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Bridging the Week by Gary DeWaal: July 15 – 19, and July 22, 2019 (Misvaluations for Higher Bonus; Failure to Supervise; New Eligible Block Trade Participants)

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Bridging the Week

- Criminal Law / Business Crimes
- Financial Institutions & Banking
- Securities & SEC

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The Commodity Futures Trading Commission and the Securities and Exchange Commission brought separate enforcement actions against the portfolio manager of a hedge fund for mismarking valuations of interest rate swaps in order to gain a higher bonus. In doing so, the CFTC relied on a controversial provision of law currently under attack in a federal appeals court in California. Separately, two principals of an introducing broker and two futures commission merchants settled charges brought by the CFTC related to the IB's placement of orders for certain customer, proprietary and discretionary accounts. The FCMs were charged with failure to supervise. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Ex-Portfolio Manager for Commodity Pool Operator and Investment Advisor Charged by CFTC and SEC for Mismarking Swaps for Bigger Bonus ;

- Improper Bunched Orders and Unauthorized Trading Prompt CFTC Enforcement

Action Against Introducing Broker and Two Futures Brokers ;

- ICE Futures U.S. Proposes To Chip Off the Old Block Trade Eligibility Restrictions ;

- Libra Not Free From Attack by Treasury Secretary and Before House Committee on Financial Services; and more.

Article Version:

Briefly:

- **Ex-Portfolio Manager for Commodity Pool Operator and Investment Advisor Charged by CFTC and SEC for Mismarking Swaps for Bigger Bonus**: Swapnil Rege, a former portfolio manager with Marinus Capital Advisors LLC, settled charges with both the Commodity Futures Trading Commission and the Securities and Exchange Commission for mismarking valuations of certain interest rate swaps from approximately June 2016 through April 2017 in order to increase his performance bonus.

- At the relevant time, Marinus was registered as a commodity pool operator with the CFTC and as an investment advisor with the SEC. After Marinus recognized Mr. Rege's purported wrongful conduct, the firm liquidated its funds, fired Mr. Rege, and reimbursed excessive fund management fees which had been assessed based on the inflated profits.

  Both the CFTC and SEC alleged that Mr. Rege achieved his purported subterfuge by manipulating an internal valuation tool used by Marinus to assess swaps and swaptions values, such that swaps with substantially identical and offsetting terms would show a fictitious profit rather than be valued at an equal and offsetting amount. As a result, said the SEC, account statements provided to customers reflected overstated returns.

  The SEC claimed that, because of Mr. Rege's inflated valuations, his portfolio showed gains of more than US $44 million for 2016, and he was paid a bonus of US $600,000 at year-end out of a total projected earned bonus of US $3.6 million. Mr. Rege was never paid the additional US $3 million.

  According to the SEC, in early January 2017, Marinus's chief executive officer recognized that Mr. Rege was not consistently using default settings in the firm's valuation tool and required him to exit certain positions. In response, Mr. Rege advised the CEO that his valuation methodology was consistent with industry practice and would be supported by industry quotes. To support his cover-up, Mr. Rege purportedly asked opposite-side brokers to provide quotes based on assumptions he articulated in order to match doctored prices in his portfolio. Mr. Rege then misled his employer by showing these quotes only after redacting the portions of the communication that detailed the underlying assumptions. Mr. Rege also allegedly entered into numerous new and deceptive trades to hide the fact that he could not exit the identified positions at their stated valuation.

The CFTC charged Mr. Rege with engaging in a manipulative or deceptive device or contrivance in violation of applicable law and a CFTC rule. (Click here to access 7 U.S.C. § 9(1) and here to view CFTC Rule 180.1.) The SEC charged Mr. Rege with aiding and abetting equivalent violations under applicable securities laws by Marinus, which itself was not charged by the SEC or CFTC. (Click here to access the 15 U.S.C. § 80b-6 (1-2 and 4).)

To resolve the two enforcement actions, Mr. Rege agreed to pay a fine of US $100,000 to the CFTC, US $100,000 to the SEC, and disgorge profits of US $600,000 along with prejudgment interest of almost US $50,000, as well as other sanctions.

