

SEC Examination Priorities; In Life as in Literature; Unregistered CTA Sanctioned: Bridging the Week January 12 to 16 and 19, 2015 [VIDEO]

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Best stock market analysis and financial commentary follows the Financial Industry's 2015 Investor's As a result, the following matters are covered in this week's *Bridging the Week* page:

- Cybersecurity, Potential Equity Order Routing Conflicts and AML Among the Top Examination Priorities for SEC in 2015;
- In Life as in Literature: *The Big Short* Featured Investment Adviser Misled Investors Says SEC Administrative Law Judge;
- Two Legacy Exchanges Previously Owned by Direct Edge Holdings Settle Charges for Not Fully Describing Order Types to SEC;
- Canadian Citizen Charged by SEC With Unlawful Layering Involving Traders in China and Korea;
- Summit Energy Services, Inc. Fined by CFTC US \$140,000 for Acting as an Unregistered CTA in Providing Risk Management Advice (includes **Compliance Weeds**);
- ICE Futures U.S. Settles a Number of Position Limit Offenses; Requires Disgorgement in One Instance;
- SEC Proposes Reporting Regime for Security-Based Swaps;

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- NFA Grants Good Faith Relief Through March 31 to Members That Conduct Business With Previously Exempt CTAs and CPOs; and more.

Cybersecurity, Potential Equity Order Routing Conflicts and AML Among the Top Examination Priorities for SEC in 2015

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations published its priorities for examinations of investment advisers, broker-dealers and transfer agents during 2015.

In addition to matters relevant to business with retail investors, OCIE indicated it will focus on:

- reviewing broker-dealers' cybersecurity compliance and controls;
- potential equity order routing conflicts (e.g., are firms choosing trading venues based on payments or credits for order flow),
- clearing and introducing broker-dealers' anti-money laundering programs—especially for firms that have not filed suspicious activity reports or have filed incomplete or late SARs, as well as broker-dealers that provide customers with direct market access from high-risk jurisdictions; and
- never before examined investment companies, among other priorities.

Earlier this month, the Financial Industry Regulatory Authority highlighted its focus for its 2015 reviews of broker-dealers. (Click [here](#) to access the article, "FINRA Highlights Member Examinations Focus for 2015," in the January 5 to 9 and 12, 2015 edition of *Bridging the Week*.)

(Click [here](#) for further information in the article, "SEC 2015 Examination Priorities Focus on Liquid Alternatives and Fixed-Income Funds" in the January 16, 2015 edition of *Corporate & Financial Weekly Digest* by Katten Muchin Rosenman LLP.)

In Life as in Literature: *The Big Short* Featured Investment Adviser Misled Investors Says SEC Administrative Law Judge

Harding Advisory LLC and Wing Chau, two of the subjects in Michael Lewis' *The Big Short: Inside the Doomsday Machine*, were held liable last week in an administrative law judge's initial decision before the Securities and Exchange Commission for misrepresentation, failure

to follow an appropriate standard of care, and fraud for their role in the purchase of subprime mortgage-backed assets for certain collateralized debt obligations that subsequently were sold to investors. (*The Big Short* is a recount of certain investors who profited by trading against the subprime mortgage bond market during the 2008-2009 financial crisis.)

The SEC's Division of Enforcement previously instituted these proceedings in October 2013.

The Division charged that, during 2006, Harding, acting as a collateral manager for one CDO—Octans I CDO Ltd.—structured and marketed by subsidiaries of Merrill Lynch & Co.—granted a third-party hedge fund—Magnetar—the right to review all collateral before purchase and effectively exercise veto rights. This was never disclosed to debt investors in Octans I, claimed the SEC. Subsequently, Harding deferred to Magnetar's collateral suggestions, which was helpful to the hedge fund, but not to the CDO's investors, claimed the SEC.

The SEC also charged that, during 2007, without adequate credit analysis, Harding acquired tranches of another CDO—Norma CDO I—to include in other CDOs that it managed—as a favor to Merrill and Magnetar—to the detriment of the other CDOs' investors.

At all relevant times, Harding was an SEC-registered investment adviser, while Mr. Chau was the firm's owner and founder.

The judge ruled that Harding violated only some but not all of the specific allegations made by the Division, while Mr. Chau was primarily liable for and solely caused Harding's Norma (not Octans)-related violations. Notwithstanding, the judge imposed penalties of over US \$1 million in disgorgement and prejudgment interest against both respondents; imposed a fine of US \$1.7 million against Harding and a fine of US \$340,000 against Mr. Chau; revoked Harding's investment adviser registration; and barred Mr. Chau from association with the securities industry.

A film version of *The Big Short*—starring Brad Pitt, Ryan Gosling, Christian Bale and Steve Carell—is expected in the near future (click [here](#) for details). A legal action by Harding and Mr. Chau against Mr. Lewis and others for libel was dismissed by a US federal court in New York in March 2013, and the dismissal was upheld by a US federal appeals court in November 2014 (click [here](#) for the decision).

