broker-Dealers

Broker-dealer examinations will also focus on the following additional areas, as applicable to a firm's business:

- *Financial Responsibility*
  For broker-dealers that hold customer assets, OCIE will examine for proper safeguarding of customer cash and securities in accordance with the customer protection rule (Exchange Act Rule 15c3-3) and the net capital rule (Exchange Act Rule 15c3-1), including assessing the adequacy of a firm's processes, procedures and controls related thereto.

- *Trading and Risk Management Practices (Including Best Execution)*
  Examiners will focus on broker-dealers' trading and risk management practices, including with respect to "odd lots" and best execution obligations. OCIE will also examine broker-dealers' controls relating to the use and supervision of automated trading algorithms, as well as firms' internal procedures and controls to manage trading risk generally.

- *AML Programs*
  OCIE will continue to prioritize broker-dealers' anti-money laundering compliance, including an assessment of whether firms are appropriately satisfying customer identification and due diligence obligations and filing SARs as required.

Additional Focus Areas Specific to Investment Advisers

Investment adviser examinations will also focus on the following additional areas, as applicable:

- *Never-Before-Examined RIAs and Private Fund Advisers*
  OCIE will continue to prioritize risk-based examinations of RIAs that have never been examined, including newly-registered advisers. OCIE also will prioritize examinations of certain investment advisers that have not been examined for a number of years, focused on whether their compliance programs are being appropriately kept up to date with growth and changes to their business. Examinations of RIAs to private funds will focus on those having a greater retail impact, such as firms that manage separately managed accounts side-by-side with private funds, as well as on compliance risks such as misuse of material, non-public information, conflicts of interest and related disclosure, and the use of adviser affiliates for client services.

- *Advisers to Mutual Funds and ETFs*
  OCIE will prioritize examinations of RIAs that advise mutual funds and ETFs. Exam focus areas include (i) RIAs that use third-party administrators to sponsor the mutual funds they advise or are affiliated with and (ii) RIAs to private funds that also manage a registered investment company with a similar investment strategy.

- *Dually-registered Advisers and Use of Third-Party Asset Managers*
  OCIE will continue to prioritize examinations of RIAs that are dually registered as, or are

affiliated with, broker-dealers, or have supervised persons who are registered representatives of unaffiliated broker-dealers. OCIE also will prioritize examining firms that utilize the services of third-party asset managers to advise clients' investments.

- *Electronic Investment Advice*
  Examinations of RIAs that provide services to clients through automated investment tools and platforms (often referred to as robo-advisers) will focus on, among other things, SEC registration eligibility, cybersecurity policies and procedures, marketing practices, adherence to fiduciary duty (including adequacy of disclosures) and effectiveness of compliance programs.

OCIE Examination Trends

OCIE completed 3,089 examinations in FY 2019. While this represents a 2.7% decrease from FY 2018, OCIE attributes the relatively small decrease to the month long suspension of examinations during the 2019 government shutdown. Compared with FY 2017, the number of examinations has increased almost 7%. FY 2019 continued the trend of devoting resources to examine RIAs. OCIE has increased its examination coverage of RIAs over the past several years from 10% in FY 2014 to a high of 17% in FY 2018. In FY 2019, OCIE examined approximately 15% of all RIAs, notwithstanding the government shutdown in early 2019. OCIE also completed over 350 examinations of broker-dealers and over 160 examinations of FINRA, including examinations of critical FINRA program areas, as well as oversight reviews of FINRA examinations.

HIGHLIGHTS OF FINRA'S EXAMINATION PRIORITIES FOR MEMBER FIRMS

FINRA's annual Risk Monitoring and Examination Priorities Letter (Letter) identifies topics on which its risk monitoring, surveillance and examination programs will focus in 2020. Continuing the approach commenced in 2019, the Letter primarily discusses new and emerging areas in greater depth and ongoing priorities with shorter summaries, while not repeating topics that have been at the center of FINRA's attention in the past.

