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Bridging the Week: Jan 9 to 13, Jan 17, 2017 (Record Retention; Position Limits-Setting Authority; Overcharging Fees; Misstating Regulatory Capital) VIDEO

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The ***Commodity Futures Trading Commission*** proposed a new records retention rule that attempts to be technology neutral and eliminates many current requirements that are mostly vestiges of a more paper-oriented age. In addition, the House of Representatives passed a bill early in its newest term that, if enacted, would repeal the Commodity Futures Trading Commission's controversial authority granted under ***Dodd-Frank*** to set certain position limits without an express finding of necessity and prohibit the CFTC from requesting algorithmic source code other than through subpoena. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- New Records Retention Regime for 21st Century Proposed by CFTC (includes **Compliance Weeds**);
- House of Representatives Passes CFTC Reauthorization Bill That Restricts CFTC Position Limits Establishment Authority and Prohibits Access to Source Code Except Through Subpoena;
- FINRA to Be Target of Enhanced SEC Inspection Focus in 2017;
- SEC Charges Publicly Traded Global Financial Services Firm With Miscomputing Regulatory Capital;
- FCM Agrees to Settle With CFTC Related to Purported Exchange Fees Overcharges (includes **My View**);
- Broker-Dealer Resolves SEC Charges That It Misled Broker-Dealer Clients Regarding How It Would Price Their Retail Customers' Orders; and more.

Briefly:

New Records Retention Regime for 21st Century Proposed by CFTC: The Commodity Futures Trading Commission proposed a revised records retention rule that aims to eliminate many existing antiquated requirements and to be "technology neutral" in order to accommodate future advances in recordkeeping technology. Among other things, the revised rule would eliminate the existing requirement that electronic records be maintained in their native file format and preserved exclusively in a non-rewritable, non-erasable format (commonly referred to as write once, read many or "WORM"). Instead, the revised rule would be more principles-based. Generally, regulatory records would be broadly defined to include all books and records required to be maintained by law or CFTC regulation, including all records of any correction or other amendments. For books and records stored electronically, regulatory records would also include data that shows how, when and by whom (if relevant) such "stored information was collected, created, accessed, modified or formatted" (e.g., metadata). Electronic records would have to be maintained in a manner that ensures their reliability and authenticity, and each person required to maintain regulatory records would have to create, put in place and adhere to written policies and procedures "reasonably designed" to ensure the person's compliance with the Commission's recordkeeping requirements. The procedures must provide for appropriate training of relevant personnel and ongoing monitoring of a firm's compliance with its record creation and retention obligations. As now, required records would have to be retained for certain minimum enumerated time periods and be open to inspection by CFTC and Department of Justice staff. Requested documents would have to be produced "promptly" upon request by CFTC staff. The CFTC will accept comments to its proposed revised record-keeping rule for 60 days following their publication in the *Federal Register*.

Compliance Weeds: Just prior to the end of 2016, the Financial Industry Regulatory Authority assessed a total of US $14.4 million in fines against 12 firms for "significant deficiencies" in their retention of required books and records on electronic storage media. FINRA claimed that the sanctioned firms typically did not retain electronic records in WORM format, failed to have a required audit system regarding such records, did not obtain or maintain a required attestation from a third-party vendor regarding their ability to provide data to the Securities and Exchange Commission, FINRA or any other regulator if a firm could not, and did not have adequate written supervisory procedures reasonably designed to ensure compliance with applicable requirements. (Click here for details regarding FINRA's actions.) Current CFTC requirements regarding electronic records are roughly equivalent to those of the SEC applicable to broker-dealers. (Click here to access CFTC Rule 1.31(b) and here to access the relevant SEC Rule, 17 CFR 240.17a-4(f).) Although the CFTC's proposed revised record retention rule is more principles-based and technology neutral than its existing requirement, it still imposes comprehensive creation and retention requirements including rigorous controls. As the notice of proposed rule-making makes clear in referencing the ongoing training requirement under the revised rule, "[t]he obligation to remain current on the legal requirements regarding compliance with §1.31 is one that a records entity ignores at its peril. The Commission takes a similar view towards the proposed obligation for each records entity to monitor compliance with the entities policies and procedures on a 'regular' basis."

