RECENT CFTC AND SRO ENFORCEMENT TRENDS AFFECTING DERIVATIVES

November 17, 2016

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INTRODUCTION

- **2015 CFTC ENFORCEMENT TRENDS**

- Reportedly filed 69 enforcement cases, including administrative cases before administrative law judges and federal district court cases before federal district court judges. The focus was on manipulation, spoofing, high frequency trading and swaps market intermediaries to ensure their compliance with supervision and reporting obligations.

- Reportedly accessed $3.144 billion in sanctions. Sanctions for 2014 and 2015 fiscal years totaled more than $6 billion.

- Fines were 12 times the CFTC's 2015 operating budget.

- Imposed an $800 million dollar civil monetary fine against one investment bank in one of the LIBOR benchmark manipulation cases. This was the CFTC's largest fine to date.

- 90% of the CFTC's major fraud and manipulation cases involved parallel criminal proceedings, including indictments against 24 individuals and criminal convictions of 35 individuals and entities.

- **2016 CFTC ENFORCEMENT TRENDS**

- From January 1, 2016 through June 30, 2016, the CFTC commenced more than 40 enforcement cases against entities and individuals, including administrative cases before administrative law judges and federal district court cases before federal district court judges.

- Like the SEC, the CFTC has announced that it will make greater use of its own administrative forum for enforcement cases.

- The CFTC is cooperating in investigations with other local, state, federal and international agencies and criminal prosecutors.

- Like the Department of Justice, the CFTC's enforcement division is emphasizing individual liability in its enforcement actions.

- Reporting violations are easy to prove and are a focus of the CFTC's enforcement effort.

- **NATIONAL FUTURES ASSOCIATION STATISTICS**

- In 2015, NFA issued 37 complaints against 67 respondents, including: (a) for failing to establish and appropriately apply methodologies for allocating bunched orders and for not maintaining adequate and verifiable audit trails for allocations of bunched orders, (b) employing trading strategies designed primarily to generate large commissions, and (c) against CPOs who received prohibited loans or advances from pools that they operated. NFA's disciplinary panels issued 39 decisions and ordered 20 expulsions and eight suspensions. NFA collected $2.5 million in fines.

- From January 1, 2016 through June 30, 2016, the NFA commenced 13 membership disciplinary cases and one emergency member responsibility action.

SPOOFING

What is a Spoofing Attack, and How Can I Stop it?

- The anti-spoofing provision of the CEA prohibits "any trading, practice, or conduct on or subject to the rules of a registered entity that ... is, is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)."

- Section 9(a)(2) of the CEA makes it a felony, punishable by imprisonment for up to 10 years and a fine of up to US$1 million, for any person to engage in spoofing. Knowing violation of the anti-spoofing provision is a felony.

- CFTC guidance: "orders, modifications, or cancellations will not be classified as 'spoofing' if they were submitted as part of a legitimate, good-faith attempt to consummate a trade." The proposed guidance further stated that "the market context, the person's pattern of trading activity (including fill characteristics), and

other relevant facts and circumstances" are factors relevant to distinguishing between legitimate trading and spoofing. The CFTC has provided examples of spoofing:

1. Submitting or cancelling bids or offers to overload the quotation system of a registered entity;

2. Submitting or cancelling bids or offers to delay another person's execution of trades;

3. Submitting or cancelling multiple bids or offers to create an appearance of false market depth; and

4. Submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards.

- <u>Manual Spoofing</u>.
  - <u>Oystacher</u>, No. 1:15-CV-09196 (N.D. Ill., October 19, 2015).
    - CFTC civil enforcement complaint in federal court in Illinois.
    - Court held that circumstantial evidence, such as the defendants' trading patterns and relevant market data can prove "manual" spoofing. Here, the defendants routinely placed and rapidly cancelled orders just before placing and filling orders on the opposite side of the market.
    - Court rejected the defendants' argument that the spoofing statute is unconstitutionally vague.
- <u>Automated Spoofing</u>.
  - <u>Sarao</u>, No. 1:15-CV-03398 (N.D. Ill., April 17, 2015).
    - CFTC civil enforcement action in federal court in Illinois.
    - According to the CFTC complaint, Defendants modified a commonly used off-the-shelf trading platform to automatically simultaneously "layer" four to

