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Bridging the Week by Gary DeWaal: August 27 to September 7 and September 10, 2018 (Quantitative Models; Cross-Border Swaps Guidance; The Meanings of “Or” and “Actual Delivery”)

Article By
Gary De Waal
Katten Muchin Rosenman LLP
Bridging the Week

- Financial Institutions & Banking
- Securities & SEC

- Manitoba
- All Federal

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Four related Securities and Exchange Commission-registered investment advisers and/or broker-dealers agreed to pay a collective penalty close to US $100 million to resolve charges related to their purported implementation and use of quantitative trading models for funds and individual managed accounts that, prior to launch, were never formally validated and never fully worked as intended. Moreover, the SEC claimed that the companies did not uniformly alert investors after they discovered the models’ errors and discontinued their use. Separately, the Chairman of the Commodity Futures Trading Commission promised to soon issue a white paper as guidance to staff to propose rules to substantially modify the Commission’s 2013 Cross-Border Swaps Regulation Guidance. As a result, the following matters are covered in this week’s edition of *Bridging the Week*:

- Three Affiliated Investment Advisers and a Related Broker-Dealer Agree to

Penalties of Almost US $100 Million for Using and Promoting Defective and Untested Quantitative Trading Models (includes **Compliance Weeds**);
- CFTC Chairman Proposes to Reform Cross-Border Swaps Rules Guidance (includes **Legal Weeds**);
- CFTC Tells Appeals Court That California District Court's Legal Rationale to Dismiss Complaint Against Precious Metal Dealer Was "Deeply Flawed" (includes **Legal Weeds**); and more.

Article Version:

Briefly:

- **Three Affiliated Investment Advisers and a Related Broker-Dealer Agree to Penalties of Almost US $100 Million for Using and Promoting Defective and Untested Quantitative Trading Models**: Four direct or indirect US-based subsidiaries of Aegon, N.V., a Netherlands-based multinational insurance and asset management company, agreed to settle charges brought by the Securities and Exchange Commission that, at various times between July 2011 and June 2015, they offered, sold and managed investment products and strategies based on defective quantitative trading models that did not perform fully as intended. The four subsidiaries are Aegon USA Investment Management, LLC ("AUIM"); Transamerica Asset Management, Inc.; and Transamerica Financial Advisors, Inc., ("TFA") each an SEC-registered investment adviser, and Transamerica Capital, Inc, an SEC-licensed broker-dealer. TFA is also a broker-dealer.

According to the SEC, beginning in 2010, a recent MBA graduate newly hired by AUIM developed for the firm quantitative models for making investment allocations and trading decisions. Beginning in fall 2011, these models were used by AUIM to manage various investment products and strategies. However, said the SEC, prior to

use, the new hire "did not follow any formal process to confirm the accuracy of his work and AUIM failed to provide him meaningful guidance, training, or oversight as he developed the models or to confirm that the models worked as intended before using them to manage client assets."

Moreover, the quantitative models were never formally validated, let alone reviewed for accuracy, by AUIM until later, alleged the SEC. This was despite numerous red flags raised by the models. For example, although in fall 2011 an internal audit highlighted that AUIM did not have "formal controls or policies and procedures to ensure quantitative model development is control and models function as expected," the firm did not adopt a written model validation policy until July 2013. Additionally, employees of at least one affiliate – TFA – appeared to be aware of errors in at least some of the models developed by the new employee before the AUIM models were selected for use, reflecting in an email exchange, "we take the hit if he screws up."

The SEC claimed that, within just a few days of launch, several "glaring errors" were found in connection with one model used in connection with one investment product. However, AUIM did not review the model for other errors until summer 2013.

The SEC said that during summer 2013, AUIM recognized that some of its allocation models contained "material errors" and stopped using one allocation model for one fund that month. Over time, other errors in AUIM models were also discovered by the firm and its affiliates and the models were no longer used. However, these errors and non-use were not always disclosed to investors.

Among other things, the SEC charged that, by marketing the investment products as relying on quantitative models, the respondents implied they worked as intended when they knew or should have known they likely did not. This operated as a fraud or deceit upon clients and prospective clients.

