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Bridging the Week: February 1 – 5 and 8, 2016 (Dark Pools; Manipulation; Position Limits; Wash Trades; Purposeful Regulation)

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Last week, two broker-dealers agreed to pay substantial fines to resolve *New York State* and ***Securities and Exchange Commission*** allegations of wrongdoing by their dark pools. In addition, one futures exchange issued a helpful Frequently Asked Questions regarding its position limits' requirements, while another published a FAQ regarding wash trades. Finally, both the heads of the Commodity Futures Trading Commission and UK Financial Conduct Authority spoke publicly about proposed new rules regarding position limits – but one strongly criticized her continent's proposed rules as "not necessary." As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Two Broker-Dealers to Pay US $154 Million to the State of NY and the SEC to Resolve Allegations of Wrongdoing by Their Dark Pools;
- CFTC Opposes Kraft/Mondelez's Attempt to Have an Appeals Court Determine Certain Legal Issues at This Time;
- NASDAQ Futures Publishes Helpful Position Limit FAQ (includes **Compliance Weeds**);
- ICE Futures U.S. Issues Revised Wash Trade FAQ (includes **Compliance Weeds**);
- CFTC Charges One Firm and Settles With Another for Illegal Off-Exchange Precious Metals Transactions (includes **Legal Weeds**)
- CFTC Chairman Offers No Timetable But Says Agency "Working Hard" on Position Limits; FCA Head Says Proposed European Position Limits Unnecessary (includes **My View**); and more.

Briefly:

- **Two Broker-Dealers to Pay US $154 Million to the State of NY and the SEC to Resolve Allegations of Wrongdoing by Their Dark Pools**: Barclays Capital Inc. and Credit Suisse Securities settled allegations by the Securities and Exchange Commission and the New York State Attorney General related to their operation of automated trading systems known as "dark pools." The banks settled the allegations by agreements to pay penalties in excess of US $154 million in aggregate to both regulators. The regulators claimed the banks made false statements and omissions in the marketing of their dark pools**.** Specifically, the regulators alleged that, from December 2011 through June 2014, Barclays, in connection with its ATS known as "Barclays LX," told clients it used a "sophisticated surveillance framework" to prevent clients from predatory trading by high-speed traders when it did not do so consistently, and failed to run surveillance reports on a weekly basis to ensure there was no "toxic flow in [LX's] book," after telling clients it would conduct such oversight continuously. Similarly, the regulators claimed that, at various time from January 2011 to April 2013, Credit Suisse, through its ATS known as "LightPool," offered clients an opportunity to avoid trading with certain counterparties, such as high-speed traders. To fulfill this promise, said the regulators, Credit Suisse claimed it would constantly score participants using objective and transparent measures. In fact, alleged the regulators, Credit Suisse performed categorizations on an ad hoc, not on a regular, basis; considered multiple subjective not objective factors when rating participants; and gave some high-speed traders warnings in advance when they might be rated unfavorably. The regulators also alleged that Credit Suisse violated applicable laws in connection with its ATS known as "Crossfinder" at various times from April 2009 through April 2014. Among other things, the regulators claimed that Credit Suisse improperly used Crossfinder's subscribers' confidential trading information for two firm applications. Additionally, Credit Suisse accepted and ranked orders on Crossfinder in less than one-cent increments, in violation of applicable law aimed at preventing orders from trading ahead based on "insignificant sub-penny differences in their prices," said the regulators.

- **CFTC Opposes Kraft/Mondelez's Attempt to Have an Appeals Court Determine Certain Legal Issues at This Time**: The Commodity Futures Trading Commission formally opposed efforts by Kraft Foods Group, Inc. and Mondelez Global LLC to formally appeal two legal issues to a federal appeals court in connection with the CFTC's pending enforcement action against the defendants alleging manipulation. Last month, the defendants requested permission from the federal court hearing the enforcement action to have a federal appeals court rule on two of the Commission's central legal theories in advance of trial. These are whether (1) "a defendant's large futures position, coupled with an alleged intent to affect market prices but absent any other false communications to the market" is prohibited "false signaling" manipulation and (2) whether the prices that result following a defendant's purchases of futures positions in a market that cause futures and cash prices to converge are artificial prices. In papers filed with the federal court, the CFTC argued that the defendants should not be permitted to file an appeal at this time because neither of the legal issues raised by them "accurately reflects the factual allegations in the Commission's Complaint." Moreover, said the CFTC, even if the defendants were to prevail on both their questions on appeal, the ruling would not end "the market manipulation aspect of this case." As a result, said the CFTC, defendants' motion did not meet "the high bar set for interlocutory appeals" under applicable law. (Click here for background on Kraft Foods' and Mondelez Global's attempted appeal.)

