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CFTC Commissioner Bowen Argues for User Fees During House Subcommittee Hearing; Commissioner Wetjen Calls for Bankruptcy Law Amendments to Permit Individual Segregation of Customer Funds

Commodity Futures Trading Commissioner Sharon Bowen argued for granting authority to the CFTC to impose user fees on certain industry participants, during a CFTC reauthorization hearing held last week before the United States House Committee on Agriculture, Subcommittee on Commodity Exchanges, Energy and Credit.

CFTC Commissioners J. Christopher Giancarlo and Mark Wetjen also spoke before the subcommittee, with Mr. Giancarlo indicating that the CFTC should realign its regulatory agenda prior to requesting additional funding. Among other things, Mr. Wetjen argued for an amendment to bankruptcy laws to provide for individual segregated accounts for customers.

During her testimony, Ms. Bowen was not specific on the type of user fees she would recommend. However, she said, “there are many ways to structure such a fee, including establishing de minimis fees on all trades, fees on certain riskier trades, or annual fees on registrants.”

Ms. Bowen claimed that the Commission required additional resources to “keep pace with our duties.” She said that CFTC current underfunding “has been an obstacle to [the] industry, including end-users.” According to Ms. Bowen,

> [w]ith a staff that is stretched so extremely thin, reviews of various applications by derivatives clearing organizations and exchanges can take longer, delaying those organizations’ efforts to improve and enhance trading for market participants. … And with a staff that is stretched so extremely thin, our rulemaking process will move much more slowly. Not only does that invite additional regulatory uncertainty into the markets we regulate, but it also means that we are less able to craft exemptions for end-users or market participants in a timely fashion, even for those entities who have a critical and real need for them.

During his appearance before the subcommittee, Mr. Giancarlo suggested that, before the Commission seeks additional resources, it should reduce “inefficiencies” in the Commission’s oversight. Mr. Giancarlo claimed that it is the CFTC’s own regulatory agenda that contributes to its overwork. According to Mr. Giancarlo,

> [f]or example, managing the CFTC’s flawed swaps trading regulatory framework is expensive and time-consuming. Fitting the square peg of the CFTC’s swaps trading rules into the round hole of the established global swaps markets requires the Commission and staff to devote enormous resources to continuously explain, clarify, adjust, exempt and manipulate rules to allow rough swaps market operability. The Commission and staff must constantly add to the plethora of no-action letters, guidance, staff advisories and other written communications that go out to the market and participants. … The CFTC’s current swaps trading regulatory framework requires enormous bureaucratic “make work” to assure industry compliance. … Similarly, the CFTC’s proposed position limits rules are overly burdensome and will require substantial agency resources to implement and sustain. … [They] would partially duplicate—at US taxpayer expense—the management of position limits already being done by DCMs at industry expense. The CFTC should work to reduce these and other examples of inefficiencies before asking for substantial budget increases.

In his testimony, Mr. Wetjen identified a number of issues that the CFTC should rapidly address. These include (1) ensuring that differences are resolved with European regulators to ensure that US clearinghouse regulatory framework is assessed as equivalent to the European framework. Otherwise, European banks will be assessed a higher capital charge for clearing trades through US clearinghouses; (2) clarifying the CFTC’s requirement that block trades involving swap execution facilities must occur away from the SEF. This has caused difficulty for SEFs and futures commission merchants in complying with their pre-execution credit checking obligations; and (3) enhancing transparency regarding clearinghouses with respect to stress tests evaluating how much of a clearinghouse’s own capital should be used and under what circumstances in case of a major clearing member default.

Commissioner Wetjen also suggested that Congress should consider amending bankruptcy laws to permit the CFTC “greater flexibility with respect to the protection of customer funds.” Currently, said Mr. Wetjen, all customer property must be distributed ratably among all customers when there is an overall shortage following an FCM insolvency. There is no ability for the CFTC to design a framework that provides for individual customer funds segregation. According to Mr. Wetjen,

> this requirement limits the commission’s flexibility in designing a model for the protection of customer funds that allows for individual segregation. … For customers who believe they can better protect their funds in the OTC marketplace this potential result is unsatisfactory.”