six exceptionally large sell orders into the visible E-mini S&P central limit order book (the Layering Algorithm), with each sell order one price level from the other. As the E-mini S&P futures price moved, the Layering Algorithm allegedly modified the price of the sell orders to ensure that they remained at least three or four price levels from the best asking price; thus, remaining visible to other traders, but staying safely away from the best asking price. Eventually, the vast majority of the Layering Algorithm orders were canceled without resulting in any transactions.

- High-Frequency Spoofing.
  - Coscia, No. 14-CR-00551 (N.D. Ill., October 1, 2015).
    - Federal court criminal conviction of commodities trader Coscia of the felony of "spoofing" (referred to as "layering") through the use of a high-frequency computerized trading program he developed. On July 13, 2016, he was sentenced to 3 years in prison. Indictment charged that he placed large futures orders, waited until his orders moved the market, and then reversed the orders to benefit his smaller orders. This strategy created a false impression regarding the number of contracts available.

Coscia would then apply this strategy in the opposite direction to immediately obtain a profit by buying futures contracts at a lower price than he paid for them, or by selling contracts at a higher price than he paid for them.

- Coscia's criminal prosecution followed his settlement in 2013 with various regulators, including the CFTC, the CME and the U.K. FCA, related to the same alleged conduct.

- SRO Layering Cases.

  - Chicago Mercantile Exchange.

    - CME brought spoofing cases against non-members for violations of CME Rules 432.B.2, 432.Q and 432.T, alleging conduct inconsistent with just and equitable principles of trade, acts detrimental to the interest, welfare, dignity or good name of the CME, and engaging in dishonorable or uncommercial conduct.

    - *In re Edward Buonopane (August 29, 2016).* The CME BCC found that the respondent entered larger-sized orders on one side of the market and smaller-sized orders on the other, which created the appearance of an

imbalance in buy/sell pressure. Once the small orders began trading, he cancelled the large orders resting on the other side of the order book. Respondent's purpose in creating this imbalance included encouraging market participants to trade with his smaller-sized orders and in many cases his orders had that effect.

- *In re Fredrik Nelson (August 29, 2016).* The CME BCC found that the respondent entered multiple, layered orders without the intent to trade, to encourage market participants to trade opposite his smaller orders that were resting on the opposite side of the book. Once the smaller orders began trading, Nielsen would then cancel the resting layered orders that he had entered on the opposite side of the book.

- COMEX and NYMEX.

  - *In re Yingdi Liu (July 22, 2016).* COMEX and NYMEX, in separate companion cases, found that the respondent entered layered manual orders in futures contracts without the intent to trade, to encourage market participants to trade opposite his smaller orders that were resting on the opposite side of the book. After receiving a fill on his resting smaller orders,

the respondent would then cancel the layered orders he had entered on the opposite side of the order book. This conduct violated Rule 575.A – Disruptive Practices Prohibited.

- *In re Geneva Trading USA, LLC (October 7, 2016).* COMEX and NYMEX, in separate companion cases, found that in 2013, the respondent's traders engaged in a pattern of activity where they entered large-sized orders on one side of the market, but then cancelled them several seconds after smaller-sized opposite orders were executed. The purpose in entering the large-sized orders was to encourage market participants to trade with the smaller-sized orders. The respondent Geneva was held strictly liable for the acts of its 2 employees, who also settled individually with the exchanges.

