

An hourglass with blue sand is centered in the frame against a solid blue background. The sand is flowing from the top bulb to the bottom bulb. The hourglass is made of clear glass, and the sand is a vibrant blue color. The lighting is soft, creating a slight shadow of the hourglass on the background.

This webinar will begin shortly.

FIA



Enforcement & Technology:

Practical Considerations for Preventing and Managing Investigations Involving Complex Technology

May 16, 2024



Reminders

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Presentation prepared by WILMERHALE® 



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Agenda

- Governance Measures to Limit Enforcement Risk
- Technology & the Enforcement Process
- Emerging and Noteworthy Trends



Governance Measures to Limit Enforcement Risk



Governance Measures to Limit Enforcement Risk

- Managing enforcement risk begins with effective supervision and governance
- These considerations are particularly important for complex technologies including electronic trading systems, generative AI, and highly-networked communications and recordkeeping systems
- Keys to effective governance include:
 - Integration of legal and compliance considerations in product design
 - Robust documentation of strategies, compliance controls, and change management
 - Tailored and ongoing surveillance and testing



Governance Measures to Limit Enforcement Risk

- **CFTC Regulation 166.3** requires CFTC registrants to “diligently supervise the handling ... of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities ... relating to its business as a Commission registrant”
- **CFTC Regulation 23.602** requires swap dealers to “establish and maintain a system to supervise, and shall diligently supervise, all activities relating to its business” that is “reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and Commission regulations”
- Designated contract markets and swap execution facilities impose similar requirements on members, even if they are not registered with the CFTC (e.g., CME Rule 432.W and BSEF Rule 513)



Governance Measures to Limit Enforcement Risk

- CFTC amended Regulation 38.251 on January 11, 2021. This amendment established Electronic Trading Risk Principles that require DCMs to:
 - ***“Adopt and implement rules governing market participants subject to its jurisdiction to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading”***
 - ***“Subject all electronic orders to exchange-based pre-trade risk controls to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading”***
 - ***“Promptly notify Commission staff of any significant market disruptions on its electronic trading platform(s) and provide timely information on the causes and remediation”***



Governance Measures to Limit Enforcement Risk

- Regulation 38.251 builds on existing CFTC and exchange guidance, but is significantly less ambitious than the now withdrawn Regulation AT proposal, which:
 - Proposed multilayered pre-trade risk controls on: (1) market participants using ATSS **or** their clearing FCMs; and (2) DCMs executing such orders
 - Proposed a registration requirement for certain proprietary traders engaged in algorithmic trading through direct electronic access to a DCM
 - The Commission [withdrew](#) Regulation AT on July 15, 2020



Governance Measures to Limit Enforcement Risk

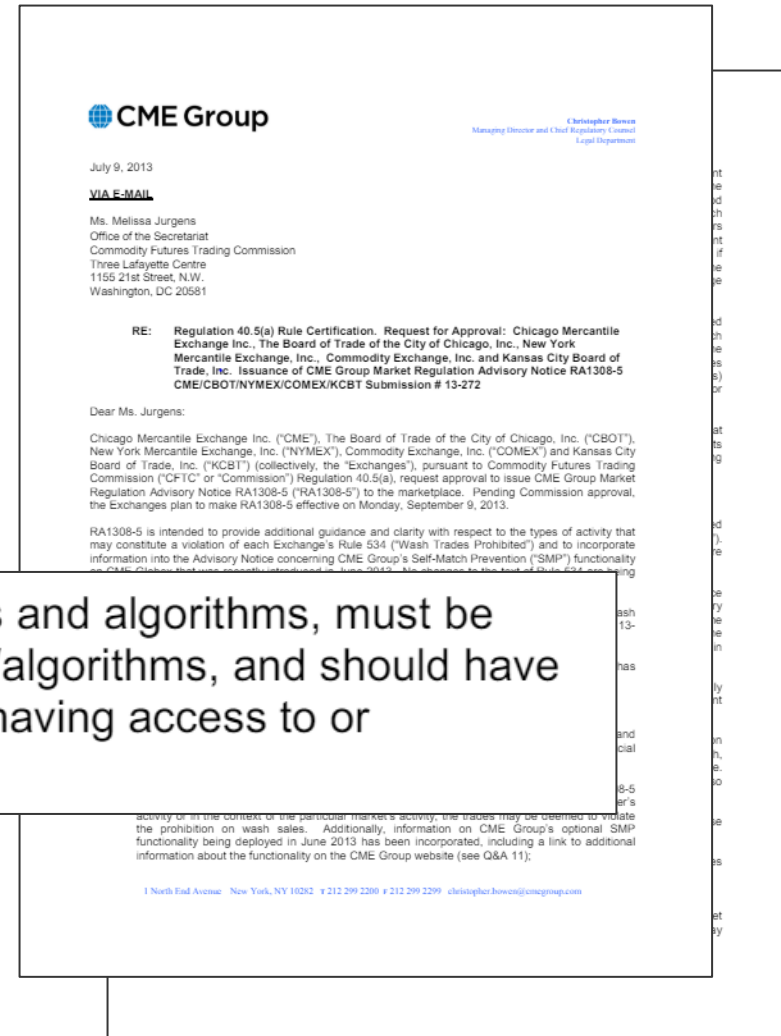
- **Effective controls and supervision are necessary for all electronic trading**
 - Any user type can generate orders that disrupt the market
 - ATSS require testing and supervision protocols and control mechanisms appropriately calibrated to the nature of the ATS
- **Effective testing and supervisory protocols**
 - Conformance testing and certification of connections by SRO for system specific controls and responses
 - Software development standards, testing, change management, re-certification
 - Real time monitoring of ATS system performance and metrics