This is the first priorities letter issued since FINRA announced that it has integrated three different examination programs into a single framework designed to better direct and align examination resources to the risk profiles and business models of member firms. Under the framework, all FINRA member firms are grouped into one of five main firm business models: Retail, Capital Markets, Carrying and Clearing, Trading and Execution, and Diversified. In addition, each firm will be assigned a single point of accountability, a senior leader who has ultimate responsibility for the ongoing risk monitoring, risk assessment, planning and scoping of examinations tailored to the risks of the firm's business activities. This initiative should make the examination process more efficient because the number of examinations a firm is subject to should be lessened and examination teams should be more knowledgeable and familiar with a firm's businesses policies and culture.

The restructuring of FINRA's examination program and the restructured Letter are a result of the FINRA360 review, and FINRA should be commended for its efforts in this regard. Consistent with this initiative, to support firms in their efforts to comply with the federal securities laws and regulations and FINRA rules, the practitioner-friendly Letter includes practical considerations and questions for each topic and contains an appendix that provides citations to additional resources applicable to those topics.

The following is a discussion of salient points in the FINRA Letter.

Sales Practice and Supervision

FINRA will continue to examine for firms' compliance with sales practice obligations discussed in previous annual priorities letters — for example, complex products, variable annuities, private placements, fixed income mark-up/mark-down disclosures, representatives acting in certain positions of trust or authority, and senior investors. For the coming year, the identified new and emerging areas are discussed below.

Regulation BI and Form CRS

Like the SEC, FINRA will review firms' preparedness for Regulation BI to gain an understanding of implementation challenges they face. After the compliance date, FINRA will examine firms' compliance with Regulation BI, Form CRS and related SEC guidance and interpretations. The Letter states that FINRA and SEC staff expect to work together to ensure consistency in examining firms for compliance with Regulation BI and Form CRS. In addition, the Letter lists a number of factors that examiners will consider when testing for compliance with Regulation BI.

Communications with the Public

FINRA will continue to review for firms' compliance with core obligations under FINRA and SEC rules governing communications with the public, supervision, and books and records requirements. In addition, FINRA will focus on the review, approval and supervision of:

- retail communications regarding private placement securities; and
- communications via digital communication channels (e.g., texting, messaging, social media or collaboration applications).

Cash Management and Bank Sweep Programs

FINRA recognizes that because many firms have altered their commission practices, including some firms' eliminating commissions altogether, cash management services that sweep investor cash into firms' affiliated or partner banks or money market funds (Bank Sweep Programs) have taken on a greater significance. Firms' Bank Sweep Programs may offer retail investors a variety of additional services, such as check writing, debit cards and ATM withdrawals.

FINRA notes that Bank Sweep Programs raise several concerns about firms' compliance with a range of FINRA and SEC rules. FINRA will evaluate these firms' compliance with, for example, FINRA Rules 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), 2010 (Standards of Commercial Honor and Principles of Trade), and 2210 (Communications with the Public), as well as Exchange Act Rule 15c3-1 (Net Capital Rule) and Exchange Act Rule 15c3-3 (Customer Protection Rule).

Sales of Initial Public Offering Shares

FINRA is focusing its attention on firms' obligations under FINRA Rules 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and 5131 (New Issue Allocations and

Distributions).

Trading Authorization

FINRA will assess whether firms maintain reasonably designed supervisory systems relating to trading authorization, discretionary accounts and key transaction descriptors, such as solicitation indicators. FINRA will review whether firms have reasonably designed supervisory systems to detect and address registered representatives exercising discretion without written authorization from the client, as required under FINRA Rule 3260 (Discretionary Accounts).

Market Integrity

FINRA notes that its examiners will continue to review firms' compliance with the obligations discussed in prior years' letters, such as market manipulation, Trade Reporting and Compliance Engine (TRACE) reporting, short sales and short tenders. Additionally, FINRA reminds firms of the upcoming implementation of Consolidated Audit Trail (CAT) reporting and that firms need to remain diligent in their compliance with the Order Audit Trail System (OATS) rules during the phased implementation of CAT. While not specifically referenced in the Letter, FINRA remains active in pursuing matters involving Electronic Blue Sheet reporting.

Direct Market Access Controls

The continued growth in automated and high-speed trading increases potential risks to the financial condition of firms, the integrity of trading on the securities markets and the stability of the financial system. FINRA, like the SEC and other self-regulatory organizations (SROs), will continue to examine for compliance with the market access rule. The examiners' approach in this area continues to evolve and be somewhat subjective, with findings of exam staff varying from year to year.

