Monday, December 21, 2015

The Commodity Futures Trading Commission issued a host of year-end final and proposed rules, including a final rule on uncleared margin for swaps and proposed rules aimed at enhancing cybersecurity at designated contract markets, swap execution facilities, derivatives clearing organizations and swap data repositories. Separately, CME Group and ICE Futures U.S. publicized multiple disciplinary actions touching upon a myriad of alleged rule violations—from improper exchange for related position transactions, forbidden pre-hedging of block trades, a position limit violation, wash sales and various other trade practice violations. As a result, the following matters are covered in this week’s edition of Bridging the Week – the last edition for 2015:

- Bah Humbug—CME Group Fines Firms for Inadequate Documentation of EFRPs; Additional Firms Cited for Pre-Hedging Block Trades and Other Violations by CME Group and IFUS (includes Compliance Weeds);

- Global Food Merchant’s Motion to Dismiss CFTC’s Enforcement Action for Alleged Manipulation Denied;

- Swap Dealers Given Initial Margin Requirement Break for Intra-Affiliate Transactions Under CFTC Final Margin Rule;

- Bank Sanctioned US $307 Million by CFTC and SEC for Alleged Conflicts of Interest in Investing Clients’ Funds;

- Broker-Dealer Fined US $1.25 Million for Not Fingerprinting Non-Registered Employees;

- CFTC Proposes Enhanced Cybersecurity Rules for Exchanges, Clearing Houses and Data Repositories (includes Compliance Weeds);

- CME Group Amends Clearing Member Audit Trail Retention Requirements for Direct Access Clients—or Does It? (includes My View);

- Swap Dealers and MSPs Reminded by CFTC Staff to Report Uncleared Swaps Timely and Accurately—or Else (includes Compliance Weeds); and more.
Bah Humbug—CME Group Fines Firms for Inadequate Documentation of EFRPs; Additional Firms Cited for Pre-Hedging Block Trades and Other Violations by CME Group and IFUS

Chicago Mercantile Exchange Group exchanges and ICE Futures U.S. brought and, in all but one case, voluntarily settled 19 disciplinary actions charging a myriad of alleged rule violations—from improper exchange for related position transactions, forbidden pre-hedging of block trades, a position limit violation, wash sales and various other trade practice violations.

The Chicago Mercantile Exchange charged five firms with engaging in so-called “transitory” exchange for related position transactions involving foreign exchange products. CME claimed that none of the firms’ transactions included documentation of the corresponding cash positions and thus were not “bona fide.” The firms included three non-CME member firms—FTC Capital, GMBH, Jamison Capital Partners LP, and TMS Capital Ltd.—and two member firms—Macquarie Equities Ltd. and Newedge USA, LLC. Newedge and TMS were each subject to two disciplinary actions. Fines for the seven disciplinary actions—which were all voluntarily settled—ranged from US $7,500 to US $60,000.

Similarly, the New York Mercantile Exchange charged four firms with engaging in EFRP transactions without a transfer of ownership of the cash commodity underlying the exchange contract, a related product or an over-the-counter instrument. Because there was no such transfer, the EFRP transactions were not “bona-fide” said NYMEX. All four firms—GDF Suez Trading, MCE Ltd, Petco Trading Labuan Co. Ltd., and Sinopec (Hong Kong) Petroleum Company Limited, were non-members. To resolve these matters, the firms agreed to pay fines from US $15,000 to US $30,000.

Two firms—NIC Holding Corp., a NYMEX member firm, and Standard Americas Inc., a Commodity Exchange, Inc. non-member—were charged by CME Group exchanges with pre-hedging block trades after receiving solicitations for such trades, but before consummation. As a result, claimed the exchanges, the firms were able to lock in profits. To resolve these matters, each firm agreed to disgorge its profit on the relevant transactions and pay a separate fine. NIC consented to pay a fine of US $75,000 and disgorge profits of $114,060, while Standard Americas agreed to pay a fine US $65,320 and disgorge profits of US $175,000.