Legal Weeds: Although the CFTC charged Mr. Rege with a provision of law that was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a California federal district court held in May 2018 that the relevant statute – which prohibits "any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the CFTC shall promulgate"– only applies in instances of fraud-based market manipulation and not fraudulent conduct alone. The court took this view based on its reading of "or" in the statute as meaning "and" which it said was supported by the Congressional dialogue leading to the adoption of the relevant provision. The CFTC appealed the district court's decision containing this conclusion, and the case is now pending at the US Court of Appeals for the Ninth Circuit in San Francisco (Click here for background in the article "Expedited Federal Court of Appeals Review of Monex Lower Court Decision Requested by CFTC" in the June 24, 2018 edition of *Bridging the Week*.)

Last week the CFTC filed a supplemental letter in connection with its appeal, advising the court that, on July 17, 2019, a federal district court in Georgia rejected the defendants' argument in an unrelated CFTC enforcement action that the identical law at issue only prohibits fraud-based manipulation and not fraud alone. (Click here to access the Order in *CFTC v. Ronald Montano et al.*, 6:18-cv-1607.) According to the CFTC, the Georgia court was the sixth court to hold that "manipulative or deceptive" in the relevant law does not mean "manipulative and deceptive" – contrary to the view of the California federal district court. (Click here to access the CFTC's supplemental letter.)

- **Improper Bunched Orders and Unauthorized Trading Prompt CFTC Enforcement Action Against Introducing Broker and Two Futures Brokers:** Two principals of an unincorporated introducing broker, and two futures commission merchants that guaranteed the introducing broker resolved charges brought by the Commodity Futures Trading Commission related to the IB's purported improper placement of bunched trades containing both customer and proprietary orders and trading for customers without obtaining powers of attorney or specific authorizations from customers.

- According to the CFTC, from approximately January 1, 2014, through September 24, 2017, William Katzelis and Shahin Maleki (d/b/a Essex Futures) routinely submitted bunched orders for post-trade allocation that contained both customer and proprietary orders as well as discretionary and nondiscretionary customer orders. After the orders were executed, the IB would provide the relevant FCM with post-trade fill instructions for the proprietary accounts, the discretionary customer accounts and the nondiscretionary customer accounts.

However, charged the CFTC, an IB cannot place both proprietary and customer orders executable at or near a market price at the same time. (Click here to access CFTC Rule 155.4(a)(1).) Moreover, said the CFTC, an IB cannot place a trade for a customer unless it is either specifically authorized by the client with exact order parameters or unless the client has provided written power of attorney authorizing discretionary trading. (Click here to access CFTC Rule 166.2.) The CFTC charged that Essex placed orders for customers without satisfying either requirement.

The CFTC also claimed that, during the relevant time, Essex through its principals failed to prepare and maintain required records of futures transactions, failed to notify the National Futures Association of the termination of certain associated persons within 30 days as mandated by a CFTC rule (click here to access CFTC Rule 3.31(c)(1)(ii)), and failed to supervise its employees and agents. (Click here to view CFTC Rule 166.3.) The IB was not charged with making fraudulent allocations.

Both Vision Financial Markets LLC and ADM Investor Services Inc. were also charged with failure to supervise by the CFTC for their handling of Essex's combined orders for proprietary and customer accounts, and discretionary and nondiscretionary trades. The CFTC claimed that both firms failed to react adequately to red flags of Essex's purported wrongful conduct.

The CFTC said that Vision, which guaranteed Essex from January 1 through November 30, 2014, should have been aware that Essex was illicitly combining proprietary and customer accounts in the same orders, from fill instructions received after the orders were filled. The CFTC implied that Vision should have recognized that Essex was not obtaining specific customer authorization for trades when it noted during an audit of the guaranteed IB during July 2014 that customer order tickets reflected identical time stamps for the time of order receipt and time of order placement. Essex also informed Vision during October 2014 that it did not contain specific customer authorization when it cancelled and replaced orders on certain customers' behalf.