Best Execution

Best execution continues to be a primary focus of FINRA. Its examinations and surveillance will focus on whether firms use reasonable diligence to determine whether their customer order flow is directed to the best market given the size and types of orders, the terms and conditions of orders, and other factors as required by FINRA Rule 5310 (Best Execution and Interpositioning). In addition to a focus on U.S. Treasury securities and options executions, FINRA will focus on:

- conflicts of interest and disclosures in connection with order routing decisions (including with respect to the recent increase in zero-commission brokerage activity); and
- the handling of odd-lot orders (including whether firms are filling customer odd-lot orders at the National Best Bid and Offer (NBBO) disseminated by the securities information processors (SIPs) and offsetting these trades with odd-lot executions at superior prices reflected in the exchanges' proprietary data feeds).

Disclosure of Order Routing Information

FINRA will examine for firms' compliance with amended Regulation National Market System (NMS) Rule 606. The amended rule requires, among other enhancements, broker-dealers to provide new customer-specific reports for "not held" orders in NMS stocks. These disclosures serve an important role in enhancing the transparency of the U.S. securities markets with respect to broker-dealers' handling and routing practices for both institutional and retail customer orders.

Vendor Display Rule

Rule 603 of Regulation NMS (Vendor Display Rule) generally requires broker-dealers to provide a consolidated display of market data for NMS stocks for which they provide quotation information to customers. FINRA will evaluate the adequacy of firms' controls and supervisory systems to provide their customers with the current consolidated NBBO as required by the Vendor Display Rule.

Financial Management

FINRA will continue to evaluate firms' compliance programs relating to Exchange Act Rule 15c3-3 (Customer Protection Rule) and Exchange Act Rule 15c3-1 (Net Capital Rule), as well as firms' overall financial risk management programs.

Digital Assets

Digital assets raise novel and complex regulatory issues under federal securities laws and regulations, as well as FINRA rules. FINRA is receiving an increasing number of new member applications and continuing member applications from firms seeking to engage in business activities related to digital assets. FINRA continues to work closely with the SEC to understand firms' business plans and determine how securities laws apply to those plans. Notably, FINRA issued Regulatory Notice 19-24 last year extending into 2020 its effort to encourage firms to keep their Regulatory Coordinator abreast of their activities related to digital assets.

Liquidity Management

FINRA will continue to review firms' liquidity management practices, as they are a critical control function and should be documented in a firm's books and records. FINRA will focus on areas it has addressed in Regulatory Notice 15-33 (Guidance on Liquidity Risk Management Practices), as well as those that may create challenges for clearing and carrying firms' contingency funding plans.

Firm Operations

FINRA will continue to examine firms' supervisory controls relating to Exchange Act Rule 10b-10 and FINRA Rule 2232 (Customer Confirmations) and firms' compliance with FINRA Rule 3310 (Anti-Money Laundering Compliance Program).

Cybersecurity

Firms should expect that FINRA will thoroughly assess whether their policies and procedures are reasonably designed to protect customer records and information consistent with Regulation S-P Rule 30. FINRA recognizes that there is no one-size-fits-all approach to cybersecurity but expects firms to implement controls appropriate to their business model and scale of operations.

Technology Governance

Firms' increasing reliance on technology for many aspects of their customer-facing activities, trading, operations, back-office and compliance programs creates a variety of potential benefits but also exposes firms to technology-related compliance and other risks. In particular, problems in firms' change and problem-management practices, for example, can expose firms to operational failures that may compromise their ability to comply with a range of rules and regulations, including FINRA Rules 4370 (Business Continuity Plans and Emergency Contact Information), 3110 (Supervision) and 4511 (General Requirements), as well as Exchange Act Rules 17a-3 and 17a-4.

FINRA Examination Trends

Since the commencement of FINRA360, FINRA has made significant changes to its examination program and has been much more willing to provide guidance to its membership to assist firms and associated persons in complying with federal securities laws and FINRA rules. These are welcome developments, hopefully ones other SROs will also adopt.

That being said, broker-dealers should review their policies and procedures in the areas discussed in the Letter and be prepared to address these areas in future examinations.

CONCLUSION

The themes and specific points outlined in the Examination Priorities do not constitute an exhaustive list of OCIE's or FINRA's concerns, and actual examinations are likely to include a number of other topic areas. Nevertheless, the Examination Priorities are likely to drive many exams in the coming year, and investment advisers and broker-dealers are encouraged to review their policies, procedures and disclosures with these priorities in mind.