Harding and Mr. Chau previously failed in their efforts before a United States federal court in New York to have the SEC litigate this case in a federal court and not before the SEC. (Click [here](#) for details in the article, “SEC Okay to Prosecute Cases Before Administrative Tribunals Rather Than Federal Courts Says US Judge,” in the December 8 to 12 and 15, 2014 edition of *Bridging the Week*.)

And briefly:

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- **Two Legacy Exchanges Previously Owned by Direct Edge Holdings Settle Charges for Not Fully Describing Order Types to SEC:** Two exchanges registered with the Securities and Exchange Commission—EDGA Exchange, Inc. and EDGX Exchange, Inc.—agreed to pay US \$14 million to settle SEC charges related to their failure to describe order types used on their facilities in mandatory SEC filings. The exchanges were previously owned by Direct Edge Holdings, LLC and are now owned and operated by BATS Global Markets, Inc. According to the SEC, since beginning operation as SEC-licensed national exchanges in July 2010, EDGA and EDGX were required to have rules that required members “reasonably to avoid” displaying quotations for equity securities that would cause a best bid price to equal or exceed a best offer price. To comply with this requirement, Direct Edge filed proposed order type rules for EDGA and EDGX for public comment in September 2009 in connection with their application for licensing. These rules provided for one default process to automatically re-price and re-prioritize a potentially problematic order unless a member provided alternative instructions. However, once commencing operation as national exchanges, EDGA and EDGX maintained three potential order types to handle nonroutable orders and changed the default option on a few occasions; the three order types had different priority in execution against each other and against other order types. This information was fully disclosed to some but not all members, allowing a few members to benefit from the changes but not all, claimed the SEC. Direct Edge filed revised rules with the SEC in summer 2014 that reflected the three order types and how they operated. The rules were approved for EDGX on October 29, 2014, and EDGA on November 13, 2014. As part of their settlement, the exchanges also agreed to implement written policies and procedures related to order types, among other undertakings. The SEC said its fine in this matter was the largest fine it has ever levied against a national securities exchange.
 - **Canadian Citizen Charged by SEC With Unlawful Layering Involving Traders in China and Korea:** The Securities and Exchange Commission filed a civil action in the US federal court in New Jersey against Aleksandr Milrud, claiming that he engaged in a disruptive trading strategy known as “spoofing” or “layering” in connection with high-speed purchases and sales of various exchange-traded securities from January 2013 to the present. According to the SEC, Mr. Milrud—a Canadian citizen who resides in Ontario, Canada and has a residence in Aventura, Florida—used other traders—primarily in China and Korea—to place multiple “non-bona fide orders” for stocks to induce other traders to trade on one side of the market at “artificially inflated or depressed prices” and then cancel the orders. Mr. Milrud and the other traders engaged in this strategy to effectuate orders to purchase or sell the relevant security on the other side of the market,

charged the SEC. To help avoid detection by regulators, Mr. Milrud allegedly instructed his traders to trade only high-volume securities, to manipulate a wide variety of securities (executing only a small number of trades in any one stock on any day), and to cause only small increases or decreases in the prices of the securities they manipulated, among other “elaborate measures.” The SEC claimed that Mr. Milrud “worked with a gaming software company to develop ‘hot keys’ that allowed his traders to quickly place and cancel multiple orders via their computers with only a few strokes of their keyboards.” Mr. Milrud also allegedly received a portion of all his traders’ profits. The SEC is seeking an injunction against Mr. Milrud and his traders, as well as a fine and disgorgement against him. Concurrently, Mr. Milrud was criminally charged with one count of conspiracy to commit securities fraud and one count of wire fraud before the US district court in New Jersey related to the same activity in an action brought by the US Attorney’s Office for the District of New Jersey.

- **Summit Energy Services, Inc. Fined by CFTC US \$140,000 for Acting as an Unregistered CTA in Providing Risk Management Advice:** Summit Energy Services, Inc.—a Louisville, Kentucky-based firm—was fined US \$140,000 by the Commodity Futures Trading Commission for advising its clients regarding the benefit of entering into over-the-counter natural gas swaps and natural gas commodity futures for compensation without being registered from October 2012 to September 25, 2014. During the relevant period, Summit held itself out on its website as providing “risk management” services regarding the value or advisability of trading in natural gas swaps or futures and had more than 15 clients. Most of Summit’s clients apparently were commercial entities that purchased physical natural gas and electricity as part of their energy needs. Generally, persons who advise other persons for compensation or profit regarding the value or advisability of trading in futures or swaps must be registered with the CFTC as a commodity trading advisor; there is an exemption for persons advising 15 or less persons over the prior 12 months and who does not hold themselves out to the public as a CTA. Summit agreed to pay the fine, as well as consented to cease and desist from further violations.

