Katten

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## SEC/CORPORATE

### SEC Adopts Amendments to Modernize Auditor Independence Rules

On October 16, the Securities and Exchange Commission adopted amendments (the Amendments) to its long-standing auditor independence rules. The Amendments, which largely mirror the amendments proposed in December 2019, reflect updates based on recurring fact patterns and related SEC staff consultations, respond to recent changes in capital market conditions and modify certain aspects of the auditor independence framework set forth in Rule 2-01 of Regulation S-X (Rule 2-01). Rule 2-01, among other things, requires auditors to be independent of their audit clients "both in fact and in appearance." As previously described in the January 17, 2020 edition of *Corporate & Financial Weekly Digest*, Rule 2-01(b) sets forth the general standard for auditor independence, while Rule 2-01(c) provides an illustrative list of relationships and circumstances in which an accountant would not be considered independent, including certain financial, employment, business and other relationships between the auditor and the audit client.

In the SEC's press release announcing the Amendment, SEC Chairman Jay Clayton notes that the Amendments "reflect the Commission's long-recognized view that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence," and that the modernized auditor independence requirements under the Amendments will "increase investor protection by focusing audit clients, audit committees, and auditors on areas that may threaten an auditor's objectivity and impartiality." The SEC's press release also indicates that the staff has, over the years and during the course of consultations, been made aware of certain relationships and services that technically constituted independence rule violations under the existing Rule 2-01 (before the Amendments), even though the auditor's objectivity and impartiality was not necessarily impaired. As highlighted in the fact sheet included with the press release, the Amendments, among other things:

1. amend the definitions of "affiliate of the audit client" in Rule 2-01(f)(4) and "investment company complex" in Rule 2-01(f)(14), which terms are used in the definition of "audit client" in Rule 2-01(f)(6). An "audit client" generally consists of "the entity whose financial statements or other information is being audited, reviewed or attested" (sometimes referred to as the "entity under audit") and each "affiliate of the audit client" and includes entities "under common control with the audit client" (sometimes referred to as "sister entities"), as well as "each entity in the investment company complex when the audit client is an entity that is part of an investment company complex" (sometimes referred to as "ICCs"). The Amendments replace the term "audit client" with "entity under audit" in Rule 2-01(f)(4)(i) and Rule 2-01(f)(4)(ii) to avoid confusion in applying the control tests used to determine whether an entity is an "affiliate of the audit client" and include in the definition of "audit client" a dual materiality qualifier, which gives the auditor discretion to determine whether both (a) a sister company (including a sister company within an ICC) is material to the controlling entity; and (b) the entity under audit is material to the controlling entity. The SEC noted in the Amendments that, "if either the sister entity or the entity under audit is not material to the controlling entity, then the sister entity will not be deemed an affiliate of the audit client." To understand the practical impact of these changes, the adopting release for the Amendments includes examples that illustrate the application of the Amendments to various factual scenarios;

2. amend the definition of the "audit and professional engagement period" in Rule 2-01(f)(5)(iii) to shorten the look-back period during which domestic first-time filers must assess and ensure their auditor's independence from three years to one year (i.e., the immediately preceding fiscal year), which results in all

first-time filers (both domestic issues and foreign private issuers) being treated the same for this purpose, as there was a one-year look-back period for foreign private issuers before the Amendments;

3. add certain student loans and *de minimis* consumer loans to the categorical exclusions from independence-impairing lending relationships set forth in Rule 2-01(c);

4. amend the business relationship rule in Rule 2-01(c)(3) (which prohibits the accounting firm or any covered person from, at any point during the audit and professional engagement period, "having any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity," including, among others, substantial stockholders of an audit client) to replace the reference to "substantial stockholders" with the concept of "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the entity under audit"; and

5. replace the transition and grandfathering provision in Rule 2-01(e) with a transition framework to address inadvertent independence violations that only arise as a result of a "corporate event," such as a merger or acquisition transaction (other than merger or acquisition transactions that are in substance similar to IPOs, such as a merger between a shell company and a private operating company), which new framework provides that the auditor's independence is not impaired so long as (a) the services or relationships that would otherwise be the basis for the violation were not prohibited prior to the effective date of the corporate event; (b) the auditor corrects the independence violations arising from the corporate event as promptly as possible and, in any event, no later than six months following the closing of the corporate event; and (c) the auditor has a quality control system to monitor the audit client's corporate events and related activities to promptly identify any potential independence violations before the closing of the corporate event.

The Amendments become effective 180 days after publication in the *Federal Register*, although voluntary early compliance is permitted after the Amendments are published in the *Federal Register* but prior to the effective date if the registrant complies with the Amendments in their entirety from the date of such early compliance.

The Amendments are available here, and the press release and fact sheet are available here.