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[1] See OCIE's 2020 Examination Priorities, available here, and FINRA's 2020 Risk Monitoring and Examination Priorities Letter, available here.

[2] Firms are encouraged to reach out to OCIE and other SEC staff members as they implement policies and procedures to comply with the new requirements. Questions may be submitted by email to IABDQuestions@sec.gov.

[3] See Exchange Act Release Nos. 86031 (June 5, 2019) (adopting Regulation BI), available here and 86032 (June 5, 2019) (adopting new rules and forms regarding the broker-dealers' and investment advisers delivery of a customer or client "relationship summary" or CRS), available here (the Form CRS Release). See also our June 2019 Sidley Update regarding Regulation BI, Form CRS and Interpretations under the Advisers Act.

[4] See Advisers Act Release No. 5248 (June 5, 2019), available here (reaffirming and clarifying aspects of a registered investment adviser's fiduciary duties), and the Form CRS Release, *supra* note 2; see also the June 2019 Sidley Update, *supra* note 2.

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SIDLEY UPDATE

SEC Warns Investors Regarding Digital Asset Initial Exchange Offerings

January 16, 2020

On January 14, 2020, the U.S. Securities and Exchange Commission (SEC) Office of Investor Education and Advocacy published an investor alert (Alert) regarding initial exchange offerings (IEOs), a type of digital asset fundraising facilitated by online trading platforms.[1] Although the Alert is directed at investors, it provides important information to blockchain companies and trading platforms. The Alert highlights the following:

- an explanation of an IEO
- IEOs that are securities offerings must comply with federal securities laws
- a platform offering an IEO may need to register as a broker-dealer, national securities exchange or operate pursuant to an exemption, such as an alternative trading system (ATS)
- IEOs offered to U.S. investors, even if offered from outside the United States, must comply with federal securities laws

Initial Exchange Offerings. An IEO is the offer and sale of a digital asset to raise capital through an online trading platform. IEOs are the latest development in the evolution of digital asset distributions, which started in 2017 with initial coin offerings (ICOs), followed in 2018 and 2019 by security token offerings (STOs). IEOs are being used to raise capital and touted by trading platforms as an opportunity to immediately trade the digital assets. This is in contrast to other digital asset offerings, such as STOs, which have generally relied on an exemption from the registration requirements of the securities laws. The Alert urges investors to use caution when considering investing through an IEO.

Securities Offerings. The SEC explains that an IEO may be an offering of securities and thus subject to the registration requirements of the Securities Act of 1933 and Securities Exchange Act of 1934 (Exchange Act). The issuance of a security must be pursuant to a registration statement filed with the SEC unless an exemption is available.[2] Even if there is no registration statement filed with the SEC, a security may need to be registered for it to trade on the secondary market.[3] The Alert notes that IEOs may be used to entice investors with the false promise of high returns, while the federal securities registration requirements compel applicable issuers to provide certain disclosures so that investors may make informed investment decisions.[4] The Alert points out that notwithstanding any statements by IEO promoters, “there is no such thing as an SEC-approved IEO.”

Broker-Dealers. Online trading platforms that facilitate IEOs may be acting as unregistered broker-dealers. Broker-dealers must register with the SEC and become a member of a self-regulatory organization such as the Financial Industry Regulatory Authority (FINRA). Registered broker-dealers are subject to requirements that function as important safeguards for investors, such as acting in a manner consistent with the SEC's customer protection standards.

National Securities Exchanges. The Alert cautions that trading platforms offering IEOs may claim to perform quality assessments of the IEOs but are typically not registered with the SEC as is required under the Exchange Act by anyone claiming to be a securities "exchange." Alternatively, a platform can operate pursuant to an exemption, such as the alternative trading system (ATS) exemption provided in Regulation ATS. ATSs must register with the SEC and join a self-regulatory organization, typically FINRA. The legal and regulatory requirements that apply to exchanges and ATSs are designed to protect investors and prevent fraudulent and manipulative trading practices.[5]

Offshore Offerings. Issuers and platforms based outside the United States must comply with U.S. securities laws if offers are being made to people within the United States. The SEC highlights as a red flag to investors if an offering purports to avoid the federal securities laws because it is conducted by a foreign entity or offshore trading platform but allows U.S. persons to invest.

