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Bridging the Week by Gary DeWaal: May 13 –17 and May 20, 2019 (Bump Goes the Futures Orders; JAC Warns FCMs)

Article By:

Gary De Waal

The Commodity Futures Trading Commission determined not to stand in the way of a rule amendment by ICE Futures U.S. to impose speed bumps on certain orders entered in two futures contracts traded on the exchange. Two commissioners raised concerns that the rule amendment might be anticompetitive. Separately, the futures industry's Joint Audit Committee reiterated prior guidance that a futures commission merchant may not guarantee customers against losses, or pay out funds from any individual account of a customer, where the payout would leave the aggregate of accounts of the customer at the FCM undermargined. Moreover, JAC strongly suggested FCMs take certain immediate actions to comply with its guidance with the implicit suggestion "or else." As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- CFTC Staff Declines to Halt Rollout of ICE Futures U.S. Speed Bumps; Two Commissioners Raise Concerns (includes Memory Lane and **Arts and Science**);
- Futures Industry Self-Regulators Warn FCMs Against Limiting Losses of Customers and Not Combining Accounts for Aggregate Margin Call Calculations (includes **Compliance Weeds**); and more.

Because of the US Memorial Day holiday on May 27, the next regularly scheduled edition of Bridging the Week will be June 3, 2019.

Article Version:

Briefly:

- **CFTC Staff Declines to Halt Rollout of ICE Futures U.S. Speed Bumps**; **Two Commissioners Raise Concerns**: The Commodity Futures Trading Commission decided not to object to a new rule amendment by ICE Futures U.S. authorizing the exchange to implement delays or "speed bumps" in the time between when new aggressor orders might otherwise execute against resting passive orders.

The rule amendment was self-certified by IFUS with a representation that its so-called "passive order protection" or "POP" functionality would initially be applied solely in the exchange's Gold Daily and Silver Daily futures contracts and involve speed bumps of three milliseconds. However, the language

of the actual rule amendment does not reference any specific futures contracts or speed bump time periods.

Notwithstanding, in recommending non-objection of IFUS's amended rule by the CFTC, the Commission's Division of Market Oversight indicated that its views were limited to IFUS's implementation of POP functionality only for gold and silver contracts and using a three-millisecond speed bump. According to DMO, "staff does not view the certification of the ICE Rule as establishing a precedent with respect to the legal and policy merits of speed bump functionalities generally." DMO expects potential application of POP functionality to any other IFUS-listed futures contracts to be preceded by separate self-certifications.

Under POP, a trader entering an order (e.g., an offer) and letting it rest in IFUS's central limit order book could cancel the order if another order was entered into the marketplace that otherwise would match against the resting order (e.g., a bid). The trader with the resting order would have up to the time of the speed bump to assess the new order (e.g., a last look) and pull the resting order prior to execution against the new order. If the resting order was pulled, the new order would remain in the marketplace. Pursuant to the amended relevant rule, the POP functionality could be activated at any time in IFUS's sole discretion. (Click here to access IFUS February 1, 2019 self-certification of amendments to its Rule 4.56)

According to IFUS, the purpose of its new POP functionality is "to encourage additional market participants, who may not otherwise trade certain Exchange markets due to a latency disadvantage, to participate in trading such products." The exchange claimed that attracting more market participants would increase liquidity "particularly in those markets where price discovery takes place in a related market rather than, or in addition to, the Exchange futures contracts and latency arbitrage is common." IFUS indicated that its speed bumps were solely intended for futures contracts with *de minimis* liquidity.

When it was proposed, many commentators objected to IFUS's amended rule. In one comment letter, for example, FIA PTG argued that IFUS's proposed speed bumps effectively gave liquidity providers an unfair opportunity to review pending orders and cancel or widen their quotes in response. FIA PTG expressed concern that "[a]llowing market participants that post resting quotes … to pull their quotes allow certain participants to display quotes that they do not intend to execute whil[e] also fostering a misleading impression of liquidity in the product." (Click here to access the FIA PTG letter; click here to access all commentators' responses.)