- **House of Representatives Passes CFTC Reauthorization Bill That Restricts CFTC Position Limits Establishment Authority and Prohibits Access to Source Code Except Through Subpoena**: Last week the House of Representatives passed a bill to reauthorize the Commodity Futures Trading Commission, which also contained provisions (1) repealing certain existing CFTC authority to set speculative position limits (click here to access the eliminated provisions: 7 US Code § 6a (2), (3), (5) and (6)) and, instead, requires the Commission to make an express finding of necessity prior to imposing and implementing any new limits; (2) expanding the definition of bona fide hedging to include transactions appropriate to the management of current or anticipated risks; and (3) freezing the current swap dealer de minimis threshold at US $8 billion absent affirmative action by the CFTC undertaken by rule or regulation. (Click here for background on the de minimis threshold.) Congress previously granted the CFTC authority to expand position limits as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act; however the extent of the CFTC's authority was previously subject to litigation. (Click here to access the relevant DC Circuit Court of Appeals decision.) The bill – entitled "The Commodity End-User Relief Act" – also precludes the Commission from requiring persons to provide it with algorithmic trading source code or similar intellectual property except through subpoena. In addition, the bill appears to authorize the firing of Division heads without cause by the Commission and requires the CFTC, within 18 months of adoption of the House bill as law, to adopt a rule providing that any non-US person or any transaction between two non-US persons to be exempt from US swaps requirements if the person or transaction is in compliance with the swaps regulatory requirements of a foreign jurisdiction that the CFTC has determined to be comparable to and as comprehensive as US requirements. The bill also instructs the CFTC not to enforce its recently implemented ownership and control reporting requirements until it enacts a new rule that raises the reporting level to at least 300 contracts and provides that a reporting entity is not required to provide natural person control data. (Click here for background on the CFTC's new concept of trading account controller.) Under the House's bill, the CFTC would operate under the same budget – US $250 million – for the current and next four fiscal years. Separately, the House also passed a reform bill for the Securities and Exchange Commission entitled the "SEC Regulatory Accountability Act." Under this bill, the SEC would be required to expressly identify any specific problem that a proposed regulation was intended to address; formally consider whether the benefits of a proposed regulation would exceed its costs; and consider any alternatives to a proposed regulation.

- **FINRA to Be Target of Enhanced SEC Inspection Focus in 2017**: The Securities and Exchange Commission's Office of Compliance Inspections and Examinations issued its 2017 priorities that included its plan to "enhance" its oversight of the Financial Industry Regulatory Authority by, among other things, "assessing the quality" of the self-regulator's examinations of individual broker-dealers. OCIE said that its 2017 priorities will broadly concentrate on reviews of matters important to retail clients; risks specific to elderly and retiring investors; and market-wide risks. Specific market-wide risks to be reviewed will be money market funds' compliance with recently adopted rules meant to address redemption risks as well as funds' stress testing; firms' implementation of their cybersecurity compliance procedures; and firms' tailoring of anti-money laundering programs to their specific risks.

- **SEC Charges Publicly Traded Global Financial Services Firm With Miscomputing Regulatory Capital**: The Bank of New York Mellon Corporation agreed to pay a fine of US $6.6 million to resolve charges brought by the Securities and Exchange Commission that it overstated its regulatory capital in each of its quarterly and annual reports filed with the SEC from the third quarter of 2010 through the second quarter of 2014. The SEC alleged that this overstatement occurred because of BONY's failure to properly reflect approximately US $14 billion of collateralized loan obligations as assets on its balance sheet during the relevant time. The SEC claimed that BONY should have subjected these CLOs to a 100 percent risk-weighting but instead subjected these variable interest obligations to a zero risk-weighting. Any reduction in weighting could only have been done with the advance approval of the Federal Reserve Bank of New York, claimed the SEC, which BONY did not obtain. As a result, charged the SEC, BONY misreported its risk capital ratios and risk-weighted assets and failed to create and retain accurate records during the relevant time. BONY corrected its reporting of its CLOs for the first time in a July 18, 2014 filing with the SEC. The SEC noted

BONY's remedial acts and cooperation in accepting the firm's offer of settlement.

