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Bridging the Week: Nov 21 to Dec 5, 2016 (Capital for Swap Dealers; New Disciplinary Proceedings Procedures; Leverage Ratio) [VIDEO]

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Last week the ***Commodity Futures Trading Commission*** re-proposed minimum capital requirements for Swap Dealers, while the ***European Commission*** proposed capital rules for EU-based banks that do not unfairly penalize banking organizations for carrying cleared derivatives positions for customers – as does the contrary approach previously taken by the Basel Committee on Banking Supervision. Additionally, the Securities and Exchange Commission weighed-in at a federal appellate court in New York in favor of a legal position taken by institutional investors against securities exchanges in a lawsuit related to alleged advantages afforded high-frequency traders. As a result, the following matters are covered in this week's edition of *Bridging the Weeks*:

- CFTC Re-Proposes Capital Rules for Swap Dealers;
- CME Group Adopts Revised Policies and Procedures Related to Enforcement Proceedings; Maximum Fine to Increase to US $5 Million Per Offense (includes **My View**);
- European Commission Amends Capital Requirements for Banks to Allow Client Initial Margin Offset to Clearing Members' Leverage Exposure;
- Inspector General Says CFTC Should Test FCMs' and SDs' Cybersecurity Policies (includes **Compliance Weeds**);
- FERC's Enforcement Arm Issues Recommendations on Effective Energy Trading Compliance Practices (includes **My View**);
- SEC Argues Exchanges Have No Absolute Immunity in Private Lawsuit Claiming Manipulation to Benefit HFTs;
- FINRA Files Proposed Rule Amendments With SEC Regarding Disruptive Trading and Expedited Proceedings (includes **Legal Weeds**);
- Supplemental Regulation AT Published in Federal Register; Comments Due January 24,

2017 (includes **My View**); and more.

CFTC Re-Proposes Capital Rules for Swap Dealers:

The Commodity Futures Trading Commission re-proposed minimum capital requirements for swap dealers and major swap participants that are not subject to prudential regulation ("Covered Entities"). Under the CFTC's proposal, there would be three alternative capital approaches: a bank-based capital approach, a net liquid assets capital approach, and a tangible net worth capital approach for SDs.

The bank-based capital approach would permit SDs to comply with capital requirements adopted by the Board of Governors of the Federal Reserve System for bank holding companies.

The net liquid assets capital approach would be consistent with the CFTC's current capital requirements for future commission merchants, the Securities and Exchange Commission's current capital approach for broker-dealers and over-the-counter derivatives dealers, and the SEC's proposed requirements for security-based swaps dealers. Under this approach, an SD would have to maintain a minimum level of adjusted net capital (i.e., relatively liquid capital) of at least the greater of US $20 million; eight percent of margin required on the SD's cleared and uncleared swaps, security-based swaps and futures and foreign futures positions; or the amount of capital required by the National Futures Association. A joint FCM and SD that was also a BD would have to meet the higher of these three tests or the requirements of the SEC for a BD.

Finally, an SD principally engaged in non-financial activities could maintain tangible net worth adjusted to exclude certain intangible assets (e.g., goodwill) of at least the greater of US $20 million adjusted by market and credit risk charges on certain of its proprietary swaps positions; eight percent of margin required on the SD's cleared and uncleared swaps, security-based swaps and futures and foreign futures positions; or the amount of capital required by the NFA.

Non-US-based SDs could potentially comply with local capital requirements as an additional alternative if approved by the CFTC pursuant to a comparability determination.

As part of its proposed capital rules, the CFTC would also require Covered Entities to provide it and the NFA with monthly financial statements and an annual certified financial statement, and to keep current books and records. Covered entities would also be subject to special early warning notification requirements related to material adverse changes in their financial condition, as well as a weekly obligation to report their uncleared swaps position and margin information "for the purposes of conducting risk surveillance." SDs that relied on the bank-based or net liquid assets capital approaches would additionally be subject to certain liquidity requirements, including performing monthly stress tests if relying on the liquid assets capital option.

The CFTC previously proposed capital rules for Covered Entities in 2011 but deferred further action pending finalization and implementation of uncleared swaps margin requirements. The CFTC finalized margin requirements in December 2015, that began being implemented in September 2016. (Click here for details.)

