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Broken Order Router; Trading Illicitly for Mom; Manipulation: Reg SHO; Reg MAR - Bridging the Week: December 12 to 16 and December 19, 2016 [VIDEO]

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Last week, a broker-dealer settled ***Securities and Exchange Commission*** and New York Attorney General charges that its marketing of an order routing system was misleading when it did not disclose to its clients and prospective clients that, because of a data coding error, the system failed automatically to evaluate different dark-pool trading venues for optimal execution of orders, as promised. Meanwhile, the Commodity Futures Trading Commission obtained a summary judgment decision that a trader's prearranged trades to transfer profits from her employer's trading account to an account of a company owned by her mom violated applicable federal law and a CFTC regulation. As a result, the following matters are covered in this week's edition of *Bridging the Week* – the last regular edition for 2016:

- Broker-Dealer Settles SEC and NYS Charges Regarding Disclosures of Dark Pool Order Routing Arrangements;
- Mom's Company Was Beneficiary of Illicit Money Pass Using Noncompetitive Trades Rules Court in CFTC Lawsuit (includes **Compliance Weeds**);
- Alleged Manipulative Stock Scheme Crux of Department of Justice and SEC Action Against Two Traders;
- CEO and Head Trader Settle SEC Charges for Alleged Reg SHO and MAR Violations; Action Against Broker-Dealer Pending (includes **Compliance Weeds**);
- Defendants in Linked ICE Future U.S. Disciplinary Actions Agree to Pay Collective Sanctions in Excess of US $1.15 Million to Resolve Diverse Charges (includes **Compliance Weeds**);
- **Follow-up**: Don't Forget to Perfect Your Independent Account Controller Exemption; and more.

Briefly:

- **Broker-Dealer Settles SEC and NYS Charges Regarding Disclosures of Dark Pool Order Routing Arrangements**: Deutsche Bank Securities Inc. settled charges brought by both the Securities and Exchange Commission and the New York State Attorney General that, from January 2012 through February 2014, it failed to disclose that an order routing system it used – known as SuperX+ – to direct orders to trading venues commonly known as "dark pools" was not operating in the manner disclosed to clients. Specifically, according to the regulators, SuperX was meant to route orders based on a number of factors, including a client's own instructions and an algorithm – named the Dark Pool Ranking Model (DPRM) – designed to evaluate execution quality and liquidity among different possible trading venues. However, because of a data coding error, SuperX+ did not perform as intended during the relevant period, said the regulators. As a result, charged the regulators, DBSI (1) only updated DPRM rankings on a single occasion from January 2012 through February 2014, and through February 2013 solely used DPRM rankings from December 2011; (2) for the entire period, continued to connect new trading venues to SuperX+ by manually assigning DPRM rankings based on subjective judgments instead of calculations automatically generated by the DPRM algorithm; and (3) included DBSI's own dark pool venue in the highest ranking position among all dark pools, despite DPRM calculations conducted in February 2013 that placed DBSI's dark pool venue in the bottom tier. (At the time, these calculations were believed to have been wrong; later, it was confirmed that, in fact, the calculations were in error and DBSI's dark pool venue should have been in the top tier.) The regulators alleged that DBSI continued to promote to its clients and potential clients during the relevant time that DPRM performed as designed and failed to disclose the algorithm's malfunction. To resolve this matter, DBSI admitted all facts alleged by the regulators and agreed to pay a fine of US $18.5 million to each of the SEC and the NYS Attorney General's Office.