- **NASDAQ Futures Publishes Helpful Position Limit FAQ**: NASDAQ Futures, Inc. issued *Frequently Asked Questions* related to position limits and accountability levels. In general, position limits on NASDAQ Futures may not be violated at any time, including intraday. (Click here to access NASDAQ Futures Rules, Chapter V, Section 13(a).) Moreover, no futures participant (i.e., any person is who authorized to access the exchange's electronic trading system directly) may "effect" a transaction for any other person that the participant "knows or has reason to believe would result in the Futures Participant, a Customer, or any other Person holding or controlling, separately or in combination" a net position in violation of a position limit. If a clearing member carries positions for a customer in excess of position limits, the exchange requires the FCM "to discover and to liquidate such excess positions" within one business day. NASDAQ Futures's FAQ provides help on understanding so-called "Diminishing Balance Contracts" where the front month volume in any given contract month ratably diminishes as the contact month progresses towards expiration. As a result, a customer holding a position in a diminishing balance contract that appears to be in excess of a position limit may in fact not be in violation of the position limit because of the manner in which portions of the position are deemed to be eliminated day by day.

Compliance Weeds: Position limit rules are generally equivalent among US exchanges, but are not 100 percent identical. In general, exchange position limits apply to all traders whether members of an exchange or not. On some exchanges (e.g., CME Group and NASDAQ Futures), if a customer breaches a position limit, clearing members will not be deemed in violation of the exchange's position limits proscriptions for a "reasonable time" (typically one business day) in order to permit a firm to discover and liquidate the violating position. However, on at least one exchange, ICE Futures U.S., clearing members are technically responsible for maintaining "their Customers' positions within [position limits] on both an intraday and end-of-day basis" (click here to access IFUS Rule 6.13(a)). As a result, it is always important for traders to monitor for position limit compliance both intraday and as of end of day. It is also important for clearing brokers to monitor their customers' position limit compliance at least as of end of day, and potentially for at least IFUS, intraday too. (Click here to access CME Group Rule 562 and here for CME MRAN RA1518-5R: *Position Limits and Accountability Levels* (November 19, 2015).) In general, violating an exchange's position limit could be construed to constitute a violation of speculative position limits' requirements of the Commodity Futures Trading Commission.

- **ICE Futures U.S. Issues Revised Wash Trade FAQ**: ICE Futures U.S. issued a revised *Wash Trade FAQ* to additionally address, among other topics, unintentional matching of buy and sell orders from the same principal, as well as the exchange's self-match prevention technology. In general, IFUS prohibits any person to execute a wash sale (click here to access IFUS Rule 4.02(c)). A wash sale (or wash trade) is a transaction or series of transactions executed in the same commodity contract at the same or similar price for accounts with the same principal on both sides. At IFUS, the same principal means "accounts that are owned by the same person, entity or a parent and its 100% wholly owned subsidiary or subsidiaries that are wholly owned by the same parent and shall also include accounts that have common ownership that is less than 100%." IFUS's FAQ makes clear, however, that buy and sell orders that are placed by independent decision makers for accounts that reflect the trading of separate business units of the same principal that coincidentally match would not be considered a violation of IFUS's wash sale prohibition. However, in such instances, "the parties to the trade must be able to demonstrate the independent control of the accounts and that the transaction had a bona fide business purpose for each party to the trade." On the other hand, IFUS indicates that if orders entered for a single automated trading system or various ATSs controlled by the same individual trader coincidentally match, resulting trades "may" be considered prohibited wash sales if such matching occurs "on more than an infrequent basis." Currently proprietary traders who access IFUS directly using algorithmic trading applications are required to use the exchange's Self-Trade Prevention Functionality to help avoid such unintentional matches.

