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Layering, Cross-Market Manipulation, Retaliatory Firing and Non-Cooperation - Bridging the Week: March 6 - 10, March 13, 2017 [VIDEO]

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A non-US entity was accused by the ***Securities and Exchange Commission*** of engaging in layering and cross-market manipulation. Perhaps more significantly, the entity's carrying broker-dealer was charged with facilitating its customer's illicit activities. Additionally, a US appeals court ruled that ***Dodd-Frank***'s anti-retaliation protections for whistleblowers also apply to employees of public companies who report securities law violations internally but not to the SEC. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- US Broker-Dealer, Its CEO and a Non-US Client Sued by SEC for Layering and Other Manipulative Schemes (includes **Compliance Weeds**);
- Federal Appeals Court Holds Companies Can't Retaliate Against Internal Whistleblowers Even When No SEC Reporting (includes **Legal Weeds**);
- CTA and Principal Barred From NFA Membership for Failing to Cooperate in Examination (includes **Compliance Weeds**);
- FINRA Proposes Comprehensive Overhaul of Competency Testing Requirements (includes **My View**); and more.

US Broker-Dealer, Its CEO and a Non-US Client Sued by SEC for Layering and Other Manipulative Schemes:

Lek Securities Corporation ("LEK"), a US-registered broker-dealer and Samuel Lek, its 70 percent owner and chief executive officer, were sued by the Securities and Exchange Commission for facilitating manipulative trading activity by its customer, Avalon FA Ltd, a non-US entity, and its two control persons, Nathan Fayyer and Serge Pustelnik.

According to the SEC's complaint, Avalon engaged in two types of manipulative conduct: layering

and cross-market manipulation involving equities and related options from December 2010 through at least September 2016.

The SEC alleged that on “hundreds of thousands of instances” during this period, Avalon placed false orders in various stocks on one side of a marketplace to drive a stock’s price up or down. It did this, said the SEC, “to trick and induce other market participants to execute against Avalon’s bona fide orders (i.e., orders that Avalon did intend to execute) for the same stock on the opposite side of the market.” After executing its legitimate orders at more favorable prices, Avalon cancelled its other-side-of-the-market layering or spoofing orders, the SEC claimed.

In addition, charged the SEC, from April 2012 through December 2015, Avalon bought and sold stocks at losses in order to influence the market for corresponding options on the stocks. Avalon then made a profit by trading these options at “artificial prices,” said the SEC.

The SEC alleged that Avalon generated more than US $28 million of profits during the relevant time period through its illicit trading activity.

In its complaint, the SEC charged that LEK and Mr. Lek were aware of Avalon’s improper activities when, among other things, Mr.Lek received an email in May 2012 explicitly describing the layering scheme from an individual who shortly afterwards became an Avalon trade group leader, as well as when regulators, exchanges and other market participants alerted LEK and Mr. Lek on various occasions from 2012 through 2016 that they were concerned that Avalon was engaging in layering. In many instances, said the SEC, the regulators provided LEK and Mr. Lek with “detailed descriptions” of Avalon’s supposed problematic conduct.

The SEC said that LEK and Mr. Lek received similar information from regulators that Avalon’s cross-market activity was also potentially manipulative beginning in August 2012 through the present. Mr. Lek also authorized the relaxation of triggering thresholds for software used by LEK to prevent layering activity for Avalon at the request of Mr. Pustelnik, charged the SEC. During the relevant time period Mr. Pustelnik was first a foreign finder for LEK and later a registered representative – while at all times retaining his association with Avalon.

The SEC filed its complaint in a federal court in New York City. Among other remedies, the SEC seeks injunctions, disgorgement and fines against each of the defendants.

Last year, a decision by the Financial Industry Regulation Authority to fine LEK US $100,000 for failing to establish and implement adequate anti-money laundering procedures was upheld by the National Adjudicatory Council – a FINRA committee that reviews initial decisions from disciplinary and membership proceedings. A FINRA panel found after a hearing in 2014, that from January 1, 2008, through October 31, 2010, LEK’s AML procedures were inadequate because they “contained little guidance with regard to manipulative trading that might require the filing of a suspicious activity report.” (Click here for details of this decision.)

