Bridging the Weeks: August 31 to September 11 and September 14, 2015 (Spoofing, Individual Accountability, Cybersecurity, Audit Opinions, Hedging and Reporting)

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During the past two weeks, Navinder Singh Sarao – the individual both the US Department of Justice and the Commodity Futures Trading Commission claim was at least partly responsible for the May 6, 2010 “Flash Crash” – was formally indicted for alleged spoofing-type trading, while the National Futures Association submitted to the CFTC for its approval proposed guidance to members regarding cybersecurity. Meanwhile, the US Department of Justice suggested it will proceed more fervently against employees of alleged corporate wrongdoers going forward. As a result, the following matters are covered in this week’s edition of Bridging the Week:

- Alleged Flash Crasher’s Formal Indictment Provides More Details Regarding His Purported Spoofing;
- US Justice Department to Emphasize Naming Individuals in Corporate Misconduct Civil and Criminal Actions;
- NFA Proposes Cybersecurity Guidance (includes My View):
  - CFTC Chairman Considers Delegating Non-Enumerated Hedging Exemptions to Exchanges; Aggregation Proposal on the Table:
  - BDO and Five Partners Charged by SEC for Issuing Misleading Unqualified Audit Opinions;
  - Forex Capital Markets Settles With CFTC for Allegedly Not Providing Adequate Oversight of Fraudulent Pool;
  - FCA Says Commodities Trading Firms’ and Brokers’ Awareness of Market Abuse Risk Is Poor;
- CFE Sanctions FCMs for Failing to Timely File Form 102s and Submit Large Trader Reporter Data Properly (includes Compliance Weeds); and more.

Video Version:
The US Department of Justice filed a formal indictment against Navinder Singh Sarao in a US federal court in Chicago on September 2, 2015, alleging that he engaged in commodities fraud, manipulation, attempted manipulation and spoofing, in violation of federal law, in connection with his trading of E-mini S&P 500 futures contracts on the Chicago Mercantile Exchange between approximately January 2009 through April 2014 (although some charges relate to conduct only from April 27, 2010, through March 10, 2014).

Mr. Sarao was previously accused of engaging in the same unlawful activities in a criminal complaint filed in the same court by the Department of Justice on February 11, 2015, and made public on April 21. This occurred shortly after Mr. Sarao was arrested at his home in the United Kingdom on April 21, in connection with his US criminal charges. Since that time, Mr. Sarao has been opposing extradition to the United States in hearings in the United Kingdom.

In a civil lawsuit filed in a US federal court in Chicago on April 17, 2015, but made public on April 21, too, the Commodity Futures Trading Commission also charged Mr. Sarao and his trading company, Nav Sarao Futures Limited PLC, with engaging in the same core wrongful conduct as did the Department of Justice. The CFTC alleged that Mr. Sarao’s disruptive trading netted him profits in excess of US $40 million between April 2010 and April 2015.

The Department of Justice and the CFTC claimed that Mr. Sarao engaged in layering activity on multiple occasions on the sell side of the market with the intent to mislead other market participants and artificially lower the price of E-mini futures contracts. Mr. Sarao accomplished this, said both the Department of Justice and CFTC, utilizing an automated trading program that frequently placed and cancelled large sell orders at a set increment away from the prevailing best bid price. Mr. Sarao typically sold E-mini futures contracts at a higher price and bought them back at a lower price in conjunction...
with his supposed “dynamic layering technique,” realizing profits, claimed both the Department of Justice and the CFTC.

In the indictment, the Department of Justice provided greater insight into its version of Mr. Sarao’s alleged wrongful conduct. Among other things, the Department of Justice referenced specific emails where Mr. Sarao expressly discussed his desire to “spoof [the market] down;” his need to have software to enter orders of different sizes to avoid other traders becoming aware of his activity and “rendering my spoofing pointless;” and contacting a programmer to know whether he could make software adjustments “because at the moment I’m getting hit on my spoofs all the time.”