MANIPULATION

- CFTC v. Wilson et al., 13-7884 (SDNY, filed Nov. 6, 2013)

  - Court recently rejected CFTC position that it did not need to prove intent to create "an artificial price" to show attempted manipulation under "old" manipulation authority

  - Question still whether action was "a legitimate source of supply and demand;" Court rejected motions for SJ from both sides

  - Unclear if CFTC, courts will see "new" manipulation authority differently

- CFTC v. Kraft Foods Group, Inc., et al., 15-cv-2881 (ND Ill, filed Apr. 1, 2015)

  - Does the D-F, broader manipulation authority cover market-power manipulation?

  - Can manipulation arise from (intended) misinterpretation of conduct in one market impacting behavior, and thus prices, in another, related market?

- In the Matter of Citibank, N.A., CFTC Dkt. 16-16 (May 25, 2016)

  - Benchmarking cases, with large CMPs, continue.

  - The hazards of instant messaging – will traders ever learn?

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MISUSE OF CONFIDENTIAL INFORMATION

- <u>In the Matter of Motazedi</u>, CFTC Dkt. No. 16 – 02 (Dec. 2, 2015)
    - Employee's use of employer's trading information to trade with employer at favorable prices and to trade ahead of employer.
    - Fraudulent misuse of confidential information.
    - Used the language of insider trading under the securities laws.
- <u>In the Matter of Pucciarelli, et al.</u>, CFTC Dkt. 16-12 (Apr. 5, 2016)
    - Employee profits off EFP's executed between his employer and his personally- owned company.
    - No charge of fraud; only found to have entered into improper EFPs.
    - Reflect settlement negotiations?
- <u>Jon Ruggles and Ivonne Ruggles</u>, NYMEX 12-9153-BC-1 (& BC-2) (Jun. 13, 2016); CFTC Dkt. 16-34 (Sep. 29, 2016)
    - Misuse of employer proprietary and non-public trading information in violation of internal policies and procedures to trade against personal accounts to their benefit.
    - Violations: NYMEX -- Rules 530 and 532 (trading ahead and disclosure of another's orders); CFTC -- CEA Sections 4(b) , 4c(a)&(b) & 6(c)(1) and Rules 1.38, 33.10(a)&(c) and 180.1
    - NYMEX -- $300K fine, disgorgement of almost $3 million and permanent bar (but also declined to be interviewed); CFTC -- $1.75 million CMP, $3.5 million disgorgement; permanent registration and trading bans.
- <u>Zhiyu Wang</u>, NYMEX 15-0139-BC (Jul. 27, 2016)
    - Executed trades in personal account, then offset with employer's trades.
    - Same charges as Ruggles.
   - $100,000 fine, disgorgement of $236,530, 3-yr suspension (but also declined to be interviewed)

EXCHANGE FOR RELATED POSITIONS/BLOCK TRADES/ WASH TRADES/NON-COMPETITIVE TRADES

- ## A central focus of SRO enforcement
  - 72 percent of CME Group 2016 Disciplinary Notices through mid-September

- ## EFRP
  - Documentation
  - Pre-negotiation
  - Timing
  - New Market Regulation Advisory Notice

- ## Block Trades
  - Pre-trade hedging
  - Timing, accuracy of reporting

- ## Wash Trades
  - Beneficial owners
  - ATS where should have known result would be matching
  - Manner of trading intended to result in orders trading against each other

- ## CFTC recently in the fray as well
  - In the Matter of Barclays Bank PLC, CFTC Dkt No. 16-30 (Sep. 22, 2016)
  - In the Matter of SG Americas Securities, LLC, CFTC Dkt No 16-33 (Sep. 28, 2016)

AUTOMATED TRADING SYSTEM FAILURES

- "Operators of algorithmic trading systems must take particular care to ensure there are safeguards and risk controls for their order-entry activity."

- "Algorithm operators have an obligation to understand the behavior of their algorithms, and test them to ensure proper and compliant operation in a variety of relevant market circumstances."

- June 2016 – Wash sales executed by ATS over "multiple dates" as a result of "ATS configuration errors and malfunctions;" also failure to supervise and failure to minimize self-trades; $75,000 fine.