Compliance Weeds: As the SEC’s action against LEK and Mr. Lek, as well as the Commodity Futures Trading Commission’s recent enforcement action against Advantage Futures LLC and two of its principals demonstrates, neither the SEC nor the CFTC appear hesitant to bring an enforcement action against a registrant if the registrant fails to take what the regulators consider to be responsible appropriate action in the face of well-supported allegations of wrongdoing by a customer. Advantage, Joseph Guinan, its majority owner and chief executive officer, and William Steele, who until May 2016 was Advantage’s chief risk officer, recently settled charges brought by the CFTC

related to the firm's handling of the trading account of one customer in response to three exchanges' warnings regarding the customer's possibly illicit trading conduct. According to the CFTC, between June 2012 and April 2013, three exchanges alerted Advantage to concerns they had regarding the trading of one unspecified customer's account, which they thought might constitute disorderly trading, spoofing and manipulative behavior, in violation of the exchanges' relevant rules. The CFTC claimed that, initially, Advantage failed "to adequately respond to the Exchange inquiries and did not conduct a meaningful inquiry into the suspicious trading." Only after the three exchanges threatened to hold Advantage responsible for its customer's conduct, did Advantage cut off the trader's access to three exchanges. However, noted the CFTC, Advantage failed to augment its oversight of the trader's remaining trading or control his access to other exchanges "despite knowing that he employed the same strategy across all markets." (Click here for details of this enforcement action.) Registrants should consider developing databases that permit them to log all regulatory inquiries and other extraordinary matters regarding their customers so they can more systematically evaluate potential red flags regarding customers' conduct.

Briefly:

- **Federal Appeals Court Holds Companies Can't Retaliate Against Internal Whistleblowers Even When No SEC Reporting**: A federal appeals court in San Francisco ruled that anti-retaliation provisions under whistleblower rules of the Securities and Exchange Commission protected an employee – Paul Somers — who reported possible securities law violations to his company's senior management and not to the SEC. Mr. Somers' employer, Digital Reality Trust Inc., had argued that, because of conflicting federal laws – the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 –, such anti-retaliation protections only existed for employees of public companies who reported potential violations internally and also to the SEC. The conflict arises because, under Dodd-Frank, anti-retaliation protection is provided for "whistleblowers" who make disclosures that are required or protected under Sarbanes-Oxley, and whistleblowers are defined as employees who report to the SEC. However, under Sarbanes-Oxley certain employees – auditors and attorneys – must report problems internally, prior to alerting federal agencies. The appeals court held that, as a result, reading the use of the word "whistleblower" in the anti-retaliation provision of Dodd-Frank narrowly would "make little practical sense and undercut congressional intent." According to the court, a narrow reading would permit an employee of a public company who files an internal report of wrongdoing to be fired for making disclosures mandated by Sarbanes-Oxley because the person has not yet made a filing with the SEC, thus undercutting Dodd-Frank's anti-retaliation provisions. However, said the court, "[e]mployees are not likely to report in both ways, but are far more likely to choose reporting either to the SEC or reporting internally." Mr. Somers was fired by his employer after making reports of wrongdoing to management. He then sued his employer in a federal district court under the anti-retaliation provisions of SEC rules adopted pursuant to Dodd-Frank. In response, Digital Trust filed a motion to dismiss saying that Mr. Somers was not a whistleblower under Dodd-Frank. Mr. Somers opposed this motion, prevailed in his argument, and the federal appeals court in San Francisco (Ninth Circuit) upheld the district court's decision. One other federal appeals court – in New York (Second Circuit) – has ruled similarly, while another – in New Orleans (Fifth Circuit) – has ruled contrariwise.

Legal Weeds: The SEC has recently brought and settled multiple enforcement actions against companies for including in their severance agreements standard language that required employees to waive monetary recovery for discussing any matter regarding their employment with a government

agency with jurisdiction over the companies. The SEC claimed that this language violated applicable whistleblower protections under law and its rules. In light of these recent actions, companies that are SEC registrants or SEC regulated, as well as Commodity Futures Trading Commission registrants and entities subject to CFTC rules, are encouraged to review their form employment and severance agreements and employee policies to ensure that they do not contain confidentiality requirements that could be interpreted by the SEC or the CFTC as preventing an employee from making a whistleblower complaint.