The Department of Justice also alleged that on approximately May 21, 2013, Mr. Sarao’s then-clearing broker provided him with a copy of the CFTC’s interpretive guidance and policy statement regarding the Commission’s anti-market disruptive practices authority published just a few days previously. In response, Mr. Sarao allegedly responded to his clearing broker, “Lol, guarantee if I switch on my computer I’ll see the same people breaking all those rules, day in, day out.” (Click here to access a copy of the CFTC’s interpretive guidance and policy statement regarding its anti-market disruptive practices authority.)

Both the CFTC and the Department of Justice claimed that Mr. Sarao’s conduct contributed to the May 6, 2010 “Flash Crash.” (The Flash Crash refers to events on May 6, 2010, when major US-equities indices in the futures and securities markets suddenly declined 5-6 percent in the afternoon in a few minutes before recovering within a similarly short time period.)

(Click here for additional details)

My View: I continue to struggle how an individual might have known what is “commonly known to the trade as spoofing” – one of the specific activities prohibited by the federal law that outlaws market disruptive practices (click here to access the relevant law, Commodity Exchange Act §4c(a)(5)(C)) – prior to the release of the CFTC’s interpretive guidance and policy statement in May 2013. Even today, prohibitions on disruptive trading practices are not uniform among exchanges. Moreover, it seems to me likely there are many legitimate reasons to place orders with the intent that they be cancelled before execution. For example, a trader might place a stop loss order or an order for a deep out of the money option far away from the current market solely as catastrophic insurance with the intent (and prayer) that it not be executed. Although it could be argued that such an order is legitimate because it is “the intent of the market participant that the order will be executed if the specific condition is met” (click here to access the answer to question 8 to CME Group’s Market Regulation Advisory Notice RA1405-5R, “Disruptive Practices Prohibited”), a trader engaging in purported layering might equivalently argue that it was his/her intent and expectation to be filled if his/her orders were hit – and he/she set aside the financial resources to demonstrate that. Mr. Sarao’s choice of words in his electronic communications may come back to haunt him, but it will also be interesting to see whether his language has been taken out of context in the criminal indictment.

Briefly:

- **US Justice Department to Emphasize Naming Individuals in Corporate Misconduct Civil and Criminal Actions**: The US Department of Justice has issued an internal memorandum requiring department staff to proactively seek “accountability” from individuals who cause corporate misconduct. According to the memorandum, “[s]uch accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties
are held responsible for their actions, and it promotes the public’s confidence in our justice system.” Among other things, the memorandum says that, going forward, to qualify for any cooperation credit, a corporation must completely disclose to the Department of Justice all “relevant facts” about individual misconduct. Department of Justice investigations must also “focus on individuals from the inception” of any investigation, and no corporate resolution may preclude criminal or civil sanctions for any individual, absent extraordinary circumstances. Moreover, says the memorandum, no corporate cases should be resolved without a “clear plan” to address related individual cases prior to any statute of limitation expiration. According to the memorandum, when a decision is made not to charge an individual under investigation, such action “must be memorialized and approved by the United States Attorney or Assistant Attorney General whose office handled the investigation, or their designees.”

- **NFA Proposes Cybersecurity Guidance:** The National Futures Association submitted to the Commodity Futures Trading Commission for its approval a proposed Interpretive Notice requiring certain NFA members to maintain formal, written information systems security programs (ISSP). Impacted members are futures commission merchants, commodity trading advisors, commodity pool operators, introducing brokers, retail foreign exchange dealers, swap dealers and major swap participants. Although the NFA makes clear that its “policy is not to establish specific technology requirements,” it will require all relevant members to have supervisory procedures that are “reasonably designed 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.” NFA expects, however, that firms’ supervisory systems will likely be different from one another “given the differences in the type, size and complexity of [m]embers’ businesses.” Among other things, NFA expects ISSPs to articulate a governance framework “that supports informed decision making and escalation within the firm to identify and manage information security risks.” ISSPs must also require assessment and prioritization of the risks associated with the use of information technology systems; the deployment of safeguards against identified threats and vulnerabilities; and implementation of a formal incident response plan to respond and recover from cyber-breaches. Employee training and the risks posed by critical third-party service providers that access a member’s system or provide outsourcing must also be addressed in an ISSP. A relevant member’s chief executive office, chief technology officer or other executive-level officer should approve its ISSP. Moreover, “sufficient information” should be provided about the ISSP to a relevant member’s board or governing body (or delegated committee) to enable it to monitor the Member’s information security efforts.” NFA contemplates that a member, which is part of a group, may comply with its ISSP requirements through participation in a consolidated entity ISSP. NFA proposes to require all members to retain all records related to their adoption and implementation of an ISSP.

