

## **BROKER-DEALER**

### **FINRA Issues Report on Examination Findings**

This month, the Financial Industry Regulatory Authority (FINRA) issued a report summarizing various findings from recent examinations of its member firms (Report). In particular, the Report sets forth selected observations from recent examinations that FINRA considers worth highlighting because of their potential significance, frequency and impact on investors and the markets. The Report also describes compliance and supervisory practices that FINRA has observed to be effective in certain circumstances.

The Report's high-level observations include, but are not limited to, the following:

- Suitability issues, including situations where registered representatives did not adequately consider an individual retail customer's financial situation and needs or other investment profile factors when making recommendations, recommendations involving overconcentration in illiquid securities that resulted in significant customer losses, failures to identify and prevent excessive trading in customer accounts, unsuitable variable annuity recommendations, and failure to conduct appropriate due diligence on volatility-linked products and other complex products;
- Failure by firms to provide required transaction-related information to customers for certain trades in corporate, agency and municipal debt securities;
- Firms failing to conduct reasonable diligence on private placements (which typically should entail meaningful independent research on material aspects of the offering, identification of red flags and addressing concerns that would be relevant to a potential investor) and/or over relying on third parties to conduct due diligence;
- Lack of sufficiently robust supervisory controls and procedures to prevent abuses of authority by registered representatives exercising discretion on behalf of customers;
- Firms not properly documenting investigations of potentially suspicious activity flagged by exception reports;
- Non-compliance with the net capital rule, including failing to sufficiently document expense-sharing agreements, taking incorrect inventory haircuts and miscalculation of operational charges;
- Non-compliance with the customer protection rule, such as improper use of customer fully-paid and excess-margin securities to fund firm operations and inaccurate reserve formula calculations;
- Firms permitting staff members who are not properly registered as Operations Professionals to engage in activities such as approving general ledger journal entries, supervising financial functions and/or approving business requirements of trading systems related to covered functions;
- Firms lacking adequate supervisory programs relating to, or otherwise failing to comply with, confirmation disclosure requirements (e.g., inaccurate disclosure of the firm's trading capacity, mislabeled disclosure of compensation and failure to disclose market maker status);
- Failure to maintain sufficient written supervisory procedures and controls regarding registered representatives' use of "doing business as" names;
- Best execution obligation violations, including with respect to firms allowing conflicts of interest relating to financial benefits from routing orders to particular venues to adversely affect the objectivity of the firm's "regular and rigorous" review of customer execution quality;
- Non-compliance with TRACE reporting rules in connection with institutional sales of fixed income securities; and
- Insufficient market access controls by firms that provide market access to their customers, including with respect to intra-day adjustment of pre-trade financial thresholds and oversight of third-party vendors.

For more complete coverage of topics addressed in the Report, and greater detail on the topics addressed above, the full FINRA Report is available [here](#).

## DERIVATIVES

See “NFA Proposes Amendments Incorporating Swaps into Compliance Rules and Interpretive Notices” in the CFTC section and “FCA Publishes Consultation Paper on Restricting CFD Products Sold to Retail Clients” and “European Commission Reported to Grant Temporary Access to UK Clearing Houses” in the Brexit/UK Developments section.

## CFTC

### **CFTC Issues Request for Input on Crypto-Assets**

As part of its LabCFTC initiative, the Commodity Futures Trading Commission issued a Request for Input (RFI) to deepen the CFTC’s understanding of the technology, mechanics, and markets for Ether and its use on the Ethereum Network. In particular, the RFI seeks to understand similarities and distinctions between Ether and Bitcoin (as well as other virtual currencies), and Ether-specific opportunities, challenges and risks.

Comments on the RFI may be submitted up to 60 days after its publication in the *Federal Register*.

A copy of the RFI is available [here](#), and the associated CFTC press release is available [here](#).

### **NFA Proposes Interpretive Notice Regarding CPO Internal Controls Systems**

On December 10, the National Futures Association (NFA) submitted to the Commodity Futures Trading Commission a proposed Interpretive Notice to NFA Compliance Rule 2-9, which would provide commodity pool operators (CPOs) with guidance on designing and implementing an adequate system of internal controls. Specifically, the Interpretive Notice requires CPOs to implement an internal controls system that is designed to protect customer funds and ensure the reliability of the CPO’s books and records and compliance with CFTC and NFA requirements. This includes adopting and implementing written policies and procedures that fully explain the CPO’s internal controls system and maintain records that support the implementation and effectiveness of that system.

In particular, the Interpretive Notice identifies certain key components for all CPO internal controls systems, relating to:

1. separation of duties (including the separation of custody and financial reporting functions and separation of responsibilities for initiating, approving, recording and reconciling transactions); and
2. risk assessment (including assessing risks related to pool subscriptions, redemptions and transfers, risk management, valuation and use of fund administrators).