Likewise, the CFTC said that ADM, which guaranteed Essex from December 1, 2014, through September 24, 2017, warned Essex not to combine proprietary and customer accounts in the same order after it became aware of such practice on December 4, 2014. Notwithstanding, ADM continued to process post-trade allocations of bunched orders to proprietary and customer accounts by Essex during the relevant period. The CFTC claimed that ADM should have recognized Essex's improper handling of customer orders because (1) it was also aware of the July 2014 Vision audit of Essex that raised concerns regarding possible unauthorized trading; (2) it later hired the ex-Vision auditor who conducted the Essex inspection who raised concerns about the IB directly to ADM's management; and (3) in March 2015, it conducted an audit of Essex that raised independent concerns about the IB's unauthorized trading.

To resolve the CFTC's complaints, Mr. Katzelis and Mr. Maleki agreed to jointly and severally pay a fine of US $500,000 and other sanctions, while ADM agreed to pay a fine of US $250,000 and Vision, $200,000.

Legal Weeds/My View: The CFTC supported its claim that Vision and ADM failed to supervise Essex's wrongful handling of bunch trades citing a CFTC regulation dealing with the post-execution allocation of bunched orders. (Click here to access the relevant CFTC regulation, Rule 1.35(b)(5).) The CFTC claimed that this rule places an "an affirmative obligation on FCMs to monitor for unusual or suspicious activity and to make a reasonable inquiry if an FCM has actual or constructive knowledge of red flags indicating a likelihood of such activity." However, there is no such express requirement in the relevant rule. The only two requirements on FCMs in the relevant provision (unless they are the eligible account manager engaging in the allocation) are (1) to maintain records to identify each order and account subject to a post-trade allocation and (2) not to accept orders for post-trade allocation from an eligible account manager if the CFTC advises it accordingly.

That being said, under guidance of the National Futures Association, FCMs have an express, affirmative obligation to take "appropriate action" if they have actual or constructive knowledge that allocations for its customers are fraudulent. (Click here to access NFA Interpretive Notice 9029 to Compliance Rule 2-10.) The CFTC acknowledged this NFA guidance in the 2013 *Federal Register* release where the CFTC adopted its amended bunch order rule. (Click here to access 68 Fed. Reg 34,790, 34,792 (June 11, 2003).) However, given that the CFTC did not charge Essex with fraudulent allocations, even this NFA interpretive notice does not appear applicable in the instant situation.

However, because Essex was a guaranteed introducing broker of ADM and Vision, the FCMs agreed to be jointly and severally liable with the firm for its principal law and rule violations under express terms of a CFTC-required guarantee agreement. (Click here to access a form of guarantee. Click here to access CFTC Rule 1.17(a)(2)(ii).) Curiously, in proceeding against ADM and Vision, the CFTC did not invoke this agreement as the basis for the firms' liability. All the CFTC claimed was that the firms "failed to supervise."

The CFTC should not impose obligations on registrants through enforcement actions that are not expressly mandated by regulation by expansion of its amorphous "failure to supervise" requirement — particularly when more viable alternative theories are potentially available. Otherwise, firms have no way to assess in advance what conduct might make them subject to costly enforcement entanglements. Rule making should solely be a product of a formal CFTC proposal and public dialogue, consistent with terms of the Administrative Procedure Act, and not through application of enforcement blind man's bluff (click here to access 5 U.S.C, §§ 551- 559).

- **ICE Futures U.S. Proposes To Chip Off the Old Block Trade Eligibility Restrictions**: ICE Futures U.S. proposed to amend its block trade rule and Block Trade FAQs to authorize additional persons beyond eligible contract participants to engage in block trades. (Click here to access IFUS Rule 4.07, and here to access IFUS's Block Trade FAQs.) Currently only ECPs are permitted to engage in block trades on IFUS.

- Under IFUS's proposed amended rule and guidance, all non-US persons would be eligible to execute block trades without regard to any specific income, asset, portfolio or other requirement. This would include non-US natural persons and corporations, among other persons.

  Additionally, IFUS proposed that any person (including US persons) which met both one of three financial requirements and one of three portfolio requirements could also enter into block trades. The financial requirements include a corporation with total assets in excess of US $5 million (without regard to liabilities); a natural person with net worth in excess of US $1 million; and a natural person with income of US $200,000 (or US $300,000 if joint with spouse) during each of the prior two years with a reasonable expectation of earning the same during the current year.