Comments on the CFTC's proposal capital rules will be accepted for 90 days following their publication in the *Federal Register*.

Briefly:

- **CME Group Adopts Revised Policies and Procedures Related to Enforcement Proceedings; Maximum Fine to Increase to US $5 Million Per Offense**: CME Group adopted amendments to its current rules governing disciplinary proceedings that, among other things, increase the monetary sanctioning authority of a Business Conduct Committee panel from US $1 million to US $5 million for each offense. In addition, the amendments eliminate the current authority of a respondent to a disciplinary proceeding to make a motion to dismiss prior to a formal hearing or to submit for consideration by a BCC panel, a settlement offer unsupported by CME Group Market Regulation staff. The amendments also empower a BCC panel to order a respondent, its legal counsel or other representative to pay out-of-pocket expenses in connection with such person's "vexatious, frivolous or bad faith conduct during the course of an investigation or enforcement proceeding," without a distinct hearing, and eliminate a BCC panel's authority to issue a reprimand as one of many potential sanctions. Numerous other changes are also included in CME Group's amendments that, absent objection by the Commodity Futures Trading Commission, will be effective December 14.

My View: In its submission to the CFTC of its proposed amendments to its current rules governing disciplinary proceedings, CME Group states that the changes "seek to update [its current provisions] to make the rules more applicable to the types of disciplinary cases going through the enforcement process while still maintaining a fair and efficient process for the resolution of disciplinary matters." Although I truly believe this sentiment is sincere and that most of the amendments are likely reasonable under the circumstances, the sheer volume of proposed changes introduced during the busy holiday season makes comprehensive review challenging. Persons who trade on CME Group exchanges and may potentially be subject to disciplinary proceedings – whether members or non-members – should carefully consider the revised amendments promptly.

- **European Commission Amends Capital Requirements for Banks to Allow Client Initial Margin Offset to Clearing Members' Leverage Exposure**: The European Commission proposed additional measures for EU-based banks that aim to enhance "institutional resilience" of the European banking system. Among the measures include imposition of a 3 percent leverage ratio for banks (i.e., regulatory capital divided by total assets including certain off-balance sheet exposures attributable to its derivatives transactions). However, the EC proposes in order "not to disincentive client clearing," that banking institutions be permitted to offset the amount of their exposures attributable to customers' derivatives positions cleared through qualifying clearinghouses by the amount of their client-posted initial margin. This would be different from the approach taken by the Basel Committee on Banking Supervision that does not permit such offset. The EC also proposed that non-EU globally systemically important banking institutions that have two or more institutions in the EU with the same ultimate parent establish an intermediate parent in the EU. Such entity may be a new holding company subject to EU capital requirements or an entity already in the EU specifically identified for such purpose. This measure appears likely taken in retaliation for a similar obligation imposed on non-US banks located in the US in 2014. The European Parliament and European Council will now consider the EC's proposed banking measures.

- **Inspector General Says CFTC Should Test FCMs' and SDs' Cybersecurity Policies**: The Office of Inspector General of Commodity Futures Trading Commission's said the agency's Division of Swap Dealer and Intermediary Oversight should use a risk-based approach to independently test the cybersecurity preparedness of future commission merchants and swap dealers. However, in response to the recommendations made by Brown & Company, certified public accountants and management consultants, in a report commissioned by OIG, the CFTC said that, "due to current budgetary constraints, the creation of an independent testing program is not feasible." The CFTC also noted that, since March 1, 2016, the National Futures Association requires all members to maintain a cybersecurity program that NFA reviews. Among other recommendations in the OIG report are that the CFTC should verify that all registrants use a secure file transfer protocol when sending sensitive financial information to the agency and that the CFTC should encourage exchanges, clearinghouses and swap data repositories to increase the frequency of their internal and external penetration testing, as well as vulnerability testing particularly after significant changes in a registrant's systems.

Compliance Weeds: All NFA members were required by March 1 to have adopted and begun enforcing formal written policies regarding cybersecurity. These policies must be "reasonably designed by members to diligently supervise the risks of unauthorized access to or attack of their information technology systems, and to respond appropriately should unauthorized access or attack occur." (Click here for further details on NFA's requirements.)