Two CFTC commissioners also expressed reservations regarding IFUS's amended rule – Brian Quintenz and Dan Berkovitz. Mr. Quintenz questioned how penalizing those who have innovated by introducing higher speeds into marketplaces promotes the objective of CFTC Core Principle 9 for designated contract markets. This provision requires a board of trade seeking DCM status to provide "a competitive, open and efficient market and mechanism for executing transactions." (Click here to access the full text of Core Principle 9.) Mr. Berkovitz likewise questioned how speed bumps – which he claimed were a "material anticompetitive burden" for at least some market participants – helped promote "responsible innovation and fair competition" among market participants which he claimed was an obligation of the CFTC to consider in evaluating new DCM rules.

Contrariwise, Commissioner Dawn Stump spoke in support of IFUS's self-certification of its amended rule, saying that under the Commission's self-certification regime, IFUS, in the first instance, must determine that its proposal complies with applicable law. Because no "reliable data or empirical analysis" supports a contrary conclusion, she believed it was appropriate for the CFTC not to object

to IFUS's self-certification.

In recommending non-objection of IFUS's amended rule, DMO acknowledged that speed bump functionalities might impact marketplaces both negatively and positively. As a result, it indicated that staff would monitor the impact of the use of POP functionality on liquidity, price discovery, competition and the potential for manipulation and disruptive trading. IFUS has not announced when it will implement its POP functionality.

In June 2016, the Securities and Exchange Commission approved the Investors' Exchange LLC as a national securities exchange. In announcing its approval, the SEC noted that an automated quotation system like IEX would satisfy the SEC's requirement that it provide an immediate response to an immediate or cancel order if it implements "an intentional access delay that is *de minimis*." At the time, IEX contemplated a one-millisecond speed bump.(Click here for further details in the article "IEX Approved as a National Securities Exchange" in the June 19, 2016 edition of *Bridging the Week*.)

Memory Lane: Shortly after its designation as a DCM in May 2009 to trade US Treasury Futures contracts, ELX Futures filed a request with the CFTC for approval of a rule authorizing participants on the exchange to transact exchange of futures for futures transactions. Although the proposed rule was drafted in generic terms, the purpose was to enable ELX market participants to establish US Treasury Futures positions on ELX while simultaneously liquidating functionally equivalent futures positions on the Chicago Board of Trade, or similarly, to establish positions on CBOT while concurrently liquidating functionally equivalent positions on ELX. (The US Treasury Futures contracts on both ELX and CBOT were materially the same, except those at ELX cleared through the Options Clearing Corporation while those at CBOT cleared through the CME Clearinghouse.)

Although the CFTC did not agree with CBOT's claim that ELX's EFF transactions constituted impermissible wash trades (because each exchange's contract cleared through a different clearinghouse), it did uphold the legitimacy of CBOT's prohibition against use of EFF's, claiming that it was not "an unreasonable restraint of trade or a material anticompetitive burden on trading." ELX became a dormant DCM as of July 1, 2017, with its last trade occurring in June 2016. (Click here for details on ELX's EFF rule in the June 16, 2011 letter from the CFTC to the CME Group, Inc.)

Arts and Science: Two weeks ago, in expressing her skepticism regarding the Securities and Exchange Commission's recently issued framework regarding when cryptoassets may constitute investment contracts (and thus securities), Hester Peirce, an SEC commissioner, lamented that the SEC's "Jackson Pollock approach to splashing lots of factors on the canvas without any clear message leaves something to be desired." (Click here for background in the article, "SEC Crypto Guidance Employing Jackson Pollock Techniques Too Cryptic Says Commissioner Hester Peirce" in the May 12, 2019 edition of *Bridging the Week*.) In response, last week, when I was in Chicago at an event at the Art Institute, I made it a point to view Mr. Pollock's painting *The Key* that is on exhibit there. This painting reflects a more deliberate painting style than some of Mr. Pollock's more spontaneously inspired creations, but viewing it nevertheless made me reflect more on Ms. Peirce's warning.