Without admitting or denying any of the SEC's findings, the respondents collectively agreed to disgorge profits of US $61.3 million, including US $8 million of interest, and pay a fine of US $36.3 million. All paid funds are intended to be distributed to affected investors.

Two former AUIM officers were named in separate complaints for contributing to AUIM's violation. They also settled their SEC charges by collectively paying an additional US $90,000 in fines which are likewise intended to be distributed to affected investors.

Compliance Weeds: Just last month I cautioned regarding the need of traders and intermediaries relying on automated surveillance systems not to just install and blindly rely on such tools, but to periodically review that such systems are working as promised, particularly after periodic updates or other changes to source code. (Click here forbackground in the Compliance Weeds section to the article "Investment Adviser Sanctioned US $4.5 Million for Not Having Policies Reasonably Designed to Protect Investor Assets Against Misappropriation " in the August 19, 2018 edition of *Bridging the Week*.)

Indeed, best practice for any automated system – whether a surveillance, risk, trading or other system – entails systematically testing the system prior to any

initial rollout, regularly testing the system, and testing the system specifically after any update or other changes to source code to ensure the system operates as intended. This seems like common sense, but it's too often forgotten.

- **CFTC Chairman Proposes to Reform Cross-Border Swaps Rules Guidance**: Commodity Futures Trading Commissioner Chairman J. Christopher Giancarlo said he would soon recommend specific rule proposals addressing cross-border swaps transactions. The purpose of these rules would be to update the 2013 CFTC Cross-Border Guidance that, he claimed, was inappropriately issued as a guidance and not as rules; is "over-expansive, unduly complex, and operationally impractical;" was incorrectly grounded on the belief that every swap involving a US person has a direct and significant effect on US commerce; and does not provide sufficient deference to comparable rules adopted by non-US regulators. As a result, claimed the CFTC Chairman, many global participants do not trade with persons subject to CFTC swaps regulation and causes fragmentation in markets. (Click here for background on the 2013 Guidance in the article "CFTC Enacts Interpretive Guidance and Passes Exemptive Order regarding Cross-Border Swaps Transactions" in the July 16, 2013 edition of *Between Bridges*.)

Mr. Giancarlo indicated that, in the proposed rules, he wants the CFTC to distinguish between swaps reforms intended to mitigate cross-border systemic risk and reforms dealing with trading practices that he claimed do not have a "direct and significant" US connection. Whereas oversight of systematic risk requires "closer cross-border regulatory coordination," said the CFTC Chairman, market structure and trading practices can be dealt with "jurisdictionally."

In addition, Mr. Giancarlo indicated that swaps reforms aimed at addressing systematic risks should seek a "strong degree" of comparability. According to the CFTC Chairman, "with respect to swaps reforms designed to mitigate systematic risk, the CFTC's jurisdiction should continue to apply cross-border to US firms on an 'entity' basis, with the availability of substituted compliance for non-US jurisdictions that have implemented comparable reforms for system risk mitigation." Mr. Giancarlo cautioned that the United States should operate on the basis of "comity" not "uniformity."

Mr. Giancarlo indicated, however, that the United States should be a "rule maker" as it relates to US markets and participants, and that non-US regulators should defer to US regulation of its own markets. However, the CFTC should defer to comparable swaps reforms in non-US markets applying a "flexible, outcomes-based approach for substituted compliance" rather than requiring a "granular, rule-by-rule comparison."

Mr. Giancarlo indicated his specific proposals will be published in a white paper in the near future.

Legal Weeds: In December 2013, three financial markets industry organizations asked a US federal court in the District of Columbia to set aside the CFTC's Cross-Border Guidance and subsequent advisories related to the handling of participants and transactions involved in the global swaps markets. The plaintiffs alleged that the CFTC endeavored to masquerade what really were "rules" by calling them "guidance" in order to avoid strict legal requirements related to the promulgation of

new rules, including, among other matters, adequately evaluating the proposed rules' prospective costs and benefits.

The three industry organizations were the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association and the Institute of International Bankers.