**My View:** The National Futures Association has taken a measured approach in requiring firms to have information systems security programs. Rather than specify a one-size-fits-all approach, NFA proposes to provide relevant member firms the flexibility to devise ISSPs commensurate with their size, customer base and product access. Moreover, recognizing that some firms already have ISSPs and other do not, NFA proposes to provide additional, more detailed guidance to certain smaller members. Relevant firms should not wait until the Commodity Futures Trading Commission approves the NFA’s proposed Interpretive Notice, which surely it will, to conduct a gap analysis between NFA’s recommendations and their current practices, and to try to begin to close any gap by drafting and implementing enhanced provisions to their ISSPs as necessary.
CFTC Chairman Considers Delegating Non-Enumerated Hedging Exemptions to Exchanges; Aggregation Proposal on the Table: Commodity Futures Trading Commission Chairman Timothy Massad provided insight regarding a number of current Commission initiatives before the Beer Institute’s annual meeting last week. Among other matters, Mr. Massad indicated he expected the CFTC to finalize rules this fall regarding margin for uncleared swaps, suggesting they will include a proposed exemption for commercial end users. (Click here for further details) Without committing to a date of release of final rules, Mr. Massad suggested that “[w]e will have more to say about issues related to position limits in the coming months.” Mr. Massad acknowledged that “hedging strategies are varied and complicated,” and suggested the Commission is taking a “closer look” at having exchanges, not the CFTC, review applications for so-called “non-enumerated” hedging exemptions. Mr. Massad also indicated the Commission is reconsidering its aggregation proposal and that the CFTC is likely to issue proposals during the fall “to minimize the chance that algorithmic trading can cause disruptions or result in unfairness.” Mr. Massad opened his comments before the Beer Institute by noting it is likely that the attendees’ “products will never cause a financial crisis. To the contrary, I suspect that your products were actually the source of a lot of comfort for many of us during the global financial crisis.”

BDO and Five Partners Charged by SEC for Issuing Misleading Unqualified Audit Opinions: The Securities and Exchange Commission filed and settled charges against BDO USA, a national audit firm, and five of its partners, for issuing misleading, unqualified audit opinions on the financial statements of General Employment Enterprises, a employment staffing services company, for the firm’s fiscal years ending September 30, 2009, and 2010. According to the SEC, near the end of BDO’s 2009 audit of GEE, GEE’s chief financial officer advised BDO that a US $2.3 million certificate of deposit the firm had purchased had not been repaid timely by the issuing New York State-chartered bank. At the time, the amount of the CD represented approximately one-half of GEE’s assets and most of its cash. In following up on this matter, BDO received conflicting stories from GEE management and board members regarding the CD although the firm ultimately received a series of payments equaling the amount of the CD from three entities unaffiliated with the bank. In response, BDO issued a letter to GEE saying that the firm had not provided sufficient evidence to BDO to resolve its audit and demanded that GEE’s audit committee engage an independent firm to conduct a full investigation. After GEE’s then-chief executive officer resigned, BDO agreed to withdraw its letter and issued an audit report which included an unqualified opinion on the firm’s 2009 financial statements that were filed with the SEC. Subsequently, BDO learned that the president of the bank that purportedly had issued GEE its $2.3 million CD had been criminally charged with participating in a conspiracy with, among others, GEE’s then-CEO and the then majority shareholder and chairman of the firm’s board of directors, and that the purported CD never existed. Notwithstanding, BDO never considered the impact of this and other related information on GEE’s 2009 financial statement and subsequently did not consider this information in issuing an unqualified opinion on GEE’s financial statements included in the firm’s 2010 mandatory financial statement filing with the SEC. The SEC charged BDO and the individual partners with failing to comply with professional standards and thus violating various federal laws and SEC rules. The SEC also charged BDO and the individual partners with causing GEE to file inaccurate financial statements with it. To resolve the SEC’s charges, BDO agreed to pay a US $1.5 million penalty, to disgorge profits and pay interest totaling approximately US $600,000 and to commit to various undertakings. The five partners agreed to pay, in aggregate, a fine of US $75,000 and four of the partners were prohibited from appearing before the SEC as an accountant for at least one to three years. The SEC also brought separate actions against GEE’s former board chairman, Stephen Pence, who is a former US
attorney and Kentucky lieutenant governor, as well as against two former GEE chief executive officers.