- **FCM Agrees to Settle With CFTC Related to Purported Exchange Fees Overcharges**: JP Morgan Securities settled an enforcement action brought by the Commodity Futures Trading Commission, claiming that the firm failed to "diligently" supervise its staff when the firm did not remit exchange fee rebates totaling US $7.8 million to relevant customers from 2010 to 2014. The CFTC claimed this was because the firm did not have, during the relevant time, automated systems to reconcile its exchange and clearing fees and utilized solely one employee to perform its fee reconciliation process. Moreover, said the CFTC, JPMS did not have adequate written policies and procedures regarding its reconciliation process. The CFTC acknowledged that, in July 2015, JPMS retained a consultant to advise it on its fee procedures, and in January 2016 implemented a new fee and commission calculation system and reconciliation tool. In addition, JPMS is currently "migrating clients to new pricing arrangements in which exchange and clearing fees are incorporated into an agreed rate, which does not change unless clients are notified of a change." JPMS has now mostly paid out all exchange rebates it previously did not pay to its clients, acknowledged the CFTC. To resolve this matter, JPMS agreed to pay a fine of US $900,000.

My View: Last summer, Barclays Capital, Inc. agreed to pay a fine of US $800,000 to the CFTC to resolve charges that it failed to supervise it staff's handling of exchange fees charged to customers from 2012 through 2014. According to the CFTC, after Barclays engaged an independent service provider to enhance its exchange fee reconciliation process in 2012, the provider, in August 2012, identified that the firm had failed in July 2012 to pass along to its customers discounts to ordinary fees from one exchange for one exchange-traded product. Apparently, afterwards, the firm accrued for overcharges to its customers "but failed to timely pay out $1.1 million in exchange fee rebates with respect to the discount program for this particular exchange-traded product." The CFTC claimed that this breakdown occurred because, during the relevant time, the firm failed to implement and maintain adequate systems for reconciling invoices from exchange clearinghouses with the amount of fees actually charged to its customers. In 2014, Merrill Lynch, Pierce, Fenner & Smith Incorporated also agreed to pay a fine of US $1.2 million to the CFTC related to the CFTC's allegation that, from at least January 1, 2010, through April 2013, the firm failed to employ "an adequate supervisory system" related to the processing of exchange and clearinghouse fees charged to the firm's customers. Although the CFTC acknowledged in both its Barclays and JPMS settlement orders that the process related to the assessment of exchange and clearing fees is "typically complicated because of the myriad applicable rates, surcharges and fee structures," it sanctioned both firms because of their failure to catch their mistakes through a reconciliation process. Rather than bring enforcement actions against FCMs for managing the best they can with a very broken process, the CFTC should encourage exchanges to institute less complicated fee and discount structures and implement tools to help firms conduct reconciliations more easily and reliably. (Click here for background on the CFTC's enforcement actions against Barclays and Merrill Lynch.)

- **Broker-Dealer Resolves SEC Charges That It Misled Broker-Dealer Clients Regarding How It Would Price Their Retail Customers' Orders**: Citadel Securities LLC agreed to pay sanctions of US $22.6 million to settle charges brought by the Securities and Exchange Commission related to the way it handled retail orders forwarded by other broker-dealers. The SEC claimed that, from late 2007 through January 2010, Citadel advised certain of its broker-dealer clients that, when receiving orders from their retail clients, it would take the other side of the trade and provide the best price it saw on various market fees or obtain the best price in the marketplace. However, claimed the SEC, at least two algorithmic programs of Citadel did not process trades in accordance with these representations and did not always get their broker-dealer clients' retail customers the best prices. Citadel's sanctions include a fine of US $16 million as well as disgorgement and interest.

And more briefly:

- **No Registration Required by CFTC Staff for Non-US CPO Where Investment Management Authority Delegated to Non-Affiliated CPO**: Staff of the Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission granted registration relief to a non-natural person commodity pool operator if it delegated all of its investment management authority to an unaffiliated non-natural person CPO, subject to various conditions. Among these conditions are that both the delegating and designated CPO agree to be jointly and severally liable for any violation of applicable law or CFTC rules. Previously, DSIO granted potential registration relief to non-natural person CPOs that delegated their management authority to other non-natural person registered CPOs provided both entities were affiliated.