- April 2016 – Employee "inadvertently failed" to deactivate an AT system using an auto spreader strategy before activating another not designed to run simultaneously; result was interaction causing continuous purchasing, causing rapid escalation of price of 6/15-12/15 Crude Oil spread, causing a Velocity Logic event; $115,000 fine.

- August 2015 – For several hours, because of "a sequence number log naming error," over 27,000 "resend requests" sent; inadequate monitoring and internal notification processes; $125,000 fine.

- Status of CFTC ATS rule proposal.
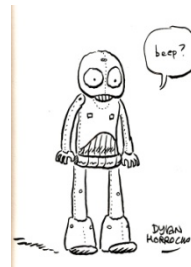
REPORTING VIOLATIONS

Form No.	Title	Rule
40	Statement of Reporting Trader	18.04
101	Positions of Special Accounts	17.00
102	Identification of Special Accounts, Volume Threshold Accounts, and Consolidated Accounts	17.01
204	Cash Positions of Grain Traders (including Oilseeds and Products)	19.00
304	Cash Positions of Cotton Traders	19.00
71	Identification of Omnibus Accounts and Sub-accounts	17.01

- <u>Large Trader Reporting by Swap Dealers</u>.

  - Enforcement cases against registered swap dealers for allegedly violating Section 4s(f) of the CEA and CFTC Regulation 20.4 and 20.7 for the failure to file daily large trader reports for reportable positions in physically settled commodity swaps.

  - *In re Australia and New Zealand Banking Group Ltd.,* CFTC No. 15-31 (Sept. 17, 2015).

    - A registered swap dealer allegedly sometimes inaccurately reported its own positions and at other times failed to submit any large trader report.

- *In re J.P. Morgan Ventures Energy Corp. and J.P. Morgan Chase Bank, N.A.,* CFTC Docket No. 16-11 (March 23, 2016).

  - A registered swap dealer that self-reported its failure to file large trader reports for physical commodity swap positions.

- *In re Barclays Bank PLC,* CFTC No. 16-20 (July 6, 2016).

  - A registered swap dealer that self-reported its failure to file large trader reports for physical commodity swap positions.

- Real-Time Public Reporting of Swaps by Swap Dealers.

  - *In re Deutsche Bank AG,* CFTC No. 15-40 (Sept. 30, 2015).

    - A swap dealer allegedly violated reporting requirements under CFTC Regulations 43.3(a), 43.3(e), 45.4(a) and 45.14(a) for real-time public reporting of swaps, by failing to report the cancellations of its swap transactions which are "continuation data" if the cancellation changes the price of a previously reported swap. The violations included sending cancellation messages to an SDR when there were no cancelled swap transactions, and sending cancellation messages but failing to timely investigate the unsuccessful processing notices it received from the SDR. The settled order also included a failure to supervise violation.

- *CFTC v. Deutsche Bank AG,* No. 1:16-CV-6544 (S.D.N.Y. August 8, 2016).

  - Alleged similar new reporting violations by the same swap dealer, caused by (a) an outage that prevented the swap dealer from reporting any swap data for multiple asset classes for 5 days and (b) subsequent efforts to end the outage that repeatedly exacerbated existing reporting problems and led to the discovery or creation of new reporting problem. As of the date this presentation was prepared, this case was not resolved.

- Customer of an FCM - Failure to Timely Produce EFRP Records to CFTC.

  - *In re Barclays Bank PLC,* CFTC Docket No. 16-30 (September 22, 2016).

    - U.K. bank allegedly failed to timely produce, following a CFTC request, numerous "exchange for related position" trade confirmations in violation of CFTC Regulation 1.31(a)(2), because they were not properly created or maintained by the bank as a customer of an FCM, in violation of then CFTC Regulation 1.35(a-2)(2).

REPORTING VIOLATIONS (continued)

- Reportable Commodity Position Reports by a Customer.