During his appearance, Mr. Wetjen also called upon the subcommittee to monitor developments that appear to be leading to a decrease in the number of FCMs. He indicated the subcommittee should “play a role” to help ensure that different regulatory authorities “do not pursue goals that are may be at cross-purposes with each other”—such as promoting central clearing of derivatives through financial regulation, and raising capital standards for global banks.

My View: I have often previously argued that regulators must be careful not to enact disparate regulations that, together, negate each other and fail to advance desired objectives. As Commissioner Wetjen observes, regulations that encourage central clearing of derivatives cannot be effective if other regulations discourage central clearing through capital surcharges. Likewise, the noble objective to encourage enhanced customer protection by requiring FCMs to use their own capital to fund customer margin deficiencies is frustrated if the same regulations encourage FCMs to require more funds up front from customers, thus increasing clients' exposure to their brokers. On and on. Preferably in advance, but certainly periodically on an ongoing basis, regulators should step back and review holistically the impact of their regulations to assess whether desired objectives are being met, and, if not (or not as well as possible), revise them.

Briefly:

- *CFTC Sues Respondents, Including Lawyer, for Single Stock Futures Pre-Arranged Trading to Pass Money*: The Commodity Futures Trading Commission sued four defendants, including a Canadian law firm and a lawyer, in a federal court in Illinois for engaging in illegal, fictitious transactions involving single stock futures. The purposes of this trading, said the CFTC, was for the respondents to transfer funds from the law firm to another corporation. The four defendants are MetroWest Law Corporation, a Canadian law firm located in Vancouver, Canada; John Briner, an attorney also residing in Vancouver, who is the 100% owner of MetroWest; Tech Power Inc., an information technology company located in California; and Matthew Marcus, the president, secretary, treasury and director of Tech Power. Mr. Marcus was a client of MetroWest and Mr. Briner, claimed the CFTC. The CFTC also noted that, previously, in October 2013, MetroWest was placed into custodianship, although Mr. Briner continued control over a MetroWest trading account. According to the CFTC's complaint, on seven consecutive days from January 28 to February 5, 2014, Mr. Marcus and Mr. Briner entered into 624 round-turn trades for 1,248 "perfectly matched, pre-arranged, non-competitive transactions in single stock futures" traded on OneChicago, LLC. The objective, alleged the CFTC, was to move US $390,000 from the MetroWest account to an account in the name of Tech Power. The transactions were structured, observed the CFTC, by having one account of Tech Power buy an illiquid single stock futures contract at a lower price in a pre-arranged transaction with MetroWest, and then later having Tech Power sell the identical SSF contract to MetroWest at a higher price. Through its litigation, the CFTC is seeking disgorgement of profits, civil monetary penalties, registration bans and injunctions against further violations of law.

- *Alleged Spoofer Fails to Convince Court to Dismiss Indictment*: A federal court judge in Illinois rejected Michael Coscia's efforts to have dismissed the federal indictment against him for alleged spoofing that was filed in September 2014. Mr. Coscia, the prior manager and sole owner of Panther Energy Trading LLC, was indicted in Chicago for alleged spoofing activities involving futures traded on CME Group and ICE Futures Europe from August through October 2011. Mr. Coscia had sought to have his indictment dismissed on the grounds that the prohibition against spoofing under federal law is void for vagueness as is the commodity fraud provisions under which he also was charged. In rejecting Mr. Coscia's arguments regarding spoofing, the court reasoned that, because First Amendment rights were not in controversy (e.g., regarding restrictions on freedom of speech or religion), "the Court must assess whether the statute is unconstitutional as applied to Coscia's conduct, … not to the conduct of the ‘hypothetical legitimate traders’ who voiced concerns about the statute’s applicability to practices such as partial-fill and stop-loss orders.” Because the alleged illegal conduct—entering large-volume orders with the intent to “immediately cancel”—tracked the language of the relevant statute, the judge refused to dismiss the spoofing counts of Mr. Coscia’s complaint. The judge also sustained the charges against Mr. Coscia for allegedly engaging in a scheme or artifice to defraud, claiming that, as written, the indictment states that Mr. Coscia “carried out his strategy ‘to create a false impression regarding the number of contracts available in the market’ … and ‘intended to trick others into reacting to the false price information he created’.” The Commodity Futures Trading Commission, the UK Financial Conduct Authority and the Chicago Mercantile Exchange previously brought enforcement proceedings in July 2013 and entered into simultaneous settlements with Mr. Coscia and Panther related to the same conduct underlying the indictment, assessing aggregate sanctions in excess of approximately US $3 million and various trading prohibitions.