Investors may not have the same legal remedies against offshore trading platforms or companies as they would with U.S. entities.

Conclusion

This Alert provides important information to trading platforms and blockchain companies that have conducted or are considering IEOs. As digital asset offerings have evolved from ICOs to STOs and beyond, the SEC has published investor alerts and bulletins regarding the application of securities laws to digital assets around the same time as other SEC releases involving similar issues. Digital asset trading platforms and blockchain companies should diligently consider the federal securities laws in any fundraising involving persons in the United States.

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[1]Office of Investor Education and Advocacy, Initial Exchange Offerings (IEOs) – Investor Alert, January 14, 2020.

[2]Securities Act of 1933, 15 U.S.C. § 77e.

[3]Securities Exchange Act of 1934, 15 U.S.C. § 78l.

[4]See our client updates: SEC FinHub's Digital Asset Framework: A Guide for Issuers and Secondary Trading Markets and The Sheriffs are in Town: Recent Developments in Initial Coin Offerings (ICO) Enforcement and Investor Education.

[5]See our client updates: Digital Asset Securities: Joint SEC and FINRA Statement Aimed at Broker-Dealer Custody and One-Two-Three Punch: SEC and FINRA Announce Actions Against Unregistered

Broker, Digital Asset Manager and FINRA Registered Person.

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SEC Issues Industry Relief to Broker-Dealers Regarding the Computation of Concentrated Margin Debit Balances under SEC Rule 15c3-3 for Certain Investment Funds

January 13, 2020

On January 8, 2020, the Staff of the SEC issued significant industry guidance through a "no-action" letter regarding so-called "concentrated debits" under SEC Rule 15c3-3, Appendix A, Note E(5) (the SEC's customer protection rule).

The letter should be beneficial for registered investment companies and unregistered "hedge" funds, in each case, that trade on margin extended to them by an SEC-registered broker-dealer, such as a U.S. prime broker (a "carrying firm"), where the same or affiliated managers manage multiple investment funds. Prior to the issuance of the no-action letter, carrying firms may have been required to aggregate the margin debit balances of all funds with the same or affiliated managers for purposes of SEC Rule 15c3-3, which made it more likely that the carrying broker (prime brokerage) would hit the debit "ceiling" in the rule and have to "cut off" or limit margin financing across all/each of such funds. The letter should also be beneficial to carrying firms by providing clarification on how to apply Note E(5) to these types of fund-customers.

As such, the no-action letter allows investment funds, that meet certain criteria as discussed herein, and that have the same or common managers to be evaluated separately for these purposes.

Background:

Brokerage customers that maintain margin accounts at a carrying firm, such as a prime broker, are, generally, subject to limits on the amount of margin/financing that such customers are eligible to receive from the carrying firm under applicable margin regulations, in particular, Regulation T and Rule 4210 of the Financial Industry Regulatory Authority, Inc. (FINRA)[1]. In addition, a customer with a large margin indebtedness or loan from its carrying firm (resulting in a large "debit" balance in the customer's margin account at the carrying firm) could, in effect, be subject to a separate limitation on the ultimate amount of the customer's margin indebtedness as a result of a limit imposed on the carrying firm under Rule 15c3-3, Appendix A, Note E(5) as promulgated by the SEC under the U.S.

Securities Exchange Act of 1934, as described herein. SEC Rule 15c3-3 is the SEC's "customer protection" rule that, generally, requires carrying firms to safeguard customers' securities and funds/cash held by such firms on behalf of, or for the account of, its customers.

Under the SEC's "customer reserve formula" set forth in SEC Rule 15c3-3, Appendix A, carrying firms are required to do periodic computations (daily, weekly or monthly, depending on the firm) of "credits" (which includes customer "free credit" balances that are subject to immediate cash payment upon the demand of a customer) and "debits" (which includes margin financing/indebtedness extended, or loaned, by the carrying firm to its customers with respect to the purchase of (long) securities positions by such customers). Under SEC Rule 15c3-3, a broker-dealer may only use credit balances in the reserve formula to finance/fund debit balances (or otherwise is required to deposit net credit balances into a special reserve bank account of the carrying firm). In this regard, a carrying firm can use customers' free credit balances (item 1 in the customer reserve formula) to finance customers' debit (margin) balances (item 10 in the customer reserve formula). However, under Note E(5) to Appendix A, carrying firms are capped at the amount of customer free credit balances that it may use to finance any particular customer's margin (item 10) debit balance, as discussed below.