Compliance Weeds: All US futures exchanges (in addition to ICE Futures U.S.) as well as the Commodity Futures Trading Commission, prohibit wash sales. Generally, where available, exchange guidance on wash sales is similar. However, unlike on IFUS, where the use of self-trade prevention functionality by algorithmic proprietary traders directly accessing the exchange is mandatory, it is optional on some exchanges (e.g., CME Group and CBOE Futures Exchange). (Click here to access CME MRAN RA1411-5RR: *Wash Trades Prohibited* (January 2, 2015) and here to access CFE Regulatory Circular RG14-o11: *Self-Trade Prevention* (March 26, 2014).)

- **CFTC Charges One Firm and Settles With Another for Illegal Off-Exchange Precious Metals Transactions**: The Commodity Futures Trading Commission brought one case and settled another where it alleged that companies and their principals engaged in illegal off-exchange retail-financed or leveraged transactions involving precious metals. In one matter, the CFTC sued Oakmont Financial, Inc. and Joseph Dicrisci, its owner, in a Florida federal court claiming that, from at least July 16, 2011, through at least July 27, 2012, they solicited and accepted orders for the prohibited sale of precious metals from retail customers to be introduced to HunterWise Commodities, LLC, a purported precious metals wholesaler and clearing firm. Previously, another Florida federal court found HunterWise itself to have engaged in the same type of prohibited sales (click here for details). In the other action, the CFTC settled a complaint against Worth Group Inc., Andrew Wilshire and Eugenia Mildner, claiming the defendants also engaged in similar prohibited sales of precious metals from at least July 16, 2011, through August 13, 2013. Among other sanctions, all defendants agreed to pay restitution, jointly and severally, of $1.25 million, and Worth and Mr. Wilshire, jointly and severally, a fine of $1.25 million too.

Legal Weeds: In general, no purchase or sale of a commodity for future delivery may occur unless the transaction is conducted on or subject to an exchange appropriately designated by the Commodity Futures Trading Commission. Forward sales of commodities where delivery is contemplated and occurs are generally excluded from this requirement. However, forward sales do not include leveraged or financed sales of physical commodities to retail persons (e.g., not so-called eligible contract participants or eligible commercial entities) where delivery of the physical commodity does not occur within 28 days. (Click here to review the relevant statutory provision, Section 2(c)(2)(D) of the Commodity Exchange Act. Click here for information regarding Jay Grossman, a Florida-based attorney, who was sued and settled an enforcement action brought by the CFTC related to his alleged aiding and abetting of multiple clients in their operation of illegal precious metal schemes for retail clients.)

- **CFTC Chairman Offers No Timetable But Says Agency "Working Hard" on Position Limits; FCA Head Says Proposed European Position Limits Unnecessary**: In a speech last week before the Commodity Markets Council, Timothy Massad, Chairman of the Commodity Futures Trading Commission, highlighted recent CFTC actions benefiting commercial end-users. These included adoption of a rule amendment that exempted commercial end-users that are members of exchanges from having to maintain pre-trade communications or text messages. Mr. Massad also noted that the CFTC has recently adopted rules confirming that swap dealers are not required to collect margin from end-users in connection with uncleared swaps, and is working on a rule to eliminate the obligation of commercial participants to report trade options to swap data repositories or file special reports known as "Form TOs." Mr. Massad indicated, however, that the Commission is "working hard" to finalize revised rules regarding position limits but committed to no conclusion date. This is because, he said, "[n]one of us currently on the Commission were in office when these rules were proposed, and therefore we are taking time to listen to you and other market participants and consider the proposals very carefully." He indicated the CFTC is exploring the possibility to amend its previously proposed new rules, "which would have the exchanges play a greater role in granting exemptions for non-enumerated hedges." Separately, Tracey McDermott, Acting Chief Executive of the Financial Conduct Authority, said that the Markets in Financial Instruments Directive II's requirement to have position limits for every single commodity derivative traded in Europe "is not necessary." She also claimed that the "practical details of position reporting were not adequately thought through" in the negotiation of the Directive. Ms. McDermott made these remarks in a speech generally supporting MiFID II before Bloomberg in the City of London.