- *US Department of Labor Proposes to Extend Fiduciary Standards to Advisers of Purchasers of More Kinds of Retirement Assets*: The United States Department of Labor issued a proposed rule that would expand the number of persons that would be considered a fiduciary for providing investment advice or recommendations in connection with retirement assets. Specifically, as proposed, any person who provides such advice or recommendations to an employee benefit plan, plan fiduciary, plan participant, individual retirement account, or IRA owner for a fee or other compensation would be considered a fiduciary, be subject to trust standards of care and loyalty, and could be held liable for a breach of such standards. Simultaneously, DOL proposed a new exemption to its so-called “prohibited transaction” rules that would permit firms and employees to continue to receive commissions and revenue sharing in connection with advice to retail retirement investors—defined as participants and beneficiaries of participant-directed employee benefit plans, IRA owners, and the sponsors of non-participant-directed plans with fewer than 100 participants. Firms and advisers seeking to take advantage of this new exemption—called the “best interest contract exemption”—would have to contractually acknowledge their fiduciary status, agree to comply with basic standards of impartial conduct, adopt policies and procedures reasonably intended to mitigate the harmful impact of conflicts of interest, and disclose certain information regarding their conflicts of interest and cost of advice. Certain activity would also be expressly carved out from implicating fiduciary standards: retirement education, order-taking and sales pitches to plan fiduciaries with financial expertise. In addition, DOL proposes a new exemption to permit advisers to sell certain debt securities on a principal basis from their own inventory to employee benefit plans and IRAs, and to receive compensation for providing loans to plans or IRAs to avoid failed securities transactions. DOL had previously proposed a change in the definition of fiduciary in 2010. DOL withdrew that proposal in connection with its issuance of its new proposals. DOL will accept comments on its new proposals through the 75th day following their publication in the Federal Register.

- *BNY Mellon Fined GBP 126 Million by UK FCA for Failure to Comply With Custody Rules*: The UK Financial Conduct Authority fined The Bank of New York Mellon London Branch and The Bank of New York Mellon International Limited GBP 126 million (US $188 million) for failing to comply with FCA’s custody rules. Among other things, FCA claimed that the respondents failed to reflect on their records the specific BNY Mellon entity with whom clients had contracted; failed to take appropriate steps to prevent the commingling of custodied assets for clients with firm assets; and, on occasion, used client assets in omnibus accounts to settle other clients’ transaction without such clients’ authorization. FCA claimed that “[t]he

[Respondents'] use of global custody platforms, which during the relevant period, did not record which Bank New York Mellon Group … entity clients had contracted, caused several of the Firms' failings."

- *Block Trades, EFRPs and Position Limits Are Continued Subjects of CME Group's Enforcement Focus*: The CME Group issued notices regarding 18 disciplinary actions last Friday—all involving modest fines from US $7,500 to $35,000—most involving allegations of improper exchange for related position transactions or block trades; wash trades or position limits violations. Two firms were the subject of multiple disciplinary actions and paid multiple fines. Jefferies LLC was the subject of four distinct disciplinary actions related to alleged infractions involving block trades. In all four matters, the firm was charged with not reporting block trades within required time frames; in two of the actions, Jefferies was also charged with misreporting the accurate time of execution of each block trade; and in one action, the firm was also charged with aggregating block orders on one side of a transaction for different beneficial owners. Lakeview Energy LLC was also charged in two actions with engaging in impermissible EFRP transactions that were structured to move positions between two wholly owned subsidiaries—Plymouth Energy LLC and CE Acquisition CO LLC. CME alleged that these transactions were impermissible wash trades, and that the EFRPs were also non-bona fide. This was because there was not appropriate documentation to support the related position component of the transactions. Green Plains Asset Management LLC was fined US $25,000 for one incident of violating a position limit intraday, while Charles Adam was fined US $15,000 and required to serve a 20-business day CME Group trading suspension for entering orders in E-mini S&P futures contracts on various occasions between July 1, 2013, and March 26, 2014, during the pre-opening session without the intent to execute "bona fide transactions." Daniel Shak also agreed to pay a fine of US $25,000 to CME Group related to his alleged violation of accountability limits in the December 2011 gold futures contract from September 14 to September 17, 2009. Just two weeks ago, Mr. Shak was fined US $100,000 for violating a prior settlement with the Commodity Futures Trading Commission related to his and his company's (SHK Management LLC) alleged manipulation of crude oil futures contracts on two days in 2008. None of the respondents to any of the CME Group disciplinary action settlements admitted or denied the rule violations on which their settlement was based.