  - *In re Agrocorp International Pte Ltd*. CFTC Docket No. 16-22 (July 11, 2016).

    - Non-U.S. cotton trader that held or controlled reportable futures positions under CFTC Regulation 15.00(p)(1)(i) failed to file CFTC Form 304 reports that report its weekly call cotton purchases and sales.

  - *In re Golden Argi International Pte Ltd.,* CFTC No. 16-21 (July 11, 2016).

    - Non-U.S. processor and trader of crude palm oil, which hedged with soybean futures contracts, for failing to file CFTC Form 204 in violation of CFTC Regulation 19.01.

REPORTING VIOLATIONS (continued)

- Regulation 19.01 requires that persons holding or controlling futures and options positions in certain agricultural commodities that are reportable, and any part of which constitute bona fide hedging, must file Form 204 reports showing the composition of the fixed price cash position of each commodity hedged.

- Reportable Agricultural Commodity Position Reports Violations by an FCM.

  - *In re CHS Inc. and CHS Hedging, LLC,* CFTC No. 16-07 (March 9, 2016).

    - Enforcement case against a cooperative and its registered FCM for the cooperative's failure to file CFTC Form 204 reports and filling incorrect reports for reportable agricultural positions. The FCM was charged with aiding and abetting the cooperative's reporting violation.

- Failure to Report Customer Segregated Account Deficiency.

  - *In re Cunningham Commodities, LLC, et ano., CFTC* No. 16-15 (May 9, 2016).

    - Failure of a registered FCM and its chief financial officer to *immediately* notify the CFTC of an overnight deficiency in its segregated customer account and of its failure to maintain its targeted residual interest amount in customer accounts that resulted from an operation cash transfer error at the firm on March 10, 2014.

- According to the CFTC, the FCM immediately corrected the error the following morning, but did not notify the CFTC of the deficiency until March 12, 2014, after CME audit staff had notified the FCM on March 11, 2014 that its records reflected a $5 million discrepancy between the amount of customer funds on deposit in segregated accounts and the amount reported.

- Inaccurate Statements Submitted to the CFTC.

  - Section 6(c)(2) of the CEA makes it a violation to knowingly submit false or misleading statements of material fact to the CFTC.

  - *In re Advantage Futures LLC, et al.*, CFTC Docket No. 16-29 (September 21, 2016)

    - FCM and its CCO for knowingly making inaccurate statements to the CFTC through the submissions of both its required risk manual (under CFTC regulation 1.1) and the annual CCO Report (under CFTC Regulation 3.3), in that both misrepresented that certain procedures were followed. The CFTC found these misrepresentations to be material because the CFTC relies on an FCM's manuals and CCO Report to meet its oversight obligations and to assess an FCM's risk management process.

- Futures Exchange – Inaccurate Reports.

  - *In re ICE Futures, U.S., Inc.*, CFTC No. 15-17 (March 16, 2015).

    - DCM submitted inaccurate and incomplete daily reports and data to the CFTC from October 2012 through May 2014, including incorrect clearing member reports, permanent record data and transaction-level data, in violation of CFTC Regulations 16.00, 16.01 and 16.02.

FAILURE TO SUPERVISE

- CFTC Regulation 166.3 requires every CFTC registrant to diligently supervise the handling by its employees and agents of all commodity interest accounts carried, operated, advised or introduced by the registrant.

- CFTC Regulation 23.602 requires each swap dealer and MSP to "establish and maintain a system to supervise, and shall diligently supervise all activities relating to its business performed by its partners, members, officers, employees, and agents (and persons occupying a similar status of performing a similar function)."

FAILURE TO SUPERVISE (continued)

- Swap Dealer Supervision – Reporting.

  - *CFTC v. Deutsche Bank AG,* No. 1:16-CV-6544 (S.D.N.Y. August 8, 2016).