  The portfolio tests are that the trader owns at least US $2 million of securities and other investments; had on deposit with the FCM during the six months prior to the first block trade at least US $200,000 in initial margin and options premium; or meets a combination of the two prior tests in accordance with a formula set forth by IFUS.

  According to IFUS in a submission to the Commodity Futures Trading Comission, it is proposing amendments to its block trade eligibility requirements because the current ECP standard "...is inappropriate and excludes qualified traders and investors from participating in this important trade type. This is particularly true in light of the globalization of futures markets."

  A clearing member will be obligated to exercise due diligence to determine that a customer is eligible to engage in a block trade in accordance with IFUS's proposed rule amendments.

  Compliance Weeds/My View: Traditionally, block trades – a form of permitted off-exchange, noncompetitive trade – have only been authorized on US-derivatives exchanges' products for eligible contract participants, as such term is defined by CFTC rule. (Click here to access 7 U.S.C. § 1a(18); see IFUS Block Trade – FAQs (No. 3); and click here for the applicable CME Group Block Trades Market Regulation Advisory Notice (see No. 2).)

  If IFUS's rule is adopted as proposed, FCMs will have to determine whether to amend their procedures (and compliance manuals) to accommodate the new authority, including adding processes to satisfy IFUS's obligation that they exercise "due diligence" to assess customers' qualifications. It will also be interesting to see if other derivatives exchanges follow suit.

More Briefly:

- **Prearranged, Block and Disruptive Trades Among Subjects of CME Group Disciplinary Actions**: CME Group exchanges resolved multiple disciplinary actions alleging violations of rules pertaining to prearranged transactions, block trades, disruptive practices and position limits.
- In one action, Larry Johnson agreed to pay a fine of US $50,000 to the Chicago

Mercantile Exchange and be suspended from access to all CME Group exchanges for 10 business days for prearranging trades on one day. Purportedly, he engaged in such conduct to transfer equity between two accounts he controlled to reduce maintenance margin requirements.

Separately, Weifeng Wang was charged by the New York Mercantile Exchange with, on multiple occasions, entering into hedges of proposed block trades after being solicited to engage in such transactions by a customer but prior to consummating such trades with the customer. By doing so, claimed the NYMEX business conduct committee, Mr. Wang was able to guarantee his employer a profit when he subsequently entered into the block trade with the customer. Mr. Wang settled this transaction by consenting to payment of a fine of US $19,000 and a five-business-day all CME Group exchanges access prohibition.

Finally, Phil Ferguson agreed to pay a fine of US $5,000 to CME and be suspended from accessing all CME Group markets for four months for engaging in spoofing-type trading on "several occasions" from June 22 through October 11, 2017, while David Thompson agreed to pay a fine of US $23,000 for violating Chicago Board of Trade position limits on one day.

- **Cooperate Extraordinarily, Says FINRA, and Benefit and Don't Forget TRACE Reporting Obligations**: The Financial Industry Regulatory Authority issued revised guidance reminding members that extraordinary cooperation could potentially result in no enforcement action, solely a cautionary letter, or an enforcement action but a reduced fine. Typically, assistance qualifying as extraordinary cooperation must exceed mandatory disclosure required by an express FINRA rule (click here to access FINRA Rule 4530). In considering whether extraordinary cooperation has occurred, FINRA will consider steps taken by the member to correct deficient procedures and systems, including the use of independent consultants; restitution to customers; voluntary self-reporting of violations beyond what is required by law or rule; and assistance given to FINRA during an investigation beyond what is solely requested. FINRA last discussed the elements of extraordinary cooperation in a 2008 guidance (click here to access).
- Separately, FINRA reminded members to have in place systems or processes to determine whether a security is a TRACE-eligible security (typically fixed income securities) and therefore reportable, even if the security involved in a transaction may not be on a TRACE-security master list. (Click here to access the definition of a TRACE-eligible security in FINRA Rule 6710.) FINRA expressed concern that "0verreliance" on lists "has resulted in firms failing to meet their TRACE trade reporting obligations when they transact in a security that is not active in the TRACE system." Under TRACE—FINRA's trade reporting and compliance engine—broker-dealers must report transactions of TRACE-eligible securities within certain time frames (typically 15 minutes; click here for precise time frames). This information is then generally made available to the public.
- **Trader Pleads Guilty in Online Broker Account Hacking Scheme**: Joseph Willner pleaded guilty to a November 2017 indictment claiming that, from September 2014 through May 2017, he engaged in hacking and securities fraud