- **Mom's Company Was Beneficiary of Illicit Money Pass Using Noncompetitive Trades Rules Court in CFTC Lawsuit**: The Commodity Futures Trading Commission prevailed in a lawsuit against Yumin Li and Kering Capital Ltd. – a company formed by Ms. Li's mother – that claimed that Ms. Li engaged in multiple illegal futures transactions from March 17 to May 6, 2015, designed to transfer US $300,462 from an account of her employer to an account in the name of Kering. The CFTC's complaint was initially filed in July 2015. According to the CFTC, Ms. Li entered multiple noncompetitive buy and sell trades in her employer's account meant to lose money and corresponding sell and buy trades in the Kering account to make an equal amount of money, all in distant Eurodollar futures contracts traded on the Chicago Mercantile Exchange. The CFTC claimed Ms. Li chose these distant futures contracts and traded them on CME Group's Globex platform outside of regular trading hours to ensure she could trade the two accounts opposite each other. Ms. Li argued that, because her employer "did not appropriately compensate her," she engaged in the illicit transactions "to obtain compensation which she believed [her employer] owed to her." In response to the CFTC's motion for summary judgment, the court said there was no dispute of relevant facts, and that Ms. Li engaged in fictitious trades in violation of law and failed to execute futures contracts "openly and competitively" as she was required (click here to access CFTC Regulation 1.38). The court held that Kering was fully liable for Ms. Li's violations under the provision of law making a principal liable for the acts of its agent as Ms. Li was also employed by Kering during the relevant time (Click here to access Commodity Exchange Act, 7 USC § 2(a)(1)(B).) As penalties, the court ordered disgorgement of US $300,462 held by Kering, and a civil penalty of $901,387 jointly and severally against Ms. Li and Kering. Ms. Li was also subjected to a five-year trading ban. (Click here for further details of the complaint.)

Compliance Weeds: Many futures exchanges have express prohibitions against executing transactions designed to pass money between accounts. (Click here for example, to access CME Rule 432.G and here to access ICE Futures U.S. Rule 4.02(f).) Because futures transactions used to achieve money passes are typically executed noncompetitively to ensure achievement of their objective, such transactions may additionally violate exchange rules prohibiting noncompetitive transactions in addition to running afoul of applicable federal law and CFTC regulation under which Ms. Li and Kering were sanctioned. (Click here to access the relevant CME Group Market Regulatory Advisory Notice.)

- **Alleged Manipulative Stock Scheme Crux of Department of Justice and SEC Action Against Two Traders**: Joseph Taub and Elazar Shmalo were the subject of a criminal action filed by the US Attorney's Office for the District of New Jersey and a civil action filed by the Securities and Exchange Commission for their role in an alleged manipulative stock scheme that netted them US $26 million in profits. According to the regulators, from at least January 2014 through the present, the defendants typically used one account to place many small lot orders in a thinly traded stock to drive its price up or down, in order to effectuate their purchase or sale of a larger quantity of the same stock in another account at an artificially beneficial price. To disguise their activities, claimed the regulators, the trading accounts used in each paired activity – which were variously in the names of the defendants, family members, or companies the defendants controlled – were held at different broker-dealers. At times, alleged the US Attorney's Office, defendants "controlled more than 80 percent of the volume of a targeted stock." Defendants could face up to five years' imprisonment and a fine if convicted in their criminal action. The SEC seeks a permanent injunction against the defendants as well as disgorgement of profits and fines. Both legal actions were filed in a federal court in New Jersey.