- **FERC's Enforcement Arm Issues Recommendations on Effective Energy Trading Compliance Practices**: The Federal Energy Regulatory Commission's Office of Enforcement ("OE") issued a white paper on effective trading compliance practices for companies under FERC's jurisdiction trading in the natural gas and electric markets. These practices are aimed to help such companies prevent and identify manipulative practices. According to OE, the white paper is meant to supplement penalty guidelines issued by FERC in March 2010 that provide for a "substantial and transparent mitigation credit" for organizations subject to civil penalties that demonstrate they have an effective compliance program. The overarching element identified by OE as being part of an effective program is having a culture of compliance. Specific measures include hiring compliance personnel with a variety of experiences who understand applicable regulatory requirements and the company's businesses; integrating compliance personnel into business units and empowering compliance personnel to succeed; and ensuring compliance personnel have adequate resources, including a sufficient number of qualified persons and technological resources to monitor trading, trader communications and compliance with internal controls. Background checks should be performed on traders as part of their recruitment and regularly thereafter. These checks should include reviews of a candidate's compliance history. Also, a trader's compensation should reflect adherence to compliance obligations. A firm should have regular training that is specific to the business and participation should be tracked; there should be express rules and restrictions; and trading activities and communications should consistently be monitored and compliance rules should be strictly enforced with all issues followed-up. Compliance rules should include a list of prohibited and approved trading activities, and special controls should be established around trading strategies involving related physical and financial positions. Finally, an environment should be fostered that encourages employees to discuss and report compliance concerns without fear of retribution, and a firm's compliance program should be regularly assessed for effectiveness. Simultaneous with the issuance of its white paper on effective trading compliance practices, OE issued a white paper on anti-market manipulation enforcement practices since 2005.

My View: Although intended for firms under FERC's jurisdiction trading in the natural gas and electric markets, staff's *Effective Energy Trading Compliance Practices* white paper sets forth many standards for an effective compliance program that might be considered generically by firms under SEC, CFTC or other financial or banking regulator oversight. FERC staff has considered compliance in a holistic, practical way, as opposed to the check-the-box approach too often recommended these days by some regulators.

- **SEC Argues Exchanges Have No Absolute Immunity in Private Lawsuit Claiming Manipulation to Benefit HFTs**: The Securities and Exchange Commission argued in a brief filed in a federal appellate court in New York that exchanges have no absolute immunity from claims filed by certain institutional investors, including the City of Providence, Rhode Island, alleging favoritism for high-frequency traders. The investors' lawsuit, initially filed in April 2014, alleged that certain exchanges, including BATS Global Markets, Inc., Chicago Stock Exchange, Inc., Direct Edge ECN, LLC, ARCA, Inc. and others, improperly revealed price data to high-frequency traders before anyone else by making available co-location services, proprietary data feeds and certain complex order types, and that this constituted market manipulation in violation of applicable securities law and an SEC rule. (Click here to access Securities Exchange Act Section 10(b) and SEC Rule 10b-5.) The district court previously dismissed all charges against the exchanges claiming that plaintiffs' complaints failed to state a claim and that their provision of data feeds and different order types was barred by the doctrine of absolute immunity. (Click here for details of this dismissal and lawsuit.) The SEC argued that while exchanges should be afforded absolute immunity when they act in their traditional self-regulatory function, the doctrine should not extend "to functions performed by an exchange itself in the operation of its own market, or to the sale of products and services arising out of those functions – like the challenged activities at the center of the plaintiffs' allegations." Although there might be other principles such as preemption and preclusion that "should" protect a self-regulatory organizations' conduct when acting in accordance with rules subject to SEC approval and oversight, said the Agency, the litigation in the plaintiffs' case was at too early a stage for the Commission to take a position on these principles' applicability at this time.