Last week, Brian Quintenz, a CFTC commissioner, invoked the introduction to Kurt Vonnegut, Jr.'s satirical science fiction fantasy, *Harrison Bergeron*, in criticizing IFUS's amended new rule that would permit speed bumps for the first time for US-traded futures contracts. He feared that the exchange's passive order protection functionality would negate speed innovation by certain traders and thus, going forward, might discourage innovation in futures markets generally. He paralleled this to Mr. Vonnegut's vision of a dystopian make-believe America of 2081, where in the interest of equality, those with natural advantages of any kind (e.g., intelligence, beauty, physical strength) are artificially handicapped with techniques and physical impediments (e.g., techniques to scramble thoughts, mandatory masks, mandatory weights) to neutralize their superiority. Mr. Quintenz's allusion to *Harrison Bergeron* was witty and helped emphasize his concerns. It left me thinking for sure and searching to find my copy of *Welcome to the Monkey House* where the *Harrison Bergeron* short story is found.

In school we likely all began an essay at one point or another, "in literature as in life..." I guess as adults, we now recognize we should have written, "In life as in literature and art..."

- **Futures Industry Self-Regulators Warn FCMs Against Limiting Losses of Customers and Not Combining Accounts for Aggregate Margin Call Calculations**: The futures industry's Joint Audit Committee issued two reminders to futures commission merchants last week, one regarding the prohibition against making guarantees against loss contained in a

Commodity Futures Trading Commission rule (click here to access CFTC Rule 1.56(b).), and the other mandating aggregation of all accounts of the same beneficial owner for the same regulatory account classification (e.g., customer segregated, customer secured and cleared swaps customer) for margin purposes, as previously advised by JAC in May 2014 (click here to access JAC Regulatory Alert 14-03).

Specifically, JAC indicated that an FCM would not comply with the CFTC's prohibition of guaranteeing a customer against loss if it included a limited or nonrecourse clause in a customer or non-customer agreement. JAC indicated that an FCM must have the "absolute right" at all times "to look to funds in all accounts of [a] beneficial owner, including accounts that are under different control, as well as the right to call [a] beneficial owner for funds." This requirement, said JAC, would preclude an FCM from restricting its ability to look for funds in different accounts of a beneficial owner that might be under different discretionary control or from agreeing not to call a beneficial owner for more funds in an account than the owner may have allocated to a manager for that account.

Additionally, JAC noted that all accounts of a single beneficial owner for the same account classification must be viewed together when considering margin funds available for distribution to any individual account. JAC indicated that an FCM may determine to call individual accounts of a beneficial owner managed by different account controllers separately. However, when paying out individual accounts, FCMs must ensure that such payments would not cause a beneficial owner for all its accounts of the same account classification to be undermargined.

JAC is a committee of CFTC-authorized US derivatives exchanges and the National Futures Association.

Compliance Weeds: Although the JAC's new guidances provide important insight into JAC's views regarding applicable law, they also set forth specific expectations for FCMs for compliance. FCMs must:

1. review and "take immediate corrective action to rectify" existing customer and non-customer agreements for any language that is potentially inconsistent with the CFTC's prohibition of guarantees against losses, including express limited or nonrecourse language;
2. ensure their internal controls and procedures require all account agreements and other documents to comply with "all industry rules and regulations," including, but not limited to, the CFTC's prohibition of guarantee against losses; and
3. ensure their policies and procedures mandate that no disbursement be made to a beneficial owner except in compliance with "industry rules and regulations." This includes requiring all accounts of a beneficial owner to be reviewed before paying out any individual account to ensure that the payout will not cause an aggregate margin deficiency, and to maintain evidence of such review and determination.

It's important that FCMs take steps to follow JAC's guidance timely.