to illicitly profit from trading in certain securities. According to the indictment, Mr. Willner hacked into at least 50 online customer brokerage accounts where he purchased securities without the customers' consent. Mr. Willner then traded opposite the hacked customer accounts to achieve profits in his own account. Mr. Willner faces up to five years of imprisonment for his offense. (Click here for background in the article "SEC Charges Day-Trader With Unauthorized Trading in Illicitly Accessed Accounts to Inflate Market Prices" in the November 12, 2017 edition of *Bridging the Week*.)

Follow-up:

- **Libra Not Free From Attack by Treasury Secretary and Before House Committee on Financial Services**: Facebook's Libra initiative was significantly attacked last week in a speech by Steven Mnuchin, Secretary of the Treasury, and during a hearing before the US House of Representatives Committee on Financial Services.

- In a White House briefing on July 15, Mr. Mnuchin expressed "serious concerns" that, as proposed, Libra could be "misused by money launderers and terrorist financiers" and said that the Financial Crimes Enforcement Network would hold any entity that deals in any cryptocurrency, including Libra, "to its highest standards." He specifically referenced President Trump's recent characterization of bitcoin as "based on thin air" and noted Treasury's commitment to ensure that the US financial system "is protected from fraud."

  Separately, the House Committee on Financial Services held a hearing on Libra on July 17. During the session, David Marcus, head of Calibra at Facebook, defended the company's initiative, noting that not only would the Libra Association – the independent member organization proposed to oversee the Libra blockchain and the Libra reserve – be regulated by Switzerland's Financial Markets Supervisory Authority, but it intended to register with FinCEN as a money service business. Additionally, Calibra – a Facebook subsidiary that intends to provide financial services using the Libra blockchain, including to introduce a digital wallet for Libra – will register as a money transmitter with state regulators and be subject to oversight by the Federal Trade Commission and the Consumer Financial Protection Bureau for consumer protection and data privacy and security issues. As a result, claimed Mr. Marcus, the Libra Association and Calibra would both be subject to anti-money laundering and Combatting the Financing of Terrorist requirements.

  Notwithstanding, numerous industry persons and Committee members criticized the Facebook initiative. (Click here to access a video of the Committee's hearing.) Among other persons, Chris Brummer, Professor of Law and Georgetown University Law Center claimed that the Libra white paper is "peppered with big promises and few details and the project … involves risks to purchasers (and, at least potentially, the financial system) that are not disclosed. Most fundamentally, he claimed, the Libra white paper does not disclose that persons could lose money on their Libra holdings and are exposed to counterparty risk "in the form of mismanagement of reserve requirements." Multiple speakers, including Gary Gensler, former chairman of the Commodity

Futures Trading Commission, argued that elements of Libra and the Libra Reserve invoked securities laws for, among other reasons, being based on a pooled investment, and that despite assurances by Mr. Marcus, may introduce systemic risks, as well as money laundering and data privacy concerns.

During its hearing, the Committee also discussed a proposed law that would preclude Facebook from being licensed as a US financial institution or from operating a virtual currency.

As described in a June 2019 white paper, the goal of Libra is to create a secure, scalable blockchain and global virtual currency to help individuals currently outside the financial system benefit from an efficient payment system and to help reduce payment transaction costs for others. Libra is intended to function as global money in the form of a non-government-issued stablecoin backed by a reserve basket of "low volatility assets" including bank deposits and short-term government securities representing multiple international currencies "from stable and reputable central banks." Facebook intends to play a principal role in developing Libra through 2019, and then turn its administration over to the Libra Association. (Click here for details in the My View section to the article "Global AML Standards Setter Says Countries Should Require Virtual Asset Service Providers to Obtain and Transmit Certain Information Regarding Senders and Recipients for All Virtual Asset Transfers" in the June 23, 2018 edition of *Bridging the Week*.)