## BROKER-DEALER

### FINRA Releases Information Notice on Cybersecurity Authentication Methods

On October 15, the Financial Industry Regulatory Authority (FINRA) released an information notice (Notice) providing additional background on authentication techniques for firms to consider as they implement cybersecurity authentication programs.

The Notice provides an overview of authentication factors that may be based on various categories of information, including PINs or passwords, "hard" physical tokens (such as key FOBs) and "soft" tokens (such as mobile phone app) that generate temporary or time-based passwords.

The Notice clarifies that the use of single-factor authentication may subject broker-dealers and customers to heightened risk of attacks on password credentials, and represent the vast majority of the hacking tactics associated with reported breaches. FINRA specifically emphasized that the use of multi-factor authentication, which uses two or more different types of factors or secrets, significantly reduces the likelihood that the exposure of a single credential will result in account compromise.

The Notice is available here.

### FINRA Releases Regulatory Notice on Revised NAC Sanction Guidelines

On October 20, the National Adjudicatory Council (NAC) of the Financial Industry Regulatory Authority (FINRA) revised the Principal Considerations in Determining Sanctions section of the FINRA Sanction Guidelines to expressly contemplate a customer's age or physical or mental impairment. In connection therewith, FINRA released Regulatory Notice 20-37.

The prior version of the FINRA's Sanction Guidelines contained 19 Principal Considerations in Determining Sanctions that adjudicators were instructed to consider. As amended, the Sanction Guidelines now contains 20 Principal Considerations.

FINRA specified that the amendments reflect NAC's overall concerns regarding the protection of customers, especially senior investors or mentally impaired customers. In furtherance of those concerns, FINRA amended Principal Consideration No. 19 to explicitly include customers' mental or physical impairment. Additionally, FINRA introduced a new Principal Consideration No. 20 to consider whether the customer is age 65 and older.

The amendments to the Sanction Guidelines are effective immediately.

The notice is available here. The revised Sanction Guidelines are available here.

## DERIVATIVES

*See "CFTC Staff Issues Advisory on Virtual Currency for Futures Commission Merchants," "CFTC and Bank of England Sign Updated MOU for Supervision of Cross-Border Clearing Organizations" and "CFTC and SEC Approve Final Rule on Security Futures Margin and Request for Comment on Portfolio Margining" in the CFTC section.*

## CFTC

### CFTC Staff Issues Advisory on Virtual Currency for Futures Commission Merchants

On October 21, the Division of Swap Dealer and Intermediary Oversight (DSIO) of the Commodity Futures Trading Commission issued an advisory to futures commission merchants (FCMs) regarding the holding of virtual currency in segregated accounts. The advisory, Letter No. 20-34, provides guidance to FCMs on how to hold and report certain deposited virtual currency from customers in connection with physically delivered futures contracts or swaps and how to maintain appropriate risk management programs concerning the acceptance of virtual currencies as customer funds.

Consistent with the existing requirements for customer funds held by FCMs, DSIO advised FCMs that, among other things:

- Virtual currency held as customer funds by an FCM must be deposited only with a bank, trust company, or another FCM, or with a designated clearing organization (DCO) that clears virtual currency futures, options on futures, or cleared swap contracts (Depository), which must provide an acknowledgment letter required under CFTC Rule 1.20(h).
- The virtual currency (e.g., bitcoin or ether) deposited must relate solely to customer trading of futures (or options on such futures) or cleared swaps contracts that provide for the physical delivery of that virtual currency. The virtual currency accepted must be intended to margin, guarantee, or secure such customer trading, and the amount must reasonably relate to the customer's level of trading in those contracts during each calendar quarter. Further, the relevant DCO must have formally determined that the virtual currency is an acceptable form of collateral for those contracts.
- Virtual currency must be available for withdrawal from a Depository upon demand and should be completed within a time that is technologically and operationally possible, but should not exceed one day, unless the procedures of the Depository specify additional time as part of its controls related to transfers of virtual currency.
- In computing its daily and month-end segregation requirement, an FCM may not offset a debit or deficit in a futures customer's or cleared swaps customer's account by the value of any virtual currency held in the respective customer's account. Therefore, an FCM may be required to deposit its own funds into segregation to cover any debit or deficit.
- An FCM may not deposit its own virtual currencies in futures customer's or cleared swaps customer's segregated accounts for any reason, including in order to meet targeted or residual interest requirements.

Further, DSIO advised that, before accepting any virtual currency into a customer's segregated account, an FCM should provide 45 days prior written notice to all futures and cleared swaps customers that the FCM will begin accepting virtual currency as of a specified date. The FCM should thereafter include the total amount of customer activity in virtual currency being supported by the deposit of actual virtual currency by customer origin as part of its disclosures required under CFTC Rule 1.55

The press release and access to CTFC Staff Letter 20-34 are available here.