More Briefly:

- **First Person Convicted and Sentenced for SpoofingUnder Dodd-Frank Law Loses Bid for Retrial**: Michael Coscia – the first person convicted and sentenced for spoofing under the Dodd-Frank law expressly prohibiting spoofing – lost his recent motion for a new trial. Specially, a federal court in Chicago declined to find that alleged "newly discovered [statistical] evidence" or evidence of other persons engaging in similar spoofing strategies as

Mr. Coscia would likely have led to Mr. Coscia's acquittal. Among other things, Mr. Coscia claimed that a retrial was warranted because, in his initial hearing, the government had claimed that his pattern of trading was "unique and extraordinary." However, claimed Mr. Coscia, the trading data utilized during the trial was for a "narrow, incomplete set of dates, futures and traders." Only after his trial, alleged Mr. Coscia, did CME Group and the Intercontinental Exchange produce broader sets of data showing that the ratio of his cancelled orders to executions was not unusual and that his "trading activity was the same as hundreds of other traders." (Click here for background in the article "First Person Convicted and Sentenced Under Dodd-Frank Anti-Spoofing Law Seeks New Trial" in the January 20, 2019 edition of *Bridging the Week*.)

- **NY Court Upholds Restriction on Stablecoin Transferring Tethered Funds to Affiliated International Exchange but Limits Time Period of Prohibition**: A New York court generally upheld the terms of a preliminary injunction imposed on an *ex parte* basis on April 24, 2019, on companies associated with the Bitfinex exchange and its affiliated stablecoin, tether. However, the court limited the term of the preliminary injunction to 90 days. Although the court continued to restrict Tether (i.e., companies associated with issuing and maintaining the functionality of tether) from providing funds from tether US dollar reserves to Bitfinex and related parties, it made clear that Tether could make all other payments in the ordinary course of its business. Previously, respondents challenged the NY AG's application that led to the preliminary injunction, claiming that it was "riddled with factual and legal errors." (Click here for background in the article "Cryptoasset Exchange and Related Stablecoin Companies Tell Court NY AG Lawsuit 'Riddled With Factual and Legal Errors'" in the May 5, 2019 edition of *Bridging the Week*.)

In other legal and regulatory developments regarding cryptoassets:

- Another Day, Another Bitcoin ETF Review Delayed: The Securities and Exchange Commission indicated that it was again extending time to solicit and receive comments on proposed rule changes by NYSE Arca, Inc. to list and trade shares of the Bitwise Bitcoin ETF Trust. NYSE Arca filed its initial request for a rule change in February 2019; the SEC first delayed its decision in March 2019. The objective of the Trust is to mimic performance of the Bitwise Bitcoin Total Return Index which was designed to measure the performance of bitcoin as traded on 10 cryptocurrency exchanges located in the United States, Europe and Asia. The Trust intends to store bitcoin in custody at a regulated third-party custodian.

- **European Commission Slaps Five Banks With Almost 1.2 Billion Euros Fine for Purported FX Spot Trading Cartel**: The European Commission fined five banks €1.1 billion (approximately US $1.2 billion) for their roles in foreign exchange spot trading cartels. The five banks were Barclays, Citigroup, JPMorgan, MUFG Bank and The Royal Bank of Scotland. According to the EC, individual traders at the various banks exchanged sensitive information and trading plans and sometimes coordinated trading strategies during time periods from December 2007 through January 2013.

- **CFTC DSIO Head Suggests Revision of Permitted Investments for FCMs and Clarification of Exemption for Floor Traders From Swap Dealer Definition Under Consideration**: Matt Kulkin, Director of the Commodity Futures Trading Commission's Division of Swap Dealer & Intermediary Oversight, said last week that the Commission is currently evaluating extending the ability of futures commission merchants to invest customer funds in certain euro-denominated sovereign debt in line with authority recently granted to

derivatives clearing organizations to make such investments. (Click here for background in the article “CFTC Authorizes Clearinghouses to Invest Customer Funds in Certain Types of Euro-Denominated Sovereign Debt; Declines Identical Relief for FCMs” in the July 22, 2018 edition of *Bridging the Week*.) Mr. Kulkin also indicated that the CFTC is considering the current floor trader exclusion from the swap dealer definition and other regulatory initiatives to enhance market quality. Mr. Kulkin made his presentation before the New York City Bar Association.

Video Version:

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