In other legal and regulatory developments regarding cryptoassets:

- **SeedCX Sprouts Two BitLicenses**: The New York State Department of Financial Services granted two additional BitLicenses to affiliated companies – Seed Digital Commodities Market LLC ("SCXM") and Zero Hash LLC; Zero Hash was also approved as a New York money transmitter. According to NYDFS, SCXM will operated as a matching engine for cryptocurrency trading, while Zero Hash will serve as the money transmitter resulting from the trading activity.
- **FINRA to Members – One More Time, Tell Us About Your and Your Affiliates' Crypto Activities**: The Financial Industry Regulatory Authority encouraged firms to continue advising their regulator coordinators if they, their associated persons or their affiliates engage in activities related to digital assets, including non-securities. Previously, FINRA requested such information through July 31, 2019; it now requests such activities through July 31, 2020. (Click here for background in the article "FINRA Asks Members to Volunteer Information Regarding Crypto-Asset Activity" in the July 15, 2018, edition of *Bridging the Week*.)
- **Memory Lane**: To capitalize on growing interest in so-called "world commodities" – gold, silver, platinum, copper, coffee, cocoa and sugar – in the early 1970s, some American firms realized a gap in then-existing law that solely regulated certain enumerated domestic agricultural commodities, and did not prohibit options on world commodities. As a result, the firms marketed such options to US persons without any regulatory protections. The result was catastrophic: there were numerous circumstances of fraudulent sales and some options grantors went bankrupt, leaving options purchasers with large losses.

In response and for additional reasons, in 1974 Congress amended the applicable law (the Commodity Exchange Act), and created the Commodity Futures Trading Commission. The new law extended coverage of the applicable law to a broad definition of commodities, and the CFTC was granted exclusive jurisdiction over all futures trading involving commodities as well as plenary authority to regulate the offer and sale of options on commodities.

Once it began operations in 1975, the CFTC began an aggressive enforcement regime against fraudulent options sellers, obtaining 55 injunctions against such firms and persons through 1977. However, the CFTC believed it was overmatched and did not have sufficient resources to fully and effectively combat fraud by options sellers, and after public hearings, put in place a suspension on most commodity option transactions effective June 1, 1978. Congress ratified this ban in September 1978, permitting the CFTC to lift its prohibition upon development of a program to regulate commodity options effectively.

In response, the CFTC approved a three-year pilot program to permit exchange-traded options on futures in 1981, and in August 1982, the CFTC approved the first options contracts under this program.

Today, options on commodities are routinely and legally traded on US and non-US exchanges (as well as over-the-counter) and accessible by all US persons including hedgers and speculators. Concerns of the late 1970s have long been forgotten and folks learning about the commodity options ban are incredulous. What seemed very disruptive and scary then is mainstream now.

(Click here for an overview of the history of early regulation of commodity options in the United States in the article "The Regulation of commodity Options" by Robert Lower, 1978 Duke Law Review, Number 5 (pgs. 1095 - 1145).)

Correction: An early edition of this article incorrectly reflected the date of the commodity options ban enacted by Congress as September 2018. It was September 1978.

- **US Futures Exchanges' SRO Organization Follows CFTC Lead and Authorizes Futures Brokers to Potentially Treat Separate Accounts of One Person as Accounts of Separate Entities for Disbursement Purposes**: The Joint Audit Committee of US futures exchanges and regulatory organizations published a Regulatory Alert noting the recent CFTC advisory authorizing derivatives clearing organizations to permit their FCM clearing members carrying multiple accounts for the same beneficial owner to treat each account as an account of a separate entity for purposes of disbursements under ordinary circumstances, subject to conditions. (Click here for background in the article "One + One No Longer Equals One – CFTC Staff Offers Path for FCMs to Treat Separate Accounts of Single Customer as Separate Accounts of Distinct Entities" in the July 14, 2019 edition of *Bridging the Week*.) Previously, the JAC issued a reminder to FCMs mandating aggregation of all accounts of the same beneficial owner for the same regulatory account classification (e.g., customer segregated, customer secured and cleared swaps customer) for margin purposes (click here to access JAC Regulatory Alert 14-03). JAC's new Regulatory Alert supersedes the prior reminder.

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