- **FINRA Files Proposed Rule Amendments With SEC Regarding Disruptive Trading and Expedited Proceedings**: The Financial Industry Regulatory Authority filed a proposed rule amendment with the Securities and Exchange Commission that expressly prohibits a type of ongoing disruptive trading activity commonly described as layering and spoofing, and provides for a disciplinary process that enables FINRA to obtain a permanent injunction in its administrative process on an expedited basis. FINRA's proposed rule does not reference the term spoofing. However, it makes wrongful a "frequent pattern" of conduct that involves a member placing multiple limit orders on one side of a market that changes the level of supply and demand of a security, followed by the same member placing one or more orders on the other side of the market that are executed followed by cancellation of the initially placed orders. This provision is different from an equivalent prohibition under the Commodity Exchange Act (click here to access CEA Section 4c(a)(5), 7 USC Sec 6c(a)(5)) that prohibits a single act of, by name – "spoofing." In addition, the proposed FINRA rule prohibits a frequent pattern where a member narrows the inside national bid and offer of a security then places an order on the opposite side of the market that executes against another market participant that joined the new inside market established by the initial order. Under existing FINRA rule (click here to access FINRA Rule 5210), no member may publish or cause to published or circulated any notice that purports to quote the bid or asked price for any security unless such member believes that such quotation represents a bona fide bide or offer. As part of its submission, FINRA also requested approval for a new rule that allows for the entry of a permanent injunction against its newly identified form of disruptive trading on an expedited basis if a hearing panel finds by a preponderance of the evidence that alleged disruptive trading has occurred and will result in significant market disruption or other significant harm to investors unless immediately halted. Unless the SEC intervenes, FINRA proposes to implement the new rule on December 15 although SEC will accept comments on the new proposal through December 19.

Legal Weeds: Curiously, FINRA's proposed rule prohibiting disruptive trading places no time frames on the prohibited activities. Although the pattern of problematic trading must be "frequent" it appears that any placing of limit orders on one side of the market where afterwards the level of supply and demand for the security changes – whether related or not – followed by placement and execution of an order on the other side of the market is prohibited where subsequently, at any time (e.g., microseconds, seconds, or minutes) the initial orders are cancelled. The described conduct may, in fact, be problematic, but it may also be legitimate. The key, in fact, is the speed these series of transactions occur as well as the intent of the orders placer. In November, three judges of the US Court of Appeals for the Seventh Circuit heard oral arguments on November 10 related to Michael Coscia's efforts to set aside his November 2015 criminal conviction on six counts of commodities fraud and six counts of spoofing in connection with his trading activities on CME Group exchanges and ICE Futures Europe from August through October 2011. During his presentation, Mr. Coscia's counsel principally argued that the provision of law prohibiting spoofing under which Mr. Coscia was prosecuted had not given him adequate notice of what trading activity was precisely prohibited. This was because the CEA solely prohibited spoofing without defining it and, prior to the time of Mr. Coscia's alleged wrong conduct, the CFTC had provided no guidance regarding what constituted prohibited spoofing. (Click here for details.) FINRA, unlike Congress, is endeavoring to prohibit problematic conduct as opposed to a word that conveys many meanings.

And more briefly:

- **European Commission Provides Additional Guidance Regarding Position Limits**: The European Commission adopted rules that provide a definitive basis for persons trading commodity derivatives and emission allowances and derivatives for their own account or providing investment services to others to calculate when such activity is ancillary to their core business and thus, under the Markets in Financial Instruments Directive II, places them outside requirements applicable to firms providing investment services. Under the EC's rule, firms should apply a numerator to assess speculative trading activity that equals 15 percent of their net derivative position plus three percent of their gross derivative position. (This calculation is based on a European concept of regulatory capital.) They should likewise apply as a denominator capital employed for the company's main business activity that equals their appropriate total equity and long term debt. If the resulting calculation results in a percentage above 10 percent, the EC agrees with a recommendation of the European Securities and Markets Authority that the firm should be regulated under MiFID; otherwise it should be exempt. Simultaneously, the EC also issued specific rules on how EU individual jurisdictions'' regulators should formally implement position limits for commodity derivatives. Previously, ESMA published its broad rules on how such jurisdictions should apply such position limits.

- **COMEX Member Settles Disciplinary Action Alleging Spoofing-Type Activities; ICE Futures Trader Agrees to Settle Alleged Position Limits Violation**: Simon Posen, a member, agreed to pay a fine of US $90,000 to resolve charges that on multiple dates from November 2014 through March 2015 he entered orders or layered orders in silver and copper futures on the Commodity Exchange, Inc. without the intent to take positions but to encourage other market participants to trade against smaller positions he had established on the opposite of the market. Within seconds after his smaller orders were filled, alleged COMEX, Mr. Posen cancelled his larger resting orders. COMEX also claimed that Mr. Posen engaged in another type of disruptive trading in February and March 2015. In addition to paying a fine, Mr. Posen agreed to a four-week suspension to all CME Group trading access. Also, Aspire Commodity LP agreed to settle a disciplinary action brought by ICE Futures U.S. that alleged it may have violated a position limit on one occasion when it held a position in excess of a conditional limit in the Henry HUB LD1 Fixed Price Future. To qualify to trade up to five times the spot month limit in the commodity, a trader must agree not to hold a position in the corresponding CME Group Natural Gas futures contract during the last three days of trading. Aspire paid a fine of $37,000 and disgorgement of profits of $18,477.50 to resolve this matter.