Compliance Weeds: As I emphasized in the preceding article, the test for CTA exemption is two part: a person who advises no more than 15 persons and does not hold themselves out to the public as a CTA. For startups, it is important not to undercut the numerical basis for an exemption from registration by claiming on a website or other promotional literature to provide advisory or risk management services regarding the value or advisability of trading in swaps or futures for compensation.

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- **ICE Futures U.S. Settles a Number of Position Limit Offenses; Requires Disgorgement in One Instance:** ICE Futures U.S. brought a number of disciplinary actions for violation of its position limit rules, in one case imposing both a fine and disgorgement as a sanction. Each matter was voluntarily settled by the respondent. In a disciplinary action against J&P (China) Capital Management Ltd., the firm agreed to pay a fine of US \$15,000 and disgorge profits of \$255,110 for violating the 5,000 lots all months combined position limit on Cotton No. 2 futures contracts on two days in September 2014. In another matter, D.E. Shaw & Co., L.P. was fined \$20,000 for one instance where one fund it advised established a position in the New York Mercantile Exchange natural gas futures contract at the same time the fund held a position in excess of the ICE Futures U.S.'s spot month position limit for its Henry LD1 fixed price futures contract during the November 2013 contract expiration. The exchange also brought and settled a disciplinary action against Virginia Power Energy Marketing, Inc. for violating position limits on two occasions in 2013 by payment of a fine of \$27,500. Separately, Heat Energy Group, LLC paid a fine of \$15,000, and both Mercuria Energy America, Inc, and Eagle Seven, LLC each paid fines of \$7,500 for their roles in block trades to help Heat resolve an unrelated customer error.
 - **SEC Proposes Reporting Regime for Security-Based Swaps:** The Securities and Exchange Commission adopted two rules requiring security-based swap depositories to register with it, and enumerating such SDRs' reporting and public dissemination requirements. The SEC also proposed rule amendments and guidance related to the reporting and public distribution of data related to security-based swap transactions. Among other measures, all security-based swaps involving US persons or registered security-based swap dealers would have to be reported to an SDR within 24 hours after execution; the rules do not address real-time reporting at this time. The rules provide for market participants to satisfy their reporting obligations under certain circumstances through satisfaction of comparable requirements of a foreign regulator. SDRs must also establish independent compliance functions, with only the Board of Directors having the authority to appoint, determine the level of compensation for and remove chief compliance officers. The CCO must also prepare an annual compliance report. Finally, there are hierarchy requirements related to the reporting of required information among the different types of parties to a security-based swaps transaction (e.g., priority for security-based swap dealers).
 - **NFA Grants Good Faith Relief Through March 31 to Members That Conduct Business With Previously Exempt CTAs and CPOs:** The National Futures

Association stated that members will not be in violation of its prohibition against conducting business with nonmembers required to be registered with the Commodity Futures Trading Commission and members of the NFA if they engage in business with certain commodity trading advisors and commodity pool operators from January 1 through March 31, 2015. These CTAs and CPOs were previously exempt or excluded from CFTC registration and had an appropriate notice of exemption on file with NFA. Since such entities are required to file a notice affirming the appropriate exemption or exclusion or CPO registration 60 days from the end of each calendar year—or by March 2 this year—it is possible that a member may have no ability to conclusively confirm the legitimacy of a claimed exemption or exclusion during this interim time. To take advantage of this relief, members must take “reasonable steps” to assess the membership status of persons who claim exemption from CPO or CTA registration with whom it conducts business by reviewing entries on NFA’s BASIC system as well as a spreadsheet NFA is updating nightly to include a list of all persons that have exemptions that require affirmation.

And even more briefly:

- **CFTC Extends No-Action Relief Regarding Reporting of Certain Identifying Information in Various Enumerated Jurisdictions:** The Commodity Futures Trading Commission’s Division of Market Oversight extended relief previously granted to swap traders with CFTC reporting obligations (most recently on June 28, 2013) related to the reporting to swap data repositories of certain information related to their swap counterparties in certain enumerated jurisdictions. The new relief expires at the latest at 12:01 a.m. Eastern Standard Time on January 16, 2016, and is subject to the same conditions as the prior relief. (Click [here](#) for more information in the article, “CFTC Staff Extends No-Action Relief to Certain Reporting Counterparties Masking Identifying Information Pursuant to Non-US Law,” in the January 16, 2015 edition of *Corporate & Financial Weekly Digest* by Katten Muchin Rosenman LLP.)
- **Magical, Not a Mystery Tour: CFTC Chairman Visits Asia:** Chairman Timothy Massad of the Commodity Futures Trading Commission announced a whirlwind tour of Asia—including stops in Beijing, Hong Kong, Tokyo and Singapore—“in view of the increasing importance of the Asian derivatives markets and his desire to further dialogue with government officials and market participants on common concerns and interests.” In his stop in Hong Kong on January 19, Mr. Massad reminded attendees of the Asian Financial Forum that he had spent five years in HK beginning in 1998. In a speech to the

Forum, he described the glass as "half full, not half empty" in describing progress to implement global harmonization of swaps market regulation.