Technology Advisory Committee

Subcommittee on Automated and High Frequency Trading

Working Group 3
Oversight, Surveillance
and Economic Analysis
6-20-2012

Governance Measures to Limit Enforcement Risk



Firms have an obligation to supervise the trading by their employees and algorithms, must be able to demonstrate the independence of the traders/trading groups/algorithms, and should have and enforce policies and procedures that preclude the traders from having access to or knowledge of one another's orders.



Governance Measures to Limit Enforcement Risk

- AI systems raise new and specific governance concerns:
 - Model Validation: Implement testing suites that experiment with unprecedented market conditions and new datasets
 - Data Bias: Verify the legitimacy and authoritativeness of data sources and implement testing to review the underlying dataset for potential built-in biases
 - Model Explainability: Ensure that AI systems generate sufficient logs to explain how trading decisions were made in order to validate that the system is not following signals based on statistical noise or hallucinations

See FINRA Report: [Artificial Intelligence in the Securities Industry](#) (June 2020)



Technology & the Enforcement Process



Technology & the Enforcement Process

- Complex technologies can raise unique issues for otherwise routine aspects of the enforcement process, including:
 - Preservation
 - Factual development and advocacy
 - Cooperation
 - Document production
- Mismanaging these aspects can negatively impact a company's ability to seek cooperation credit or create independent violations of the CEA



Technology & the Enforcement Process

- CFTC staff issued an [Enforcement Advisory](#) on January 19, 2017, outlining the factors considered when assessing the existence and quality of cooperation
- Principal among the factors the Division of Enforcement considers are:
 - Whether the company's cooperation resulted in "**material assistance**" to the Commission's investigation
 - The **timeliness** of the company's initial cooperation
 - The nature of the company's cooperation, including whether it was "**truthful, specific, complete, and reliable**"
 - The **quality** of the company's cooperation, including whether the company "willingly used all available means to ... preserve relevant information under the company's appropriate control"



Technology & the Enforcement Process

- However, “certain actions by the company or its counsel may limit or offset the credit a company might otherwise receive”
- “Uncooperative conduct” includes, among other things:
 - **Misrepresenting or minimizing** the nature or extent of the misconduct
 - Providing **specious explanations** for instances of misconduct identified
 - **Failing to respond to requests and subpoenas** in a complete and timely manner
 - **Failing to preserve relevant information** under the company’s control



Technology & the Enforcement Process

- **CFTC Regulation 1.31** requires that registrants keep required books and records in a “readily accessible” manner for the duration of the retention period for electronic records; all of these documents are required to be “promptly” produced upon request of the CFTC
- CFTC has brought actions against firms that did not appropriately preserve documents relevant to an investigation
- Technology can raise unique preservation issues:
 - Transitory files/logs
 - Raw/processed logs
 - Data outputs/model runs



Technology & the Enforcement Process

- Enforcement matters involving complex technologies may involve requests for commercially sensitive materials, including:
 - Source code
 - System configurations or operational parameters
 - Detailed descriptions of strategies or software
- Staff generally sensitive to confidentiality concerns, but Commission takes the position that it is entitled to any information relevant to its investigation
 - Proposed Regulation AT would have required electronic trading firms to “[m]aintain[] a source code repository” and “**make it available for inspection**,” in accordance with § 1.31,” without a subpoena
 - In its 2017 [notice](#) withdrawing Regulation AT, the Commission announced that it had “decided not to pursue regulatory proposals that would ... compel market participants to divulge their source code and other intellectual property **absent a subpoena**”