- **Forex Capital Markets Settles With CFTC for Allegedly Not Providing Adequate Oversight of Fraudulent Pool:** Forex Capital Markets, LLC, a registered futures commission merchant and retail foreign exchange dealer, settled charges brought against it by the Commodity Futures Trading Commission for its alleged failure to follow its own compliance procedures by not identifying and reporting suspicious conduct by one of its clients – the Revelation Forex Fund, LP. RFF was a purported hedge fund that the CFTC sued in 2013 for stealing US $7.4 million of client funds. According to the CFTC, Forex Capital’s compliance department reviewed RFF’s website on at least three occasions from April 1 to July 10, 2013, but failed to note RFF’s false claim of profitable performance. Moreover, said the CFTC, during the same time, Forex Capital’s compliance department failed to identify that the existence of RFF’s website itself violated one of the requirements of RFF’s purported exemption from CFTC registration as a commodity pool operator – that the firm not engage in advertising. Moreover, claimed the CFTC, during the relevant time, neither Forex Capital’s account services team nor its compliance department identified that the margin requirements and net notional value of RFF’s positions regularly exceeded the amount permissible under RFF’s claimed CPO registration exemption. In addition, the CFTC charged that Forex Capital failed to provide requested documents and documents the firm was obligated to provide, and that this failure also violated a prior 2011 settlement with the CFTC to provide documents when requested. Forex Capital agreed to pay a penalty of US $700,000 to resolve this matter.

- **FCA Says Commodities Trading Firms’ and Brokers’ Awareness of Market Abuse Risk Is Poor:** The UK Financial Conduct Authority expressed concern that, in connection with a thematic review of 12 commodities brokers and trading firms, some firms evidenced “complacency” towards the risk of market abuse and weakness in intraday risk monitoring. Many firms also could not demonstrate “effective” procedures to identify and report suspicious transactions. According to FCA, “[w]e are concerned that some firms believe commodity markets are ‘too deep, too liquid, and there are too many participants’ to be manipulated.” The FCA condemned this conclusion as “misguided” and “surprising” in light of recent cases of manipulation in other deep and liquid markets (e.g., in LIBOR, foreign exchange and gold). Besides finding few firms with adequate intraday risk monitoring, FCA also concluded that “[c]redit risk was usually assessed but left unhedged,” while “[m]arket risk was usually given consideration, but on a portfolio basis little attention was paid to concentration risk which, in the event of stressed market conditions, could result in large financial pressures and liquidity risks.”