    - On August 18, 2016, the CFTC filed a federal court enforcement case alleging reporting violations caused by a system outage. The CFTC's complaint alleges that the reporting violations occurred because the swap dealer failed to perform its supervisory duties diligently in violation of CFTC Regulation 23.602. As of the date this presentation was prepared, this case was not resolved.

  - *In re Wells Fargo Bank, N.A.,* CFTC No. 16-32 (September 27, 2016).

    - From March 2013 to November 2015, a registered swap dealer submitted inaccurate large trader reports that contained multiple errors, including missing data and data presented in a format inconsistent with CFTC requirements, including, at various times, records that failed to use the correct clearing member identifier and improperly formatted swaption expiration date values, in violation of CFTC Regulations 20.4 and 20.7.

FAILURE TO SUPERVISE (continued)

- Swap Dealer Supervision - Discretionary Trading.

  - *In re INTL FCStone Markets, LLC,* CFTC Docket No. 15-2 (August 19, 2015).

    - Its energy traders often obtained verbal authorization to enter into discretionary trades in violation of written procedures that required written authorization to exercise discretion over customer trades and that the swap dealer did not have significant controls in place to monitor discretionary trading.

- FCM Failure to Supervise - Trading in a Customer Account.

  - *In re Advantage Futures LLC, et al.,* CFTC Docket No. 16-29 (September 21, 2016).

    - FCM and its officers failed to diligently supervise the handling of certain commodity interest accounts in violation of CFTC Regulation 166.3, despite being on notice from three exchanges of unlawful trading in several futures contracts by one customers, consistent with spoofing and/or manipulative or deceptive trading. The FCM did not promptly or thoroughly investigate the identified trading activity, resulting in the customer continuing to engage in suspect trading activities.

FAILURE TO SUPERVISE (continued)

- FCM Failure to Supervise - Handling of Customers' EFP Wash Trades.

  - *In re SG Americas Securities, LLC, as successor to Newedge USA, LLC,* CFTC No. 16-33 (September 28, 2016).

    - From June 2010 to January 2014, an FCM participated in unlawful wash trades on the CME and CBOT through the use of non-bona fide EFPs. The CFTC alleged that certain account executives either knew that commonly owned and controlled clients netted out positions through EFPs or failed to inquire why the clients were routinely on both sides of the positions, which constituted wash trades. The FCM failed to diligently supervise its employees' handling of the transactions and lacked adequate policies and procedures designed to detect and deter these violations.

- IB Failure to Supervise - Recordkeeping.

  - *In re eFloorTrade LLC and John Moore,* Docket No. 16-cv-7544 (SDNY, September 27, 2016).

    - Federal court enforcement action against a registered IB that provides trade execution services to its customers. The CFTC complaint alleges that the defendants failed to ensure that policies and procedures were in place to make and keep books and records that the IB is required to make and keep

as a CFTC registrant, including electronic trading instructions written records of customer orders that it placed and relevant emails and failed to adopt adequate procedures on how to handle its customers' margin deficiencies. These supervision failures, according to the Complaint, also contributed to recordkeeping violations.

- CFTC Registration Denial based on an SEC Failure to Supervise Order.
  - *In re Steven A. Cohen,* CFTC Docket No. SD 16-01 (August 16, 2016).
    - Section 8a(3)(C) of the CEA provides that registration may be refused to any person who has failed reasonably to supervise another person who is subject to such person's supervision, with a view to preventing violations of, *inter alia*, the federal securities laws.
    - The SEC entered an Order finding that the respondent had failed to reasonably supervise an employee with a view to preventing that employee's violation of Section 10(b) of the 1934 Act and Rule 10b-5. The respondent had consented to the SEC Order without admitting or denying the findings therein. Respondent was therefore subject to a statutory disqualification from registration with the CFTC and restricted his registration under specified terms based on the failure to supervise findings in the SEC Order.

Conclusion

Thank you for your attention.

Please use the "question" function on your webinar control panel to ask a question to the moderator or speakers.

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