Technology & the Enforcement Process

- CEA § 6(c)(2), 7 U.S.C. § 9(2), states: “It shall be unlawful for any person to make any false or misleading statement of a material fact to the Commission ... or to omit to state in any such statement any material fact that is necessary to make any statement of a material fact made not misleading in any material respect, if the person ***knew, or reasonably should have known***, the statement to be false or misleading”
- CEA § 9(a)(4), 7 U.S.C. § 13(a)(4), makes it unlawful for “[a]ny person ***willfully*** to ... make any false, fictitious, or fraudulent statements or representations ... to a registered entity, board of trade, swap data repository, or futures association designated or registered under [the Act]”

Technology & the Enforcement Process

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

RECEIVED CFTC
Office of Proceedings
Proceedings Clerk
4:46 pm, Sep 29, 2023

In the Matter of:)
GOLDMAN SACHS & CO. LLC,)
Respondent.) CFTC Docket No. 23-60

ORDER INSTITUTING PROCEEDINGS PURSUANT TO
SECTION 6(c) AND (d) OF THE COMMODITY EXCHANGE ACT, MAKING
FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I. INTRODUCTION

The Commodity Futures Trading Commission ("Commission" or "CFTC") has reason to believe that Goldman Sachs & Co. LLC ("Goldman" or "Respondent") violated Section 6(c)(2) of the Commodity Exchange Act (the "Act"), 7 U.S.C. § 9(2), and Commission Regulation ("Regulation") 166.3, 17 C.F.R. § 166.3 (2022). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Respondent engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

In anticipation of the institution of an administrative proceeding, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions ("Order"), and acknowledges service of this Order.¹

¹ Respondent consents to the use of the findings of fact and conclusions of law in this Order in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party or claimant, and agrees that they shall be taken as true and correct and be given preclusive effect therein, without further proof. Respondent does not consent, however, to the use of this Order, or the findings or conclusions herein, as the sole basis for any other proceeding brought by the Commission or to which the Commission is a party or claimant, other than: a proceeding in bankruptcy or receivership; or a proceeding to enforce the terms of this Order. Respondent does not consent to the use of the Offer or this Order, or the findings or conclusions in this Order, by any other party in any other proceeding.

- *In re Goldman Sachs & Co. LLC*, CFTC No. 23-60 (Sep. 29, 2023): In response to a request for information from the CFTC's Division of Enforcement, the firm omitted discussion of "preventative controls that should have—but did not—suspend the operation of the algorithm" at issue. *Id.* at 2.
- CFTC found this conduct violated CEA § 6(c)(2)



Emerging and Noteworthy Trends



Emerging and Noteworthy Trends: AI

- CFTC staff issued a [Request for Comment](#) (“RFC”) on January 25, 2024, to “understand current and potential AI use cases and the associated potential risks to [CFTC] jurisdictional markets and the larger financial system”
- Notable features of the RFC:
 - Includes a series of 20 questions seeking input on how market participants use AI and the potential risks with AI use
 - Focuses on potential challenges with supervision, not whether existing technology complies with current regulations
- It is likely that the information gathered from the RFC will inform future CFTC AI-related initiatives and more formal regulatory actions



Emerging and Noteworthy Trends: AI

- RFC questions seeking to understand how market participants use AI include:
 - General uses of AI
 - Potential uses of AI
 - Geographic distribution of use of AI
 - Roadblocks preventing use of AI
 - Reliance on third-party providers
 - Governance of AI use
- RFC questions seeking input regarding potential risks with AI use include:
 - Governance
 - Cybersecurity
 - Explainability and transparency
 - Data quality and bias
 - Market manipulation and fraud
 - Consumer protection
 - Privacy and confidentiality
 - Other (third party-service providers, risks to competition)



Emerging and Noteworthy Trends: AI

- In January 2024, the CFTC issued a [Customer Advisory](#) addressing how AI technology can be used to defraud investors and instructing the public to do the following before entrusting money to AI-driven trading platforms:
 - Research the background of the company or trader
 - Research the history of the trading website
 - Obtain a second opinion
 - Know the risks of underlying assets



Emerging and Noteworthy Trends: AI

- The CFTC's Division of Enforcement [announced](#) on June 29, 2023, that it had established a new task force named the "Cybersecurity and Emerging Technologies Task Force"
- The task force will address issues including:
 - Exploring the role that emerging technologies such as AI and machine learning may play in violations of the Commodity Exchange Act and CFTC regulations
 - Ensuring that registrants adequately supervise their use of emerging technologies