Separately BTG Pactual Commodities (US) LLC, a NYMEX non-member, agreed to pay a fine of US $15,000 and disgorge profits of almost $65,000 to resolve NYMEX charges related to its alleged violation of a spot month position limit for a limited period on one day. Three COMEX non-members agreed to pay an aggregate fine of US $70,000 for engaging in a series of wash trades on two days in 2014 between accounts with the same beneficial owner. The non-members were Li Ji Liang, Guanchao Pang and Wellica International Trading Limited.

Fusion Asset Management LLP resolved charges brought by ICE Futures U.S. that its employees traded funds they managed opposite each other allegedly to move positions from one fund to another without using the exchange’s crossing functionality. IFUS acknowledged that “[n]o harm to any customer was…alleged [o]r proven.”
agreed to pay a fine of US $50,000 to resolve this matter.

Finally, an IFUS hearing panel entered a default judgment against Jude Sullivan. The exchange claimed that Mr. Sullivan, Mark Porter and Kevin Wicinski, all former floor brokers, may have violated exchange rules when Mr. Sullivan, between March and July 2011, withheld customer orders and engaged in several non-competitive transactions opposite Mr. Porter and Mr. Wicinski at favorable prices to them. The panel ordered Mr. Sullivan to pay restitution to the harmed customers of almost US $46,000 and banned him from trading IFUS products for two years. Mr. Wicinski and Mr. Sullivan agreed to resolve charges against them for IFUS trading bans of eight months and 12 months, respectively.

**Compliance Weeds:**

**EFRPs:**

A transitory exchange for related position is one where the execution of the EFRP is contingent—either by express agreement or otherwise—upon the execution of another EFRP or related position transaction, and where the combined transactions result in the offset of the related position without the parties incurring market risk. Prior to August 4, 2014, most transitory EFRPs on all CME Group exchanges were prohibited. However, there were exceptions for EFRPs involving foreign currency, metals and energy products. Beginning August 4, 2014, transitory EFRPs involving these products also were prohibited. However, “immediately offsetting” exchange for physical transactions (a type of EFRP transaction) were authorized for foreign currency, but:

the Exchange would expect to see confirmation statements issued by the bank/foreign exchange dealer party to the Transaction. These confirmation statements should be the type normally produced by the bank/foreign exchange dealer for confirmation of currency deals and should indicate, by name, the identity of the counter party principal to the Transaction.

CME Group explained that, immediately offsetting EFP transactions were not transitory because,

the offsetting physical transaction is not contingent on the EFP in any way. If, for example, the futures leg of an immediately offsetting EFP in foreign currency is not accepted for clearing, the futures transaction is void ab initio and the counterparties would be left with the stand-alone physical transaction.

(Click [here](#) for relevant CME Group advisory notice regarding EFRPs, including “immediately offsetting” EFPs. This MRAN includes CME Group Rule 538K.)

IFUS also permits immediately offsetting EFP transactions in foreign currency futures. (Click [here](#) for relevant IFUS FAQs regarding such transactions.)

Immediately offsetting EFPs are only available for foreign currency products on CME Group and IFUS.

Practically speaking, immediately offsetting EFP transactions involving foreign currency products achieve the same result as what were formerly transitory EFP transactions. However, documentation requirements are likely more complex for some traders, particularly involving managed accounts.

It is critical for parties always to ensure there is proof and/or relevant documents to support the related position component of any EFRP no matter what product. Relevant documents must be saved for at least five years.

**Block Trades:**

Once a party is solicited for a block trade, it cannot disclose the details of the solicitation to any other party except to facilitate the execution of the block trade. This ban is in effect until a public report of the block trade is made by the exchange.