- **UK FCA Issues Final Rules to Implement European Recovery and Resolution Directive:** The Financial Conduct Authority issued a policy statement and final rules to implement in the United Kingdom the European Recovery and Resolution Directive. The RRD was adopted by the European Parliament in May 2014 (click [here](#) to access) to help minimize the negative impact the failure of certain credit institutions and investment firms might have on their customers and markets, and to help ensure that shareholders and creditors, and not taxpayers, incur the risk of losses. The rules—the majority of which are effective today (January 19) —apply to investment firms that are regulated prudentially by the FCA that engage in proprietary trading or take balance sheet risk for profit, or group entities that contain such an investment firm or credit institution. UK firms that are regulated both by the Prudential Regulation Authority and FCA (e.g., deposit takers and insurance firms, and certain significant investment firms) will be subject to RRD rules implemented by the PRA.
- **FIA Publishes Overview of ESMA Technical Advice and Consultation on MiFID II:** The Futures Industry Association has published an overview of the European Securities and Markets Authority’s final technical advice and consultation paper regarding the Markets in Financial Instruments Directive II and Markets in Financial Instruments Regulation, published on December 19, 2014. (Click [here](#) for more information in the article “ESMA Publishes Implementing Rules for MiFID II, in the December 15 to 19 and 22, 2014 edition of *Bridging the Week*.)

For more information, see:

Canadian Citizen Charged by SEC With Unlawful Layering Involving Traders in China and Korea:

<http://www.sec.gov/litigation/complaints/2015/comp-pr2015-4.pdf>

See also, criminal indictment:

<http://www.justice.gov/usao/nj/Press/files/pdf/2015/Milrud,%20Aleksandr%20Complaint.pdf>

CFTC Extends No-Action Relief Regarding Reporting of Certain Identifying Information in Various Enumerated Jurisdictions:

<http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/15-01.pdf>

Cybersecurity, Potential Equity Order Routing Conflicts, and AML Among the Top Examination Priorities for SEC in 2015:

<http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf>

FIA Publishes Overview of ESMA Technical Advice and Consultation on MiFID II:

http://www.futuresindustry.org/downloads/FIA%20Special%20Report%20Series_%20ESMA%20publishes%20technical%20advice%20and%20launches%20consultation%20on%20MiFID%20II.pdf

ICE Futures U.S. Settles a Number of Position Limit Offenses; Requires Disgorgement in One Instance:

[/ckfinder/userfiles/files/J%20%26P%20\(China\)%20Capital\(1\).jpeg](/ckfinder/userfiles/files/J%20%26P%20(China)%20Capital(1).jpeg)

[/ckfinder/userfiles/files/Heat%20Energy\(1\).jpeg](/ckfinder/userfiles/files/Heat%20Energy(1).jpeg)

[/ckfinder/userfiles/files/Virginia%20Power\(1\).jpeg](/ckfinder/userfiles/files/Virginia%20Power(1).jpeg)

[/ckfinder/userfiles/files/DE%20Shaw\(1\).jpeg](/ckfinder/userfiles/files/DE%20Shaw(1).jpeg)

In Life as in Literature: *The Big Short* Featured Investment Adviser Misled Investors Says SEC Administrative Law Judge:

<http://ftp.sec.gov/alj/aljdec/2015/id734ce.pdf>

Magical, Not a Mystery Tour: CFTC Chairman Visits Asia:

http://www.cftc.gov/PressRoom/Events/opaevent_massad011915

See also, HK speech of Chairman Massad:

<http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-7>

NFA Grants Good Faith Relief Through March 31 to Members That Conduct Business With Previously Exempt CTAs and CPOs:

<http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4529>

SEC Proposes Reporting Regime for Security-Based Swaps:

http://www.sec.gov/news/pressrelease/2015-6.html#.VLh76Fpvl_g

Summit Energy Services, Inc. Fined by CFTC US \$140,000 for Acting as an Unregistered CTA in Providing Risk Management Advice:

<http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfsummitorder011615.pdf>

Two Legacy Exchanges Previously Owned by Direct Edge Holdings Settle Charges for Not Fully Describing Order Types to SEC:

<http://www.sec.gov/litigation/admin/2015/34-74032.pdf>

UK FCA Issues Final Rules to Implement European Recovery and Resolution Directive:

<http://www.fca.org.uk/static/documents/policy-statements/ps15-02.pdf>

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