Emerging and Noteworthy Trends

- **Traditional elements under CEA Section 6(c) and 9(a)(2):**
 - Defendant possessed an ability to influence market price
 - An artificial price existed
 - Defendant caused the artificial price
 - Defendant specifically intended to cause the artificial price
- **Regulation 180.1**
 - Mirrors Exchange Act Rule 10b-5 and prohibits use of “manipulative or deceptive” devices
 - Adopts recklessness standard
 - Also prohibits insider trading based on misappropriation of confidential information



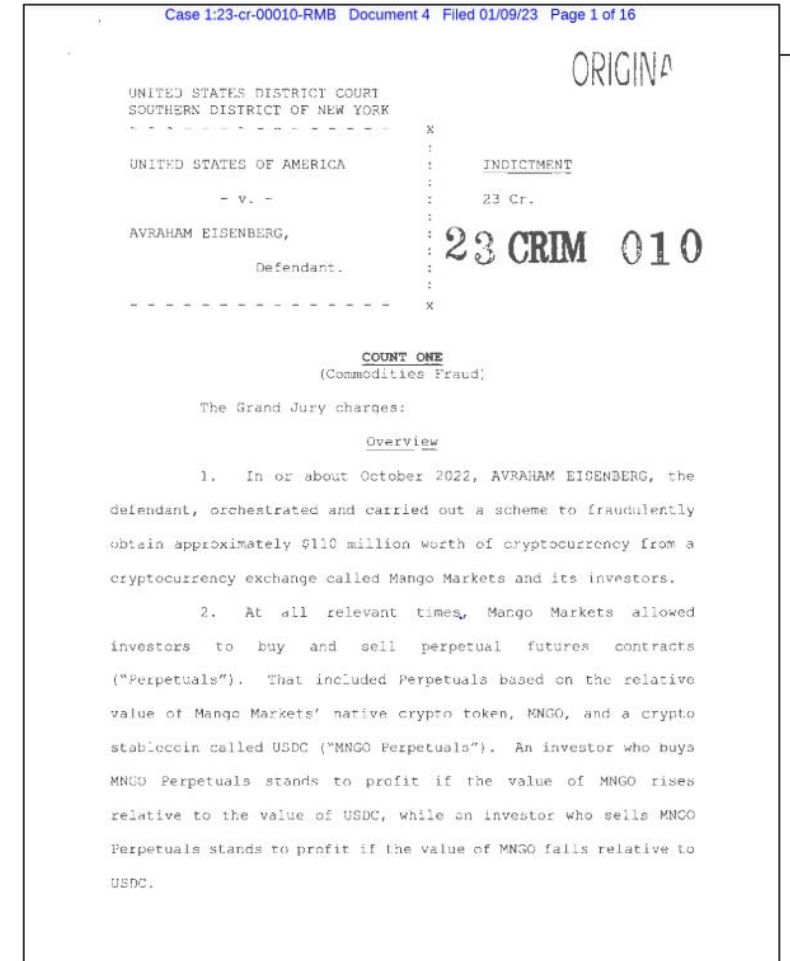
Emerging and Noteworthy Trends

- A recurring issue in electronic markets is differentiating inadvertent self-trading and impermissible wash trading
- For example, the CME issued a [Market Regulation Advisory Notice](#) regarding wash trades on September 17, 2020
 - CME Rule 534 prohibits **intentionally** engaging in activity between accounts with the same beneficial owner to avoid taking a bona fide market position exposed to market risk
 - However, **inadvertent trades** between **independent algorithms** owned by the same beneficial owner will generally be considered bona fide and not manipulative

Emerging and Noteworthy Trends

- *United States v. Eisenberg*

- Eisenberg convicted with manipulating Mango Markets DeFi protocol
- Scheme involved manipulating the spot price for MNGO tokens to benefit related derivative position, which allowed Eisenberg to borrow exist artificial equity in account
- Defense claimed conduct was lawful because it was permitted by platform
- “Code is law” argument in tension with spot market activity





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FIA

The logo consists of the letters 'F', 'I', and 'A' in a bold, sans-serif font. The 'F' is dark grey. The 'I' is dark grey. The 'A' is formed by two overlapping shapes: a light green triangle pointing upwards and a light blue triangle pointing downwards. The background features large, overlapping geometric shapes in light green, light blue, and light grey.