In September 2014, the court dismissed the industry organization's lawsuit claiming that the relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act on which the CFTC based its guidance applied extraterritorially when swaps activity outside the United States had a "direct and significant connection" with US commerce stood independently "without the need for implementing regulations." As a result, the court said, theCFTC was not required to issue *any* guidance (let alone binding rule) regarding its intended enforcement policies. Indeed, "[t]he CFTC's decision to provide such a non-binding policy statement benefits market participants and cannot now, all other things being equal, be turned against it." (Click here for background on the initial industry organization lawsuit and court decision in the article "Federal Court Tosses Out Challenges to CFTC Cross-Border Guidance and Policy Statement" in the September 16, 2014 edition of *Between Bridges*.)

- **CFTC Tells Appeals Court That California District Court's Legal Rationale to Dismiss Complaint Against Precious Metal Dealer Was "Deeply Flawed"**: The Commodity Futures Trading Commission filed a brief in the federal appeals court in California hearing its appeal of the dismissal of its enforcement action against Monex Deposit Company and other defendants for alleged fraud in connection with their financed sale of precious metals to retail persons by a federal district court in May 2018. The CFTC argued that the district court's ruling was in error and "based on two deeply flawed and counter-textual interpretations" of relevant provisions of applicable law.

The federal district court had held that:

1. the CFTC cannot use the prohibition against persons engaging in any manipulative or deceptive device or contrivance in connection with the sale of any commodity in interstate commerce enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act to prosecute acts of purported fraud except in instances of fraud-based market manipulation; and
2. actual delivery of precious metals in financed transactions to retail persons falls outside the CFTC's authority when ownership of real metals is legally transferred to such persons within 28 days even if the seller retains control over the commodities because of the financing beyond 28 days.

(Click here for further background on the district court's dismissal in the article "California Federal Court Dismissal of CFTC Monex Enforcement Action Upsets Stable Legal Theories" in the May 6, 2018 edition of *Bridging the Week*.)

In its brief to the appeals court, the CFTC expressed its disagreement with the district court's rationale.

First, the CFTC argued that the relevant law's prohibition against "any manipulative

or deceptive device" is unambiguous. (Click here to access § 6(c)(1) of the Commodity Exchange Act, 7 U.S.C. § 9(1).) The CFTC claimed that "or" means that the test is disjunctive. Moreover, as evidenced in legislative history, the CEA provision borrowed language from the Securities Exchange Act's equivalent provision, § 10(b) (15 U.S.C. § 78j(b); click here to access), and Congress intended that the CFTC's new authority would be applied "in a similar manner" as the long-standing securities provision – namely, disjunctively.

Second, the CFTC said that, since the term "actual delivery" is not defined in the CEA, its ordinary meaning must apply. This would require the formal transferring of something, which did not occur by Monex, claimed the CFTC. Monex solely held an amount of metal equivalent to its obligations to all its customers, but controlled the metal at all times. Its customers only had book entries, said the Commission. As a result, the statutory requirements for "actual delivery" were not met.

Monex is required to file its answering brief by October 4.

(Click here for additional details on the CFTC enforcement action against Monex in the article "Retail Metals Dealer and Principals Sued by CFTC for Illegal Transactions and Fraud" in the September 10, 2017 edition of *Bridging the Week*.)

Legal Weeds: A federal court in Massachusetts is expected to rule soon on a motion to dismiss made by Randall Crater and the relief defendants in the CFTC's *My Big Coin Pay, Inc.* enforcement action filed earlier this year. In that action, the CFTC claimed that My Big Coin Pay, Inc. and two persons closely involved with the company – Mr. Crater and Mark Gillespie – allegedly engaged in a virtual currency scheme that misappropriated approximately US $6 million from 28 or more persons from at least January 2014 through January 2018. (Click here for background in the article "CFTC Sues Unregistered Company and Promoters of Fake Virtual Coin for Alleged Fraud and Operating Purported Ponzi Scheme" in the January 28, 2018 edition of *Bridging the Week*.)