- **NFA Seeks to Enhance Retail Forex Dealers' Disclosure of Trade Information to Customers**: The National Futures Association submitted a new rule to the Commodity Futures Trading Commission for its approval that would require Forex Dealer Members to provide their retail customers with information that would enable them to assess the quality of their Forex executions. Under the rule, FDMs would be obligated to provide such customers, upon request, transaction data for the 15 transactions in the same currency pair that occurred within 15 minutes immediately before their execution and after their execution. FDMs would be required to notify their customers of the right to request this information by a prominent notice on their web portal and on each customer transaction statement.

- **CFTC Codifies Prior Exemptive Relief Into Final Rules Regarding CPO Financial Reports**: The Commodity Futures Trading Commission issued amendments to its regulation applicable to financial reports that commodity pool operators are obligated to provide in connection with each commodity pool they operate. The amendments authorize alternative generally accepted accounting principles in annual reports and periodic account statements and provide relief from the annual report audit requirement under certain circumstances when a pool's first fiscal year is four months or less. The amendments codify relief that CFTC staff has granted previously.

- **Consolidated Risk Disclosure Approved for Non-Institutional Customers by CFTC Staff**: The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight authorized futures commission merchants and introducing brokers to use a consolidated risk disclosure document for non-institutional customers that incorporate separate risk disclosures required by different CFTC rules. The Futures Industry Association prepared the consolidated document.

- **NFA Reminds Entities Acting Under CTA or CPO Registration Exemption to File Annual Affirmation**: The National Futures Association issued its annual reminder that persons claiming authorized relief from commodity pool operator or commodity trading advisor registration requirements must affirm the applicable notice of exemption by 60 days of each calendar year-end. In 2017, this is by March 1. Not filing a notice of exemption will result in the entity being subject to applicable Commodity Futures Trading Commission registration requirements.

Follow-up:

- **Political Update: Former CFTC Acting Chair, Sharon Brown Hruska, Named to Landing Team for CFTC and SEC**: Sharon Brown-Hruska, a former commissioner and Acting Chair of the Commodity Futures Trading Commission, was named a member of the landing team for president-elect Donald Trump for the CFTC, the Securities and Exchange Commission and the Farm Credit Administration. While at the CFTC, Ms. Brown-Hruska, among other generally pro-market positions, objected to the SEC's adoption of a hedge fund advisor registration rule that, in her view, duplicated existing oversight by the CFTC and the National Futures Association (click here to access a relevant speech).

- **Supplemental Regulation AT Published in Federal Register; Comments Due January 24, 2017**: The Commodity Futures Trading Commission supplemental notice regarding Regulation Automated Trading was published in the *Federal Register* on November 25. Comments are due by January 24, 2017.

My View: The sincere and valiant effort of CFTC staff to address many of the industry's concerns in the originally proposed Regulation AT has, in many instances, created an even more confused regulatory proposal that is likely to capture far more than the intended number of market participants. The fundamental issue is that Regulation AT continues to try to do too much, particularly in an area where exchanges have robust rules and the industry has voluntarily instituted many best practices. Indeed, as an example, CME Group already has a rule that holds members and non-members liable for not supervising their agents, while agents, at CME Group, include "any automated trading systems…operated by any party." These provisions already provide great incentive for members and non-members to associate robust risk controls with their AT systems, and to ensure that they are appropriately tested and monitored. (Click here for details regarding these CME Group obligations.) The CFTC should use the opportunity to re-review the existing landscape of regulatory requirements by exchanges and to, as necessary, amend obligations of exchanges under core principles to fine tune their existing requirements to ensure that legitimate objectives of the CFTC are achieved. There is no reason for the CFTC to institute a duplicative and confusing regime.

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