- **CTA and Principal Barred From NFA Membership for Failing to Cooperate in Examination**: For the second week in a row, a panel of the Hearing Committee of the National Futures Association banned a firm and an individual principal and associated person of the firm from NFA membership for not cooperating with NFA staff during an examination. Last week, the panel held that Samico Worldwide Markets, Inc., a registered commodity trading advisor, and Thomas Gasparini, a principal and AP of the firm, failed to cooperate with NFA staff when they failed to produce bank account statements and written explanations for certain transactions, as requested during an examination of Samico during December 2015. NFA staff sought such information because of concern regarding regular undocumented cash deposits that were made into the operating bank account of Samico and into a proprietary trading account of Mr. Gasparini at a futures commission merchant. According to the NFA, "[u]ndocumented cash deposits into the operating account of a CTA and undocumented deposits into a CTA's proprietary trading accounts are clear red flags for NFA." The panel also held that Samico and Gasparini failed to maintain certain required records, including a cash receipts and disbursements journal; a general ledger detailing assets, liabilities, capital, income and expense accounts; and cancelled checks and other bank records. Two weeks ago, Nex Capital Management LLC, also a registered CTA, and Jacob Wohl, an associated person and principal of Nex Capital, were permanently barred from being members of the NFA or from acting as principals of an NFA member for likewise failing to cooperate with an NFA examination. (Click here for details.)

Compliance Weeds: Not only must registrants cooperate fully with regulators, but documents registrants file with regulators must be accurate and not misleading. In a recent enforcement action against Advantage Futures LLC by the Commodity Futures Trading Commission, the agency charged that when Advantage submitted its risk management policies manual, credit and risk policies and procedures manual and chief compliance officer annual report to it on "multiple occasions" between November 2013 and May 2015, two senior officers of the firm "knew that the documents did not accurately represent Advantage's actual practices" and therefore contained false or misleading statements in violation of applicable law. (Click here to access Commodity Exchange Act Section 6(c)(2), 7 USC §9(2).) (Click here for details regarding the Advantage Futures enforcement action.)

- **FINRA Proposes Comprehensive Overhaul of Competency Testing Requirements**: The Financial Industry Regulatory Authority proposed a sweeping overhaul of its requirements regarding qualification examinations. Currently, only persons specifically sponsored by a FINRA-regulated firm, may take qualification examinations. FINRA proposes to modify this requirement and offer a "Securities Industry Essentials" examination to anyone seeking to enter the securities industry whether associated with a member firm or not. Persons who then become affiliated with a FINRA member firm would be required to take a second, more specialized knowledge examination to perform specific functions. For example, an individual seeking to become a general securities representative, which currently requires passing a 250-question Series 7 examination, would first take a 75-question SIE examination and then a

specialized Series 7 test containing 125 questions; similarly, a person seeking to qualify as an operational professional, who today would be required to pass a 100-question Series 99 exam, would instead also first be required to pass the SIE test, then a specialized Series 99 examination containing only 50 questions. In addition, under an additional FINRA proposal, persons who transfer to a financial services affiliate of a FINRA member could return within seven years without retaking their qualification examinations provided they complete securities industry continuing education. Currently, a person must retake qualifications examinations after they cease being sponsored by a registrant after two years. FINRA submitted its rule amendments to the Securities and Exchange Commission for approval; the SEC is likely to provide 21 days for comments to FINRA's proposal once it is published in the *Federal Register*.

My View: FINRA's proposed examination rule amendments will somewhat address two practical issues: only persons associated with a FINRA member can currently take qualification examinations and persons must retake qualification examinations after leaving a FINRA registrant after two years. The development of a core examination that people can build upon once they join a broker-dealer will be a benefit to both member firms and prospective employees as potential hires will be able to demonstrate basic competence prior to joining a member firm. Moreover, employees of financial services firms will not have to worry that, when transferring to an affiliated entity, they might have to transfer back within two years or be required to retake their qualification examinations should they do so later. However, the circumstances under which individuals are waived from retaking their qualification examinations seems too narrow. FINRA should formalize other circumstances where individuals may leave a member firm for related work and return to either the same or a different member firm years later without having to retake qualification examinations (e.g., where a person leaves a registrant but continues to engage in securities industry-related work for a non-FINRA member). Currently, such a person may be able to obtain a waiver from examination requirements but solely upon specific application.