NFA submitted the proposed Interpretive Notice under the “10-day” effectiveness provision, meaning that, absent objection from the CFTC, it will become effective 10 days after its submission.

A copy of the NFA submission is available [here](#).

### **NFA Proposes Amendments Incorporating Swaps into Compliance Rules and Interpretive Notices**

On December 10, the National Futures Association (NFA) submitted to the Commodity Futures Trading Commission for review and approval proposed amendments to various NFA Compliance Rules and four NFA Interpretive Notices to incorporate swaps into these rules and notices.

Specifically, the NFA proposal would amend the following Compliance Rules:

- NFA Compliance Rule 1-1 (Definitions) to add related definitions;
- NFA Compliance Rules 2-2 (Fraud and Related Matters) to include references to swaps, counterparties and related concepts, including with respect to anti-fraud, anti-manipulation and other prohibitions;
- NFA Compliance Rule 2-3 (Sharing in Profits) to expand the rule to cover all commodity interests;
- NFA Compliance Rule 2-6 (Expelled or Suspended Member or Associate) to expand the rule to apply to all commodity interests and clarify the scope of the rule.
- NFA Compliance Rule 2-10 (Recordkeeping) to clarify that the requirements relating to English records and fluency apply to swap dealer members (among others);
- NFA Compliance Rules 2-38 (Business Continuity and Disaster Recovery) to clarify the Member categories subject to their coverage;
- NFA Compliance Rule 3-1 (Department of Compliance) to remove the limited purpose definition of commodity interest; and
- NFA Compliance Rule 3-15 (Member or Associate Responsibility Actions) to incorporate references to commodity interests and counterparties.

The Board also approved amendments to four Interpretive Notices to integrate the applicable rule amendments.

A copy of the proposed amendments is available [here](#).

## DIGITAL ASSETS AND VIRTUAL CURRENCIES

*See “CFTC Issues Request for Input on Crypto-Assets” in the CFTC section and “FCA Publishes Consultation Paper on Restricting CFD Products Sold to Retail Clients” in the Brexit/UK Developments section.*

## BREXIT/UK DEVELOPMENTS

### **Short Selling (Amendment) (EU Exit) Regulations 2018 Made in Preparation of Brexit**

On December 7, the Short Selling (Amendment) (EU Exit) Regulations 2018 (UK Regulations) were published, together with an explanatory memorandum. A draft version of the UK Regulations was published on October 10.

The UK Regulations ensure that the regime established in the United Kingdom under the EU Short Selling Regulation (SSR) will continue to operate effectively after its withdrawal from the European Union on March 29, 2019 (Exit Day).

The UK Regulations will amend the SSR and the delegated legislation made by the European Commission under such regulation. They also amend Part 8A of the Financial Services and Markets Act 2000, which implemented parts of the SSR in the UK.

The UK Regulations will go into effect on Exit Day.

The UK Regulations are available [here](#), and the related explanatory memorandum is available [here](#).

### **FCA Publishes Consultation Paper on Product Intervention Measures for Retail Binary Options**

On December 7, the UK Financial Conduct Authority (FCA) published a consultation paper on product intervention measures for retail binary options.

The FCA is proposing to prohibit the sale, marketing and distribution of binary options in or from the UK to retail consumers by creating new rules in its Conduct of Business sourcebook (COBS).

The FCA has expressed significant concerns regarding investor protection from the sale of binary options to UK retail consumers. The FCA has justified these concerns based on evidence of aggressive and/or misleading marketing of these products, their inherent complexity and lack of transparency, and the level (and speed) of retail consumer losses experienced when trading binary options.

The consultation closes to comments on February 7, 2019. The FCA will aim to publish a policy statement by March 2019. In the meantime, the FCA reminds firms that they need to continue to comply with similar intervention measures made by the European Securities and Markets Authority (ESMA), for as long as ESMA's decision notice in relation to such measures is in force in the UK.

The FCA's consultation paper is available [here](#).

## **HM Treasury Publishes Updated Draft Brexit Statutory Instrument Relating to Collective Investment Schemes**

On December 6, HM Treasury published updated versions of the draft Collective Investment Scheme (Amendment etc.) (EU Exit) Regulations 2018 (Draft CIS (Brexit) SI) and the related explanatory information.

Draft CIS (Brexit) SI ensures that the regime established under the UCITS IV Directive for investment funds and their managers continues to operate effectively after the United Kingdom's withdrawal from the European Union (Brexit) on March 29, 2019 (Exit Day). It includes amendments to the retained provisions of delegated acts made under UCITS IV and UK legislation such as the Financial Services and Markets Act 2000.

HM Treasury is expected to lay the Draft CIS (Brexit) SI before Parliament before Exit Day.

The Draft CIS (Brexit) SI will go into effect on Exit Day, with the exception of certain provisions, such as those relating to temporary recognition, which will go into effect on the day after the date on which the regulations under the Draft CIS (Brexit) SI are made.