### CFTC and Bank of England Sign Updated MOU for Supervision of Cross-Border Clearing Organizations

On October 20, the Commodity Futures Trading Commission and the Bank of England (BoE) announced that they had signed an updated Memorandum of Understanding (MOU) regarding the cooperation and exchange of information to preserve the benefits of cross-border clearing activity. The MOU emphasizes the importance of supervision of central counterparties (CCPs) and clarifies that the central counterparty's home jurisdiction is the primary supervisor. CFTC Chairman Heath P. Tarbert and BoE Deputy Governor for Financial Stability Jon Cunliffe published a joint op-ed further describing the agreement, which is available here.

The press release and access to the MOU is available here.

### CFTC and SEC Approve Final Rule on Security Futures Margin and Request for Comment on Portfolio Margining

On October 22, the Commodity Futures Trading Commission and the Securities and Exchange Commission, at their first-ever joint open meeting, approved (1) a joint final rule to lower the margin requirement for an unhedged security futures position from 20 percent to 15 percent, which was approved over the dissents of Commissioners Lee and Crenshaw of the SEC; and (2) the issuance of a joint request for comment on the portfolio margining of uncleared swaps and non-cleared security-based swaps.

The CFTC press release and access to the *Federal Register* releases are available here. The SEC press release is available here.

## BANKING

### Banking Agencies Issue Proposed Rule Addressing Role of Supervisory Guidance

On October 20, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau (CFPB), and the National Credit Union Administration (each, a Banking Agency, and collectively, the Banking Agencies) published a proposed rule (the Proposed Rule) that would codify the Interagency Statement Clarifying the Role of Supervisory Guidance issued by the Banking Agencies on September 11, 2018 (the 2018 Statement). The 2018 Statement provided that regulatory guidance did not have the force and effect of law and did not create binding obligations on the public.

The Proposed Rule was issued in response to a petition for rulemaking that certain agencies received on November 5, 2018, pursuant to the Administrative Procedure Act requesting that such agencies codify the 2018 Statement. The petition argued that codification was necessary to bind future banking agency leadership.

The commentary to the Proposed Rule describes the distinction between "regulations" and "supervisory guidance," noting that supervisory guidance is issued by an agency to "advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power'" and provide transparency to ensure consistency in the Banking Agencies' supervisory approaches. In addition, the Proposed Rule: (1) makes clear that Banking Agency examiners will not criticize or issue enforcement orders against institutions that fail to comply with supervisory guidance; (2) encourages the Banking Agencies to be specific in criticisms and findings; and (3) commits the Banking Agencies to attempting to reduce the issue of multiple duplicative guidance documents.

The comment period will close 60 days after publication of the Proposed Rule in the *Federal Register*.

More information is available here.

# UK DEVELOPMENTS

*See "CFTC and Bank of England Sign Updated MOU for Supervision of Cross-Border Clearing Organizations" in the CFTC section.*

### FSB Publishes Global Transition Roadmap on LIBOR

On October 16, the Financial Stability Board (FSB) published a global transition roadmap, including a timetable of actions to be taken by financial and non-financial institutions exposed to the London Inter-bank Offered Rate (LIBOR) benchmarks, to ensure a seamless transaction away from LIBOR by the end of 2021 (the Roadmap).

The key steps suggested by the FSB to mitigate the risks before the end of 2021 in the Roadmap include:

- by now, firms should have identified and assessed all existing LIBOR exposures, assessed the necessary changes to its systems and processes and devised a plan for communicating with end-users of LIBOR products maturing beyond the end of 2021 to ensure they are aware and supported through the transition;
- by the effective date of the ISDA Fallbacks Protocol (Protocol), firms are encouraged to adopt to the Protocol or consider making alternative arrangements to mitigate risk;
- by the end of 2020, lenders should be capable of offering non-LIBOR linked loan products to their customers by either offering a choice of reference rates underlying the loan or including language in the loan for a conversion by the end of 2021 for any new or refinanced LIBOR referencing loans;
- by mid-2021, firms should strive to establish formalized plans to modify legacy LIBOR-linked contracts to alternative reference rates and implement required system and process changes to enable the transition to robust alternative rates; and
- by the end of 2021, firms should be prepared for LIBOR to cease and conduct business in alternative rates or be in a position to switch rates efficiently.

The FSB emphasized the importance of all regulated financial institutions to have transparent LIBOR discussions with its home state and host state regulators throughout the transition period.

The FSB advised firms to monitor developments regarding other interbank offered rates relevant to its business.

The Roadmap is available here.

### FCA Publishes New and Updated Whistleblowing Webpages

On October 21, the UK's Financial Conduct Authority (FCA) published new and updated webpages relating to whistleblowing (the Webpages).