And more briefly:

- **Singapore MAS Working to Use Distributed Ledger Technology for Fixed-Income Securities Settlements and Cross-Border Payments; SEC Denies Bitcoin ETF**: The Monetary Authority of Singapore concluded an experimental project to facilitate domestic interbank payments through digital ledger technology, relying in part on creation of a digital representation of the Singapore dollar. MAS now plans to advance knowledge learned during this project to make fixed-income securities trading and settlement more efficient through DLT and to organize cross-border payments through central bank digital currency. Separately, the Securities and Exchange Commission disapproved a rule change proposed by the Bats BZX Exchange to list and trade shares of an exchange-traded fund tied to Bitcoin. The SEC denied Bats' application, saying it did not have surveillance-sharing agreements with significant regulated markets that currently trade Bitcoin – which it said it needed to help prevent fraudulent and manipulative acts. (Click here to access a copy of the SEC's determination.)

- **HK SFC Sanctions Securities and Futures Broker for AML Breaches in Handling Third-Party Payments**: The Hong Kong Securities and Futures Commission fined Guangdong Securities HK $3 million (US $386,000) for failing to comply with anti-money laundering requirements in connection with third-party payments. According to SFC, between February 2011 and March 2013 the firm failed to make "appropriate" inquiries prior to processing third-

party payments. In many cases, the firm had no information regarding the relationship between a client, the third party and the purpose for a payment. Among other things, Guangdong Securities is authorized to deal in both futures and securities.

- **Federal Impasse Panel Orders Increase in CFTC Employees' Pay**: On March 1, following an apparently unusually contentious hearing, a Federal Service Impasse Panel ordered the Commodity Futures Trading Commission to provide funding for a merit pay increase of one percent to the agency's bargaining-unit employees retroactive to the first pay period after October 1, 2016. In addition, the CFTC must provide the same employees with a one-time bonus equal to one percent of their annual salary by no later than the first pay period in April 2017. The union representing the employees had asked for a 3 percent merit-pay increase. Although the arbitrator hearing this matter was persuaded by the comparative underpayment of relevant CFTC staff compared to other financial regulators, it also took note of the likely non-increasing budget of the agency over the next few years. Last week, the CFTC announced the hiring of Daniel Davis as its general counsel; Mr. Davis has particular experience in labor and employment law. (Click here for a copy of the CFTC's press release announcing the hiring of Mr. Davis.)

- **ICE Europe Reminds Members and Participants of Revised Large Trader Reporting Requirements Effective March 27**: ICE Futures Europe reminded its members that they and market participant must be in full compliance with its ownership and control requirements by March 29. Under these requirements, clearing members must identify all reportable position and volume threshold accounts for exchange contracts subject to the exchange's position reporting requirements. These requirements are equivalent to the Commodity Futures Trading Commission's OCR requirements. (Click here for background.) Market participants are obligated to assist members in their OCR obligations, as necessary.

- **NFA Conforms Financial Requirements Regarding Withdrawals of FCM Residual Interest to Recent CFTC No-Action Letter**: NFA proposed to amend its financial requirements to conform with a recent no-action letter issued by the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight authorizing futures commission merchants to withdraw excess residual interest from cleared swaps customer accounts prior to a formal next day segregation calculation, as currently required under one of its regulations (click here to access CFTC Rule 22.17(b)). Such withdrawals are authorized in response to margin deposits provided by cleared swaps customers to reduce their undermargined amounts since the firm's last formal segregation computation – subject to strict conditions.

- **CBOE Futures Privilege Holders Resolve Disciplinary Actions**: CBOE Futures Exchange brought two actions in November 2016 against trading privilege holders who allegedly placed orders in the CBOE Volatility Index Trade at Settlement futures that were rejected by the exchange for being placed pre-market open, when the firms knew or should have known such orders would be rejected. In one action, Virtu Financial settled charges against it by agreeing to pay a fine of US $25,000 for "several occasions" in 2015; in another action, Locust Walk Trading LLC agreed to pay a penalty of US $15,000 for the same offense for "several occasions" between May and August 2015. Separately, Sumo Capital LLC, also a trading privilege holder, agreed to pay a fine of US $40,000 for not providing required audit trail records to the exchange or being able to show such records were maintained as required by exchange rule for the period November 2013 through August 2015.

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