The Draft CIS (Brexit) SI is available [here](#), and the related explanatory information is available [here](#).

## **FCA Publishes Consultation Paper on Restricting CFD Products Sold to Retail Clients**

On December 7, the UK Financial Conduct Authority (FCA) published a consultation paper on restricting contract for difference (CFD) and other derivative products sold to retail consumers.

In its consultation paper, the FCA is proposing to intervene in the CFD market to address allegedly poor conduct by firms offering CFD products to retail customers, and to limit the sale of CFDs and similar products with excessive risk features that could result in harm to such customers. The FCA has proposed rules that will require firms to:

1. limit leverage depending on the volatility of the underlying asset;
2. close out a customer's position when their funds fall to 50 percent of the margin needed to maintain open positions on their CFD account;
3. provide protections that guarantee a client cannot lose more than the total funds in their CFD account;
4. stop offering monetary and non-monetary inducements to current and potential customers encouraging them to trade; and
5. provide a standardized risk warning, informing potential customers of the percentage of their retail client accounts that make losses.

The FCA also is asking for feedback on whether exchange-traded futures and related over-the-counter derivative products present similar risks of harm to retail customers and may therefore need similar rules. Additionally, the consultation paper includes the draft Conduct of Business (Contracts for Difference) Instrument 2019, which will make changes to the Conduct of Business sourcebook of the *FCA's Handbook*.

The consultation paper closes to comments for CFD proposals on February 7, 2019, and for other retail derivative products on March 7, 2019, after which the FCA will aim to publish its policy statement by March 2019. If the FCA decides to extend the scope of its rules for other retail derivative products, it will consult on this later in 2019.

The FCA will consult separately early next year on banning the sale, marketing and distribution of derivatives that references cryptoassets to customers treated as retail clients.

The FCA's consultation paper is available [here](#).

## **European Commission Reported to Grant Temporary Access to UK Clearing Houses**

On December 12, it was reported that the European Commission (EC) intends to grant temporary and conditional equivalence status to UK central counterparties (CCPs) under the European Market Infrastructure Regulation (EMIR) in the event of the United Kingdom withdrawing from the European Union (Brexit) without concluding a withdrawal agreement ("no-deal Brexit").

The EC's draft decision would grant continued access to UK CCPs by the remaining 27 EU member states, for all classes of cleared derivatives, for a 12-month period in the event of a no-deal Brexit, although details have yet to be confirmed by a committee of national officials. Without such equivalence rights, EU banks for brokers would not be able to use UK trading venues to trade derivatives after a no-deal Brexit, which could result in significantly increased trading costs or an inability to hedge market exposures.

The draft decision states that equivalence would be granted on the condition that the Bank of England cooperates in information sharing with the European Securities and Markets Authority (ESMA). The exchange of information would cover clearing for all financial instruments denominated in EU currencies, trading venues and clearing participants, as well as subsidiaries of union credit institutions and investment firms.

The EC also is planning to grant equivalence to central securities depositories, where assets are exchanged for cash. These two initiatives form part of a reportedly wider set of no-deal Brexit preparations in the EU that will be addressed in the very near term.

## **BREXIT/EU DEVELOPMENTS**

### **ECJ Rules That Article 50 Notice of Intention to Leave the EU Can Be Unilaterally Revoked**

On December 10, the European Court of Justice (ECJ), in the case of *Wightman and Others v. Secretary of State for Exiting the European Union*, ruled that the notice of an intention to leave the European Union, once properly submitted, can be unilaterally revoked, rather than requiring the consent of all other EU Member States.

On March 29, 2017, the UK notified the European Council of its intention to withdraw from the EU under Article 50 of the Treaty of the European Union (TEU), triggering a two-year period for the UK and EU to negotiate an agreement on the terms of the UK's withdrawal. A judicial review was brought in the Scottish Court of Session in December 2018 by members of the Scottish, UK and European Parliaments, seeking clarification as to whether notification of the UK's intention to withdraw could be revoked unilaterally. The Scottish Court of Session asked the ECJ to interpret Article 50 of the TEU to determine the issue.

The ECJ stated in its ruling that notification of intention to withdraw is not itself definitive or irrevocable. If the Member State in question decides to remain, in accordance with its own constitutional requirements, it may revoke its notice of withdrawal up until the actual time of withdrawal (such time being the expiration of the two-year negotiation period or, if earlier, when a withdrawal agreement goes into effect ). Such revocation would need to be unequivocal, unconditional and be made by a written notice addressed to the European Council.

The ruling, therefore, clarifies that the UK could, after a parliamentary vote, withdraw its Article 50 notice prior to March 29, 2019 (Exit Day), and remain in the EU.

The full judgment 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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BREXIT/UK/EU DEVELOPMENTS

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