Note E(5) was adopted in October 1985[2] and limits the amount of debit balance that a broker-dealer can recognize in item 10 of the customer (and, also, the PAB[3]) reserve formula with respect to (i) a single customer's account (other than an omnibus account), (ii) guaranteed accounts, (iii) accounts under "common control", and (iv) other "related accounts." As noted above, a debit balance for these purposes means the aggregate/outstanding margin balance of a customer extended/loaned by the carrying firm to the customer to allow the customer to purchase (long) securities.[4]

The primary purpose of Note E(5) is to protect customers' free credit balances (cash balances available for immediate withdrawal by the customer) carried by a broker-dealer against fraudulent debits as well as the credit risk arising from margin debits of a large customer. The request letter to the SEC noted the belief that the SEC did not, when it adopted Note E(5) in 1985, contemplate that investment funds, with different beneficial ownership, but that have a common manager or have affiliated managers under common control – either public or private funds - would be subject to Note E(5).[5]

Pursuant to the customer (and PAB) reserve formula of Exhibit A to SEC Rule 15c3-3, a broker-dealer enters the amount of debit balances in customers' cash and margin securities accounts on item 10 thereof. However, Note E(5) to item 10 generally requires the broker-dealer to reduce debit balances in margin accounts (other than omnibus accounts) by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital[6] (the "Note E(5) Reduction"). Note E(5) further provides that related accounts (e.g., accounts under common control) will be deemed to be a single customer's account for the purposes of Note E(5).

Carrying firms, such as prime brokers, have historically found it difficult to determine when the item 10 debit balances of investment funds – such as hedge funds and registered investment companies, in each case, that have the same, or an affiliated, investment manager who directs the trading activities for the applicable fund - are required, or not required, to be aggregated/combined for the purposes of the Note E(5) Reduction. As such, carrying firms may, conservatively, have elected to aggregate such debit balances thereby resulting in investment funds, within a single investment family/group that trade separately from one another, to run up against the debit “limit” or “ceiling” imposed on broker-dealers under Note E(5). As a result, carrying firms that are subject to the Note E(5) Reduction may have limited the amount of margin financing that such broker-dealer would extend to any one of such “concentrated” investment fund-customers (and, thus, potentially limited the degree of trading by such investment fund-customers) separately from loan limits under applicable margin regulations.[7]

The SEC’s Industry Relief:

On January 8, 2020, the Staff of the SEC issued a “no-action” letter to the Securities Industry and Financial Markets Association regarding the treatment of certain investment funds under Note E(5) to SEC Rule 15c3-3, Appendix A[8]. This relief is industry guidance that applies to all carrying firms and is effective immediately.

Pursuant to the no-action letter, the SEC has provided needed clarity to the application of the Note E(5) Reduction that should be beneficial to investment funds with common or affiliated investment managers that trade on margin provided by their carrying firms as well as to carrying firms in achieving compliance with their requirements under Note E(5).

In this regard, the SEC Staff will not recommend enforcement action to the Commission if a broker-dealer, for the purposes of the Note E(5) Reduction, does not treat the account(s) of a “Publicly-offered RIC”[9] as being under common control with the account(s) of one or more investment companies or investment funds notwithstanding that the entities share a common investment manager or have affiliated investment managers.

In addition, the SEC Staff will not recommend enforcement action to the SEC if a broker-dealer, for the purposes of the Note E(5) Reduction, does not treat the account(s) of a “Private Investment Fund” [10] or a “Privately-offered RIC” [11] as being under common control with the account(s) of one or more investment companies or investment funds notwithstanding that the entities share a common investment manager or have affiliated investment managers if any of the following conditions is met:

1. The aggregate amount of debit balances in the account(s) of the Private Investment Fund or Privately-offered RIC does not exceed a “de minimis” balance (set at 2.5% of the broker-dealer's tentative net capital) [12]; or

2. The Private Investment Fund or Privately-offered RIC is not narrowly held[13], or;

3. If narrowly held, the Private Investment Fund or Privately-offered RIC does not have ownership in common[14] with any other Private Investment Fund or Privately-offered RIC that shares a common investment manager or has affiliated investment managers.[15]

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[1] Although with portfolio margining under FINRA Rule 4210(g), an eligible/qualifying customer, which could encompass certain investment funds, can qualify for greater leverage than otherwise permitted under a “strategy-based” margining arrangement under Regulation T.