The Webpages discuss:

1. when to report wrongdoing to the FCA, how the FCA protects the identities of whistleblowers and what the FCA will do with the information reported;
2. the legal and FCA protection available to whistleblowers and how the information reported is handled;
3. how to report wrongdoing to the FCA's Whistleblowing Team and how the information reported is handled. The Webpages also include steps an individual should take before making a report; and
4. the impact of whistleblowing information provided to the FCA in regulating its firms. Case studies are available on the Webpage to demonstrate how the FCA's Whistleblowing team have previously handled reports and their outcomes.

The Webpages are available (1) here, (2) here, (3) here and (4) here.

# EU DEVELOPMENTS

### ESMA Publishes Consultation Paper on Draft RTS Relating to CCPs

On October 19, the European Securities and Markets Authority (ESMA) published a consultation paper on draft regulatory technical standards (RTS) concerning central counterparties (CCPs) under Regulation (EU) 2019/2099 (EMIR 2.2) (the Consultation Paper).

Under EMIR 2.2., ESMA, in conjunction with the European System of Central Banks are required to develop RTS where a CCP wishes to extend its business and requires an extension of authorization to do so. ESMA is also required to develop conditions for CCPs under which changes to the models and parameters are substantial and require validation by the national competent authority (NCA) and ESMA.

In the Consultation Paper, ESMA proposes a flexible and pragmatic approach, with a degree of discretion by dividing the conditions into criteria and indicators regarding additional services and activities requiring an extension of authorization. If both criteria and indicators have been met, the condition would be subject to a college consultation on whether the procedure should be triggered under Article 15 of EMIR.

ESMA clarifies that because the criteria are objective, they are capable of a simplified college consultation procedure where the CCP’s NCA finds that one or more of the criteria have been fulfilled by the CCP’s proposed changes.

However, the indicators would be subject to an extensive college consultation procedure because they are more complex. ESMA proposes that the CCP’s NCA assess the indicators and if one or more indicators have been fulfilled, the NCA should carry out an initial analysis of whether an extension of authorization or a validation is required. The college should then be consulted on the outcome of the NCA’s initial analysis, but the final decision would remain with the NCA.

ESMA further proposes that the same approach should apply to changes to models and parameters by a CCP.

The deadline for comments on the Consultation Paper is November 15. ESMA intends to publish its final review report and submit the draft RTS to the European Commission in the first quarter of 2021.

The Consultation Paper is available here.

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


**For more information, contact:**

SEC/CORPORATE

| | | |
|---|---|---|
| **Mark J. Reyes** | +1.312.902.5612 | mark.reyes@katten.com |
| **Mark D. Wood** | +1.312.902.5493 | mark.wood@katten.com |

FINANCIAL MARKETS AND FUNDS

| | | |
|---|---|---|
| **Henry Bregstein** | +1.212.940.6615 | henry.bregstein@katten.com |
| **Wendy E. Cohen** | +1.212.940.3846 | wendy.cohen@katten.com |
| **Guy C. Dempsey Jr.** | +1.212.940.8593 | guy.dempsey@katten.com |
| **Gary DeWaal** | +1.212.940.6558 | gary.dewaal@katten.com |
| **Kevin M. Foley** | +1.312.902.5372 | kevin.foley@katten.com |
| **Mark D. Goldstein** | +1.212.940.8507 | mark.goldstein@katten.com |
| **Jack P. Governale** | +1.212.940.8525 | jack.governale@katten.com |
| **Christian B. Hennion** | +1.312.902.5521 | christian.hennion@katten.com |
| **Carolyn H. Jackson** | +44.20.7776.7625 | carolyn.jackson@katten.co.uk |
| **Susan Light** | +1.212.940.8599 | susan.light@katten.com |
| **Richard D. Marshall** | +1.212.940.8765 | richard.marshall@katten.com |
| **Paul McCurdy** | +1.212.940.6676 | paul.mccurdy@katten.com |
| **Fred M. Santo** | +1.212.940.8720 | fred.santo@katten.com |
| **Christopher T. Shannon** | +1.312.902.5322 | chris.shannon@katten.com |
| **Robert Weiss** | +1.212.940.8584 | robert.weiss@katten.com |
| **Allison C. Yacker** | +1.212.940.6328 | allison.yacker@katten.com |
| **Lance A. Zinman** | +1.312.902.5212 | lance.zinman@katten.com |
| **Krassimira Zourkova** | +1.312.902.5334 | krassimira.zourkova@katten.com |

BANKING

| | | |
|---|---|---|
| **Christina J. Grigorian** | +1.202.625.3541 | christina.grigorian@katten.com |

UK/EU DEVELOPMENTS

| | | |
|---|---|---|
| **Carolyn H. Jackson** | +44.20.7776.7625 | carolyn.jackson@katten.co.uk |
| **Nathaniel Lalone** | +44.20.7776.7629 | nathaniel.lalone@katten.co.uk |
| **Neil Robson** | +44.20.7776.7666 | neil.robson@katten.co.uk |


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