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BROKER-DEALER

FINRA Issues Notice Regarding Disruptive Quoting and Trading Activity Rule Changes

On June 7, the Financial Industry Regulatory Authority published Regulatory Notice 17-22, which addresses two rule changes implemented in December 2016 regarding disruptive quoting and trading activity. The first rule change adopts new Supplementary Material .03 to Rule 5210, which defines two types of prohibited activities and states that a “frequent pattern or practice” of these activities is considered disruptive quoting and trading activity. The first prohibited activity involves a scenario where: (1) a party enters multiple limit orders on one side of the market that changes the level of supply and demand for the security; (2) the party enters one or more orders on the opposite side of the market which are subsequently executed; and (3) the party then cancels its original orders. The second prohibited activity consists of a scenario where: (1) a party places an order inside the national best bid and offer; and (2) the party then submits an order on the opposite side of the market that executes against another market participant that joined the new inside market.

The second rule change amends FINRA’s procedural rules regarding temporary cease and desist orders. This amendment creates a process whereby FINRA can issue a permanent cease and desist order on an expedited basis against a respondent that engages in a frequent pattern or practice of the prohibited activities defined under Supplementary Material .03 to Rule 5210.

FINRA Regulatory Notice 17-22 is available here.

DERIVATIVES

See “FCA Focuses on Dividend Arbitrage” in the UK Developments section and “FIA Publishes Letter Opposing Relocation of Euro-Denominated Derivatives Clearing” in the Brexit/EU Developments section.

BANKING

OCC Issues FAQs on Managing Third-Party Relationships

On June 7, the Office of the Comptroller of the Currency (OCC) issued frequently asked questions (FAQs) to supplement OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance,” which was originally issued on October 30, 2013. These FAQs address questions from national banks and federal savings associations. The FAQs and underlying OCC Bulletin 2013-29 apply to all national banks and federal savings associations, and primarily focus on defining third-party relationships, tips for reducing oversight costs, and guidance on engaging with FinTech companies.

The OCC intends to review banks’ questions on OCC Bulletin 2013-29 from time to time and issue future FAQs or other guidance when it deems necessary.

The full text of the OCC FAQs is available here.

UK DEVELOPMENTS

FCA Focuses on Dividend Arbitrage

On June 2, the Financial Conduct Authority (FCA) published issue 52 of *Market Watch*, its market conduct and transaction reporting newsletter. The newsletter focuses on the practice of dividend arbitrage, the intention of which is to place shares in alternative tax jurisdictions around dividend dates, with the aim of minimizing withholding taxes (WHT), or generating WHT reclaims. This may involve several different trading activities, such as trading and lending securities and trading derivatives, including futures and total return swaps, that are designed to hedge movements in the price of the securities over the dividend dates.

The newsletter states that the FCA reviewed the practices of firms executing transactions with or on behalf of clients who engage in dividend arbitrage, and that most comply with the FCA's requirements. However, the FCA is concerned that some firms may not have undertaken a sufficiently detailed assessment of the purpose and nature of the transactions, raising the risk that firms are involved in contrived transactions which support fraudulent WHT claims. In addition to being potentially criminal in nature, the FCA states that such practices could amount to market abuse due to the potential for false or misleading signals about the supply or demand of a relevant security.

The newsletter reinforces the FCA's expectations for regulated firms, such as inter-dealer brokers, settlement agents and custodians. Firms are required to establish and maintain effective controls to ensure that they manage these types of risks, especially regarding financial crime risk.

The newsletter is available here.

BREXIT/EU DEVELOPMENTS

ESMA Updates MiFID II Q&A on Investor Protection

On June 6, the European Securities and Markets Authority (ESMA) updated its question and answer document (Q&A) relating to investor protection under the revised Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR).

The updated Q&A contains new questions and answers relating to the following topics:

- information on costs and charges;
- post-sale reporting (specifically on fulfilling the obligation to report on a portfolio depreciating by the 10% threshold); and
- "appropriateness" in relation to complex financial instruments.

The Q&A is available here.

FIA Publishes Letter Opposing Relocation of Euro-Denominated Derivatives Clearing

On June 6, the Futures Industry Association (FIA) published a letter addressed to European Commission (EC) Vice–President Valdis Dombrovskis, detailing its concerns about the potential approach of forced relocation of euro-denominated derivatives clearing to the European Union. Forced relocation was raised as an option for ensuring the protection of the financial stability and monetary policy of the European Union in the EC's May 2017 communication on certain challenges for critical financial market infrastructures and for further developing the Capital Markets Union.

FIA states that relocation would be the most disruptive and expensive approach to overseeing third-country central counter-parties (CCPs), without improving the oversight of this activity. It opposes relocation for the effects it will have on the derivatives markets, including:

- **Fragmentation.** FIA states that fragmentation of the market would result in the creation of two distinct pools of trading liquidity, one offshore with the majority of euro-denominated swaps traded by foreign institutions and a smaller and less-liquid on-shore pool for swaps traded by EU institutions. This small pool could impact a CCP's ability to successfully port or auction client positions of a defaulting clearing member and increase systemic risk.
- **Weakening the stability of the EU.** FIA points out that a key part of promoting financial stability through the use of CCPs is having a significant pool of clearing members available to accept clients or positions from a defaulting clearing member. As well as the already-declining number of clearing firms, a location policy could increase concerns around the market's ability to absorb clients of a defaulting clearing member.
- **Costs for end-users.** FIA believes that the fragmentation of clearing among multiple CCPs would reduce the benefits of portfolio margining; risk offsets would be lost and end users would have to post more margin to accommodate this heightened risk, estimated to be as much as an additional $77 billion. End users would also face higher execution costs due to lower volumes and a reduced number of market participants.

FIA instead supports the EC's use of recognition and enhanced supervision as being a more effective and less disruptive way to protect financial stability. They note that the European Union has been a leader in developing "equivalence" regimes for third countries, which have the ability to raise standards to meet those of the European Union. The letter ends by recognizing that further enhancements between EU and UK supervisory authorities may be needed after Brexit, but that history has shown that a location policy is not needed to meet their intended regulatory objectives.

The letter is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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