[2] See SEC Release No. 34-22499 (October 3, 1985).

[3] SEC Rule 15c3-3, Appendix A, also applies to "PAB accounts", which are, generally, proprietary accounts of U.S. and foreign broker-dealers as well as foreign banks acting as a broker-dealer.

[4] Separately, for the purposes of the possession and control requirements of a carrying firm under SEC Rule 15c3-3(b) and (c), the carrying firm must compute an "adjusted" margin debit balance of its customers (such adjusted balance being net of credit balances in the customer's account (other than short sale proceeds)).

[5] See, for example, footnote 8 to the Commission's proposed release relating to, among other things, Note E(5) – SEC Release No. 34-20655 – where the Commission stated that for purposes of establishing control under Note E(5), "ownership of 10% or more of the common stock of the relevant entity will be deemed to be sufficient." The latter suggests that the Commission was contemplating control of a non-fund corporate entity, and not an investment fund.

[6] Pursuant to SEC Rule 15c3-1(c)(15), the SEC's net capital rule applicable to carrying firms, "tentative net capital" generally means a broker-dealer's net capital after deduction of non-allowable assets, such as unsecured receivables, but before deduction of proprietary "haircuts" on securities and other assets/positions of the broker-dealer.

[7] The Note E(5) Reduction does not prohibit a carrying firm from extending margin indebtedness to a "concentrated" customer in excess of the margin debit cap/ceiling thereunder; rather, the rule just limits the ability of the carrying firm to finance such margin indebtedness using/with its customers' free credit balances (by imposing a cap/ceiling on the amount of the item 10 debit balance that the carrying firm may include in the customer reserve formula under SEC Rule 15c3-3, Appendix A. The carrying firm, however, would not be restricted under Note E(5) in providing the additional financing to such customer using/with the firm's own funds.

[8] See https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-010820-15c3.pdf

[9] A "Publicly-offered RIC" means an investment company that is registered under the U.S. Investment Company Act of 1940 ("1940 Act") and that issues publicly-offered shares/interests (registered under the U.S. Securities Act of 1933 (the "1933 Act")).

[10] A "Private Investment Fund" means an investment fund that is not registered under the 1940 Act because it is excluded from the definition of "investment company" by reason of Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

[11] A "Privately-offered RIC" means an investment company that is registered under the 1940 Act and whose shares/interests are privately offered without registration under the 1933 Act (in reliance on the exemption from registration under the 1933 Act set forth in Section 4(a)(2) of the 1933 Act and, generally, also SEC Rule 506 of Regulation D there-under).

[12] 2.5% of tentative net capital is equal to 10% of the 25% of the tentative net capital threshold in the Note E(5) Reduction.

[13] Under the SEC's no-action letter, a Private Investment Fund or a Privately-offered RIC will not be deemed to be "narrowly held" if the broker-dealer has determined within the last 12 months that the fund or company has at least ten investors and no single investor has more than a 10% ownership interest in the Private Investment Fund or the Privately-offered RIC.

[14] For purposes of the SEC's no-action letter, ownership in common will be deemed to occur whenever a Private Investment Fund or Private Investment Company shares at least one investor in common with another Private Investment Fund or Private Investment Company.

[15] The SEC's no-action position addresses only the question of "common control," and does not address other types of "related accounts," such as accounts subject to "cross guarantees," as those terms are used in Note E(5) to item 10. Moreover, the no-action position does not address the circumstance in which a single account, even an account of a Publicly-offered RIC or of a Private Investment Fund or Privately-offered RIC that is not narrowly held, exceeds the tentative net capital limit described in Note E(5) to item 10. In that circumstance, Note E(5) to item 10 requires the broker-dealer to reduce the debit balance in the single margin account by the amount by which it exceeds 25% of the broker-dealer's tentative net capital.

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