- **CME Group Delays Until May 1 the Compliance Date of Certain Reporting Obligations Under Its New OCW Rules**: CME Group delayed until May 1, 2o17, the date by which reporting firms must combine reportable positions in a particular contract with all other positions in any contract month and in any contract that aggregates with that contract. Most recently, this requirement was to be effective today. (Click here for details regarding this obligation in CME Group Rule 561.A – 2d paragraph.)

- **FIA Publishes Due Diligence Questionnaire for IT Outsourcing**: FIA's e-Trading Working Group published a due diligence questionnaire intended to help investment firms subject to the Markets in Financial Instruments Directive II assess whether third-party vendors providing algorithmic software comply with regulatory standards. Under Regulation Automated Trading as recently re-proposed by the Commodity Futures Trading Commission, AT Persons may obtain a certification from third-party algorithmic software providers to satisfy their regulatory obligations regarding development, testing and monitoring of algorithmic trading systems. However, an AT Person would be expected to "conduct due diligence to reasonably determine the accuracy and sufficiency of a certification."

- **Singapore MAS Proposes Amendments to Security and Futures to Enhance OTC Regulation and Implement Market Misconduct Prohibitions**: A new bill initially proposed by the Monetary Authority of Singapore aimed at enhancing regulatory protections for retail investors and toughening provisions dealing with market misconduct passed the Singapore Parliament last week. Among other provisions, the new bill clarifies that the prohibition against manipulation based on false or misleading statements applies "regardless of the price effect." The bill has not yet been enacted as law.

- **Alleged Improper ADR Handling Results in SEC Charges and Settlement**: ITG Inc. agreed to pay a fine and disgorgement totaling US $24.4 million to settle charges brought by the Securities and Exchange Commission that it caused the issuance of so-called "pre-release" American Depository Receipts since at least 2011 when it had not taken reasonable steps to ensure that the concomitant number of the underlying shares were owned and custodied by the person on whose behalf ITG was acting, as required by SEC rule. (An ADR is a negotiable certificate that ultimately evidences ownership of shares of a non-US company that have been deposited with a bank. In a lawful pre-release transaction, foreign shares have been purchased but not yet delivered to a custodian; in such circumstances the shares must be owned and custodied by the person on whose behalf the pre-released ADRs are obtained.)

- **CFTC Proposes Housekeeping Rules Related to Sharing Swap Data With Other Regulators and Publication of Final Disciplinary Actions by SEFs and DCMs**: The Commodity Futures Trading Commission proposed rules to authorize swap data repositories to grant access to swap data to certain domestic and foreign regulatory authorities without their agreeing in writing to abide by a confidentiality and indemnification agreement as currently required by CFTC rules (the application of this provision has previously been waived in part through a CFTC Interpretive Statement, however; click here to access). Instead they would agree to be subject solely to a written confidentiality (but not an indemnification) arrangement to avoid such regulatory authorities' possible breach of law. In addition, the CFTC proposed rules related to exchange disciplinary matters to require, among other things, publication of final disciplinary and access denial actions by swap execution facilities and designated contract markets on their websites.

- **LCH.Clearnet Ltd. Granted Authority to Commingle Funds to Margin Swaps, Futures and Foreign Futures in a Swaps Account for Portfolio Margining**: LCH.Clearnet Ltd. was granted authority by the Commodity Futures Trading Commission to hold in a single cleared swaps account customer funds to margin on a portfolio basis cleared swaps, domestic futures and foreign futures related to swaps and futures that currently or may in the future be cleared through LCH. LCH and all futures commission merchants acting pursuant to the CFTC authority must hold all customer funds in accordance with the CFTC's regulation pertaining to cleared swaps accounts.

Follow-up:

- **NFA Members Warned to Apply Caution When Dealing With Exempt CTAs and CPOs**: The National Futures Association issued its annual reminder that members dealing with lawfully exempt-from-registration commodity trading advisors and commodity pool operators should take "reasonable steps" through March 1 to ensure such persons are lawfully exempt. This is because lawfully exempt CTAs and CPOs have until March 1 to file with the NFA an annual affirmation regarding their exemption and, if they do not, may be required to be registered. Reasonable steps, said NFA, include reviewing certain information regarding such CPOs and CTAs it provides online. NFA members are not permitted to conduct a customer business with persons required to be registered with the Commodity Futures Trading Commission and members of the NFA who are not.

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