My View: The UK Treasury recently announced that Andrew Bailey from the Bank of England will soon take over the reigns as head of the Financial Conduct Authority. Although her tenure has been short, Tracey McDermott, current Acting Chief Executive Officer of the FCA, has shown a remarkable frankness and level-headedness for a regulator, and her style will be missed. Recently Ms. McDermott gave a powerful speech about the pendulum of regulation where she strongly suggested that the current amount of oversight has likely shifted too far and might impede innovation. (Click here for more details.) She has now openly questioned Europe's proposed expansive commodity derivatives' position limit scheme that could seriously impede the development of liquidity in some contracts. Ms. McDermott is not an industry defender in regulator's clothing. She has made it clear she favors tough regulation, and FCA's soon-to-be-implemented policy to potentially hold senior managers accountable for breaches in their area of responsibility is one of many indicia of that. But she has also made clear that regulating for the sake of regulating is not good public policy. According to Ms. McDermott, regulators need to take a "disciplined approach" in their oversight:

> not tough for the sake of being tough
> not making rules for the sake of introducing rules
> ?not activity for the sake of being seen to be active
> But interventions and actions which are robust, well thought through and designed to deliver that overarching aim of markets working well.

What a refreshing approach to regulation! Hopefully Ms. McDermott's thoughtfulness will long outlast her brief tenure as FCA CEO, and her too-short applied sensibility will influence other regulators worldwide for a much longer time!

And more briefly:

- **Senate Agriculture Committee Seeks More Information on CFTC Accounting Practices**: The US Senate's Committee on Agriculture, Nutrition and Forestry wrote a letter to the Commodity Futures Trading Commission requesting additional information on the CFTC's leasing and accounting practices that recently prompted KPMG to issue a qualified opinion regarding the CFTC's financing and note that it had material inadequacies in internal controls. KPMG found that during its 2014 and 2015 fiscal years, the CFTC may have improperly accounted for office leases. (Click here for additional information regarding KPMG's findings.)**?**

- **EC Proposes Applying Anti-Money Laundering Rules to Virtual Currencies**: The European Commission announced an action plan to improve its fight against terrorism financing. Among other things, the EC proposes to bring all virtual currency exchange platforms under the scope of the European Anti-Money Laundering Directive (click here to access).

- **BIS to CCPs: Ensure Sufficient Liquid Resources for Settlements**: The Committee on Payments and Market Infrastructures issued an advisory related to the clearing of deliverable foreign exchange instruments. Among other things, BIS said that clearinghouses intending to clear deliverable FX instruments should ensure they have sufficient qualifying, highly reliable liquid resources to cover all shortfalls that might arise in the settlement of all cleared transactions in all default scenarios that might arise in "extreme but plausible market conditions."

- **EUREX Clearing Granted DCO Registration by CFTC**: Eurex Clearing AG was granted registration by the Commodity Futures Trading Commission as a Derivatives Clearing Organization for swaps. However, Eurex Clearing will be prohibited from acting under its registration until it has the capability to accept or reject trades automatically within 60 seconds after submission by a relevant exchange.

- **Citi Becomes First Bank to Settle LIBOR Class Action Complaint**: Citibank, N.A., agreed to settle a class action lawsuit by payment of $23 million that alleged the bank and numerous other banking defendants unlawfully manipulated the London Interbank Offered Rate and the Tokyo Interbank Offered Rate from at least June 1, 2006, through September 2010. Plaintiff urged the New York-based federal court hearing this case to accept Citi's settlement as an "ice breaker" to potentially serve as a "catalyst" for other defendants to settle. Plaintiff initially filed its lawsuit in April 2012.

- **FCA Aims to Hold Senior Managers More Accountable for Firm Misconduct Under Their Responsibility**: The Financial Conduct Authority finalized a policy statement making clear that senior managers of banks can be held accountable for regulatory breaches that occur within their area of responsibility. The policy statement will be effective beginning March 7, 2016. In addition, senior managers will have to be included in FCA's certification regime (somewhat akin to registration) as of the same date. Algorithmic traders working at banks will also be included within FCA's certification regime as of September 7, 2016.

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