Compliance Weeds: I have previously articulated the correct requirements in connection with EFRPs and block trades, and discussed requirements to comply with position limits. Any violation of an exchange's rules related to EFRPs, block trades or position limits potentially constitutes a violate of CFTC rules prohibiting non-competitive trades, and speculative position limit violations, respectively.

- *NY AG Settles With Ernst & Young Over Alleged Financial Statement Fraud Prior to Lehman Collapse*: The New York State Attorney General settled a lawsuit against Ernst & Young related to its involvement in the financial statement preparation of Lehman Brothers Holding, Inc. The NY AG had alleged that the auditing firm had countenanced Lehman's inclusion of certain repurchase transactions as sales and not as financings, which permitted the firm to remove "tens of billions of dollars" of securities from its balance sheet. According to the NY AG, the repo transactions—known as "Repo 105"—"served no legitimate purpose. … Lehman used the funds derived from the transactions to pay down billions of dollars or liabilities, which had the effect of temporarily and misleadingly reducing Lehman's leverage ratio, an important metric for analyzing Lehman's liquidity and financial health." The NY AG had charged that E&Y's failure to include any reference in Lehman's financial statements about the Repo 105 transactions was "fraudulent and deceptive." To resolve this matter, E&Y

agreed to pay US $10 million, which the NY AG will distribute to investors in Lehman Brothers securities. Lehman Brothers filed for bankruptcy protection in September 2008, and remains the largest bankruptcy in American history.

- *Deutsche Bank Branch in Dubai Fined for AML, Client Onboarding and Governance Weaknesses*: The Dubai Financial Services Authority fined Deutsche Bank AG Dubai the equivalent of US $2.3 million (UAE Dirham 8.4 million) for not meeting its standards regarding governance, systems and controls, as well as compliance arrangements and anti-money laundering processes. Moreover, at various times from January 1, 2011, to January 22, 2014, Deutsche Bank represented to DFSA that its Private Wealth Management business solely referred clients in Dubai to other Deutsche Bank entities outside of Dubai when in fact the business was advising and handling customers within Dubai, said DFSA. As a result, DFSA also charged Deutsche Bank with providing DFSA with false information about its activities in Dubai, and not promptly correcting the false information.

And even more briefly:

- *PIMCO Joins Chorus Against New Bank Capital Requirements*: The Pacific Investment Management Company, LLC joined the chorus of firms and regulators that are raising concerns about international efforts to increase capital buffers and reduce leverage at the largest banks. In a viewpoint published online, PIMCO raised concerns regarding requirements that force banks to hold significant capital to support derivatives trading by their clients, “even when banks are merely functioning as conduits.” PIMCO argued that if banks find the costs “to perform vital functions around derivatives trading too costly,” they will either pass on the costs or exit the clearing business. “Already, we have seen both, and neither is desirable,” it says.

- *MF Global Inc. 100% Unsecured General Creditor Payout Approved by US Bankruptcy Judge*: The United States bankruptcy judge overseeing the liquidation of MF Global Inc., approved the trustee’s proposal to pay all unsecured general creditors $461 million. Once paid, this distribution would result in total distributions to unsecured general creditors of 72 percent of their approved claims.

- *FCA Issues Final Guidance on Multilateral Trading Facilities*: The Financial Conduct Authority has finalized guidance regarding multilateral trading facilities. (MTFs are loosely analogous to automated trading systems in the United States that are regulated by the Securities and Exchange Commission.) Among other things, MTFs must have “transparent and non-discretionary rules and procedures for fair and orderly trading;” may make available rules’ supporting documents (e.g., terms of business, user agreements) to a closed group only (in order not to stifle innovation); and have a “proportionate and effective sanctions regime” to ensure compliance with its rules by its users.

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