- **CEO and Head Trader Settle SEC Charges for Alleged Reg SHO and MAR Violations; Action Against Broker-Dealer Pending**: The Securities and Exchange Commission resolved charges against Paul Davis, Chief Executive Officer, Chairman of the Board and 35-percent owner of Wilson-Davis & Company, Inc., a registered broker-dealer, and two of WDCI's registered persons – Byron Barkley and Anthony B. Kerrigone – for their alleged role in WDCI's purported violation of Regulation SHO and the SEC's Market Access Rule from at least November 2011 through May 2013. The SEC charged in a separate complaint solely against WDCI (which was not settled) that, during the relevant time, the firm routinely effected short sales in securities on its own behalf without borrowing the security or entering into a bona fide arrangement to borrow the security, or having a reasonable basis to believe the security could be borrowed for delivery by the date the security was required to be delivered, as required by Reg SHO (click here to access this regulation at 15 USC §§ 240.200-.204). The firm said that it was exempt from such requirements because it was a market-maker. However, charged the SEC, it was not. In addition, the SEC charged that, during the relevant time, the firm did not maintain systems and controls in connection with its direct access to exchanges reasonably designed to manage the financial, regulatory and other risks of having such access, as required by Reg MAR (click here to access this regulation at 15 USC § 240.15c3-5). The SEC charged (1) Mr. Davis for signing a required certificate in all years from 2012 to 2014 saying that WDSI was in compliance with Reg MAR when it was not; (2) Mr. Barkley, WDSI's Head Trader, for knowing or not knowing when he should have known that WDSI did not comply with Reg MAR; and (3) Mr. Kerrigone, a proprietary trader for WDSI, for relying on the market-maker exemption to Reg SHO when executing short sales without having a "reasonable understanding of the rule." To resolve the SEC's charges against

them, Mr. Davis agreed to pay a fine of US $25,000; Mr. Barkley, disgorgement of $67,710 and prejudgment interest and a fine of US $50,000; and Mr. Kerrigone, disgorgement of US 486,840 and prejudgment interest and a fine of US $50,000.

Compliance Weeds: Under Reg SHO, a broker-dealer accepting a short sale of an equity security from a customer (or engaging in a short sale in its own proprietary account) must first borrow the security, enter into a bona fide arrangement to borrow the security, or have reasonable grounds to believe the security can be borrowed before the delivery date. Broker-dealers comply with this so-called "locate requirement" by maintaining so-called "easy to borrow" lists, which set forth equity securities they reasonably believe they can borrow. (Click here for background regarding Reg SHO in an SEC publication, *Key Points About Regulation SHO*.) Reg MAR generally requires brokers and dealers with access (or providing access) to trade securities directly on an exchange or alternative trading system to have procedures and processes to control market access so as not to jeopardize "their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system," as well as to ensure compliance with all applicable regulatory requirements. (Click here for background regarding Reg MAR in an SEC publication, *Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access*.) By comparison, the Commodity Futures Trading Commission currently requires certain pre-trade risk controls by all clearing future commission merchants for all orders they receive for automated and non-automated execution, where they provide electronic market access, and when they authorize third-party brokers to execute orders to be given-in for customers (click here to access CFTC Regulation 1.73). The CFTC is proposing additional risk control requirements for executing FCMs. (Click here to access background on the CFTC's most recent proposal.)

- **Defendants in Linked ICE Future U.S. Disciplinary Actions Agree to Pay Collective Sanctions in Excess of US $1.15 Million to Resolve Diverse Charges**: Four respondents in linked disciplinary actions commenced by ICE Futures U.S. agreed to settle their disputes by paying sanctions in excess of $1.15 million; however, from the published decisions, it is unclear precisely what was the possible overall wrongful conduct that gave rise to the sanctions. In the disciplinary action associated with the largest fine, Mathew Webb agreed to pay a fine of US $503,627 and disgorge profits of US $303,627, as well as a five-year trading ban on ICE Futures U.S., for possibly engaging in 52 fictitious transactions and permitting his electronic trading system ID to be used by co-worker Lee Tippett. The exchange also charged Mr. Webb with possibly committing or attempting to commit a fraudulent action on the exchange. In addition, Mr. Tippett agreed to pay a fine of US $100,000 and serve a nine-month exchange trading ban for possibly executing 25 fictitious transactions and using Mr. Webb's ETS ID. In addition, MDW Capital LLC agreed to be permanently barred from all trading on ICE Futures U.S. for possibly engaging in practices "inconsistent with just and equitable principles of trade and conduct detrimental to the best interests of the Exchange," while Classic Energy LLC consented to paying a fine of US $250,000 and adding compliance staff for possibly not complying with recordkeeping requirements in connection with customers' orders, misreporting the correct execution time of block trades on multiple occasions, and submitting a block trade below the block threshold on one occasion. In an unrelated action, Niraj Taneja, agreed to pay a fine of US $25,000 and a 15-day trading suspension for, on one day, possibly engaging in layering-type activity involving large orders on one side of the market, which he promptly cancelled after receiving fills on pre-positioned "iceberg order" or a small order on the other side of the market.