- **CFE Sanctions FCMs for Failing to Timely File Forms 102 and Submit Large Trader Reporter Data Properly:** The CBOE Futures Exchange brought disciplinary actions against three members – Banco Santander SA, Phillip Futures Pte Ltd. and Raiffeisen Bank International AG – for allegedly failing to timely file CFTC Forms 102 within three days of establishing a large trader position, as required, and against the same three members and Macquarie Bank Ltd. for purportedly not reporting to CFE for multiple months reports of large trader positions electronically via the Securities Industry Automation Corporation, as also mandated by the exchange. Each of the firms agreed to pay a fine of US $15,000 to resolve its disciplinary action. Separately, Eagle Seven LLC also agreed to pay CFE US $15,000 to resolve a claim that on “several occasions” during March and April 2014, the firm allegedly entered orders for CBOE Volatility index future contracts prior to the pre-open session that were rejected by the exchange, which the firm purportedly knew would be rejected. According to CFE, this practice was inconsistent with just and equitable principles of trade.
Compliance Weeds: CFE’s disciplinary actions regarding late filings of CFTC Forms 102 serve as a reminder that the deadline for futures commission merchants to begin filing electronically revised Forms 102A and 102B (information regarding large traders and volume threshold traders) is rapidly approaching. Temporary relief by the Commodity Futures Trading Commission from filing the new forms expires as of September 30, 2015. A helpful reminder to clients of what information they should be providing to FCMs either directly or through a Futures Industry Association portal can be found on the FIA’s website (click [here](#) to access).

And more briefly:

- **Bitcoin Options Exchange Receives CFTC Temporary Designation as SEF:** LedgerX LLC received temporary registration as a swap execution facility by the Commodity Futures Trading Commission. LedgerX applied for registration as a SEF and a derivatives clearing organization in order to list and clear fully collateralized, physically settled options on Bitcoin. LedgerX’s application for designation as a DCO is still pending. (Click [here](#) for further details)

- **ESMA Consults on Final Draft Requirements Related to Position Reporting for Commodity Derivatives and Other Matters:** The European Securities and Markets Authority issued a consultation paper seeking views on remaining technical standards (somewhat equivalent to US regulations) on which ESMA has not yet consulted. These relate to the format and timing of communications related to the suspension and removal of financial instruments from trading on a regulated market, a multilateral trading facility or an organized trading facility; standard forms and procedures to apply to a data reporting service provider when applying to be authorized or concerning subsequent changes to its management; and position reporting for commodity derivatives, emission allowances or derivatives on emission allowances by market operators, certain market participants and certain investment firms. Comments will be accepted through October 31, 2015.

- **ICE Futures U.S. Settles Disciplinary Actions for Position Limits and Block Trade Violations:** ICE Futures U.S. settled three disciplinary actions for alleged spot month position limit violations for payment of fines between US $28,127 and US $35,000, and disgorgement of profits in two of the instances. The exchange also settled three disciplinary actions for alleged incorrect handling of block trades. In one action involving ICAP Energy, LLC, the firm agreed to pay a fine of US $7,500 for brokering a block trade that allowed one counterparty to move positions from one of its proprietary account to another in order to correct an erroneous allocation.

- **NFA Announces Effective Dates for New Forex Member Requirements:** The National Futures Association announced the effective dates of its recently issued new Forex dealer member requirements. In general, firms must be in compliance with all new requirements beginning January 4, 2016. However, an FDM’s first quarterly risk exposure report will be due for the quarter ending March 31, 2016, the first review and testing of an FDM’s risk management program must be completed by January 4, 2017, and the first chief compliance officer annual report must be completed for an FDM’s first fiscal year end occurring after January 4, 2016.

- **ICE Futures Canada Issues Guidance on Subsequent EFRPs to Correct Original EFRPs:** ICE Futures Canada issued a guidance on exchange for related position transactions that reminded traders that they are not permitted to engage in an EFRP and then engage in a subsequent EFRP to adjust or correct the related position component. As an example, the exchange notes that a physical grain transaction might have a 10 percent loading tolerance for which the full tonnage is priced through an exchange for physical transaction. If less than full tonnage is loaded, the parties cannot
conduct a reverse EFP to account for the lower tonnage. Instead, the counterparties “must either trade these positions competitively in the open market, cash-settle the difference between themselves, or otherwise resolve the under-shipment outside of the EFP structure.”

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