Mr. Crater and the relief defendants argued in papers to support a motion to dismiss that the CFTC has no jurisdiction to bring its enforcement action alleging fraud in connection with the sale of the virtual currency known as "My Big Coin," because the virtual currency was not a commodity under applicable law. This is because, said the defendants, the virtual currency was neither a good nor an article, nor a service, right or interest in which contracts for future delivery are dealt in. If My Big Coin is not a commodity, the CFTC had no authority to prosecute a fraud case against them under applicable law, claimed the defendants.

Moreover, as did Monex, the defendants argued that the CFTC had no standing to bring a general anti-fraud case against them relying on a fraud-based manipulation prohibition adopted as part of Dodd-Frank.

The CFTC disagreed with the defendants' legal arguments, claiming that My Big Coin was either a good or an article, and thus a commodity, or in the alternative was a category of virtual currencies, like Bitcoin, for which futures contracts currently exist. In addition, the CFTC said that the reasoning of the *Monex* decision was flawed. The Commission claimed that the relevant law prohibited "any manipulative or deceptive device" (emphasis added), and rejected the federal court's

view that “or” should be read as “and.”

More Briefly:

- **US-Based Subsidiary of Foreign Bank Agrees to Pay US $90 Million to Resolve Charges of Attempting to Manipulate ISDAFIX Benchmark**: BNP Paribas Securities Corp. agreed to resolve charges brought by the Commodity Futures Trading Commission that, on multiple occasions from approximately May 2007 through at least August 2017, it attempted to manipulate the USD ISDAFIX – the then-leading global benchmark referenced in many interest rate swaps products. According to the CFTC, the firm engaged in attempted manipulation through trading activities or false submissions that contributed to each day’s “fix” price. The problematic conduct – that the CFTC claimed was engaged in by some BNPP traders and supervisors – was meant to benefit derivatives positions held by BNPP. BNPP agreed to pay a fine of US $90 million to resolve the CFTC’s action. The CFTC acknowledged BNPP’s cooperation in accepting its offer of settlement.
- **FINRA Implements Revised Qualification Examinations October 1**: The Financial Industry Regulatory Authority’s new licensing regime for individuals and corresponding revised fee schedules will go into effect on October 1. Generally, under FINRA’s new qualification examination program, prospective registrants must first take and pass a Securities Industry Essentials examination and then take representative and supervisor qualification examinations, as relevant to the person’s role. (Click here for additional background in the article “FINRA Proposes Comprehensive Overhaul of Competency Testing Requirements” in the March 12, 2017 edition of *Bridging the Week*.)
- **SEC Contemplates Further Delays in CAT Rollout**: The Securities and Exchange Commission effectively accepted that rollout of Phase 1 of the Consolidated Audit Trail (“CAT”) – which will entail only self-regulatory organizations reporting of equities transactions – will not begin until November 15, 2018. Large broker-dealer reporting of equities transactions will commence on November 15, 2019, while all aspects of small broker reporting will begin on November 15, 2022. Last year SEC Chairman Jay Clayton formally declined to extend initial deadline dates for CAT rollout. (Click here for details in the article “SEC Chairman Denies Request to Formally Delay First Phase of CAT Rollout” in the November 19, 2017 edition of *Bridging the Week*.)
- **New SEC and CFTC Commissioners Confirmed**: Last week, Dan Berkovitz, previously General Counsel of the Commodity Futures Trading Commission and a Democrat, was sworn in as a CFTC commissioner, after his formal Senate approval. Dawn Stump was also approved by the Senate as a CFTC commissioner, and Elad Roisman as a Securities and Exchange Commission commissioner. Mr. Berkovitz served as CFTC General Counsel from 2009 to 2013. Both Ms. Stump and Mr. Roisman are Republicans.
- **SEC Suspends Trading of Two Cryptocurrency Notes**: The Securities and Exchange Commission suspended the trading of two cryptocurrency notes, Bitcoin Tracker One (Symbol: CXBTF) and Ether Tracker One (Symbol: CETHF). The SEC said it suspended trading because of "confusion amongst market participants regarding these instruents." Trading in both securities was suspended as of 5:30 pm ET on September 9 until at least 11:59 pm ET on

September 20.