Compliance Weeds: Iceberg orders are authorized orders on CME Group exchange and ICE Futures U.S. where a trader can submit large volume orders to the marketplace in increments while only publicly displaying a small portion of the total order size. Both ICE Futures U.S. and CME Group, in guidance, warn that it may be a violation of their disruptive trading prohibitions for iceberg orders to be used as part of a scheme to mislead other participants. According to ICE Futures U.S., for example, it would be a violation of its rules "if a market participant pre-positions an iceberg on the bid and then layers larger displayed quantities on the offer to crease artificial downward pressure that results in the iceberg being partially or completely filled." (Click here to access Q/A 8 in the ICE Futures U.S. January 2015 guidance, *Disruptive Trading Practices*. Click here to also see Q/A 9 in the relevant CME Group Market Regulation Advisory Notice entitled *Disruptive Practices Prohibited*.)

And more briefly:

- **CME Group Member Firms Settle Disciplinary Actions for Alleged EFRP and Position Limits Violations**: Archer Daniels Midland Company, a member, settled a disciplinary action by agreeing to pay a fine of US $25,000 for allegedly engaging in two exchange for physical transactions without entering into related cash positions. The purpose of the transactions, said CME Group, was to transfer positions between two ADM subsidiaries. Separately, DV Trading LLC agreed to pay a fine of $25,000 and disgorge profits of US $2,670 to resolve charges that it violated a spot month position limit on one occasion. The CME Group acknowledged that the firm liquidated the offending overage "within milliseconds" of the opening on the next business day after it held the offending position.

- **SEC OCIE Commences Investment Adviser Multi-Branch Sweep**: The Securities and Exchange Commission's Office of Compliance Inspections and Examinations announced it would review investment advisers to assess their supervisory practices over advisory personnel in branch offices. Among other things, OCIE said it would review how supervision is structured "to the unique risks in particular branches" and the "role and empowerment" of compliance staff responsible for overseeing branch offices.

- **ESMA Provides Additional Input on MiFID II**: The European Securities and Markets Authority issued supplemental guidance on the Markets in Financial Instruments Directive II through publication of a revised *Questions and Answers*. The revised publication addresses new issues regarding best execution, underwriting and placing, inducements and information on costs and charges, among other topics.

- **Introducing Broker Settles NFA Charges Regarding Its AML Program**: OKC Trading LLC, a registered introducing broker, settled charges brought by the National Futures Association that it failed to conduct annual independent audits of its anti-money laundering program and failed to have its employees complete annual AML training, in violation of the applicable NFA Rule (click here to access NFA Rule 2-9(c)). OKC agreed to pay a fine of US $15,000 to resolve this matter.

Follow-up:

- **Don't Forget to Perfect Your Independent Account Controller Exemption**: The *Aggregation of Positions* rules recently adopted by the Commodity Futures Trading Commission were published in the *Federal Register* last Friday with an effective date of

February 14, 2017 (click here to access). That date might be Valentine's Day, but you won't love it if you are a so-called "eligible entity" (e.g., commodity pool operator or commodity trading advisory) currently relying on an Independent Account Controller exemption and you don't formally make a notice filing perfecting it with the CFTC by that date – if you trade commodity futures in any of the nine currently regulated products (click here for list of relevant contracts at CFTC Rule 150.2). As of the effective date of the new aggregation rules, all persons claiming exemptions from aggregation based on certain old and new exemptions, including the IAC and owned entity exemptions, must file a notice in advance to perfect such exemption!

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