Moreover, pre-hedging, anticipatory hedging or trading ahead of any portion of a block trade in the same product or a closely related product is prohibited following solicitation to participate in such transaction. Counterparties to the block trade, however, may initiate trades to hedge or offset the risk of a block trade as soon as they execute the trade, even before the public report of the trade by the exchange. A closely related product is one that is highly correlated, serves as a substitute for, or is the economic equivalent of the product subject to the block transaction.

(Click [here](#) to access the relevant CME Group Rule 526 and [here](#) to access the related advisory notice regarding block trades.)

**Briefly:**
Swap Dealers Given Initial Margin Requirement Break for Intra-Affiliate Transactions Under CFTC Final Margin Rule: The Commodity Futures Trading Commission approved final rules for uncleared swaps for Swap Dealers and Major Swap Participants. In general, in connection with each swap transaction, the rules require the two-way posting and collection of initial margin by SDs and MSPs that are not subject to oversight by prudential regulators (e.g., the Board of Governors of the Federal Reserve System)—so called “covered swap entities”—in swaps transactions with any registered SD or MSP and certain enumerated financial end users with so-called “material swaps exposure.” Initial margin will not be required for swap transactions between covered swap entities and commercial end users. The receiving party must segregate mandatory initial margin with a custodian that is not an affiliate. Variation margin requirements will differ depending on the types of counterparties. The CFTC rules generally follow rules recently adopted by US prudential regulators with one major exception: swaps between affiliated entities may not be subject to initial margin requirements under prescribed circumstances. In a dissenting statement to the release of the CFTC’s final rules, Commissioner Sharon Bowen objected to this difference claiming that, “[b]y not requiring the collection of interaffiliate initial margin … we lose a vital shock absorber that is intended to help immunize institutions and the system against the risk of default.” CFTC Chairman Timothy Massad defended the difference, arguing that “[i]mposing the same third-party transaction standards on these internal activities of consolidated entities is likely to significantly increase costs to end-users without any commensurate benefit.” The final rules will be effective April 1, 2016 but will be phased-in in stages, beginning September 1, 2016.

Global Food Merchant’s Motion to Dismiss CFTC’s Enforcement Action for Alleged Manipulation Denied: The US trial court handling the enforcement action by the Commodity Futures Trading Commission against Kraft Foods Group, Inc. and Mondelez Global LLC (collectively, “Kraft”) over Kraft’s alleged manipulation of wheat futures contracts in 2011, denied Kraft’s June 2015 motion to dismiss two counts of the case. The CFTC claimed in its initial enforcement action that wheat trades entered by Kraft for the alleged purpose of hedging were in fact initiated for the purpose of artificially lowering prices in the related cash market. This activity, claimed the CFTC, was a violation of federal law and the Commission’s rules. Kraft had sought to dismiss one count of the Commission’s complaint that relied on the CFTC’s recently gotten anti-manipulative or deceptive device or contrivance authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act claiming, “[a]t its core, the CFTC’s complaint accuses [the firms] of fraud and manipulation for seeking to purchase wheat at the best price it could in the face of difficult market conditions.” Additionally, Kraft said that the Commission’s claims under its traditional manipulative authority should also be dismissed because the CFTC failed to plead that the firms’ conduct caused an artificial price and they had the requisite specific intent. At the outset, the Court rejected the Commission’s claim that the CFTC’s new manipulative device authority creates two causes of actions—one for manipulation and one for fraud. The Court held this new authority only creates a cause for fraud, although the fraud could involve “fraudulent manipulation or misconduct in the marketplace.” Notwithstanding, the Court held that the CFTC satisfied its burden to plead (not at this stage, prove) fraudulent manipulative conduct by alleging “… what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed and what effect the scheme had on the market for the commodities at issue,” and that's Kraft purported conduct was either reckless or intentional. Likewise, the court claimed that the CFTC satisfied its pleading obligations to allege manipulation and attempted manipulation. (Click here for details.)

Bank Sanctioned US $307 Million by CFTC and SEC for Alleged Conflicts of Interest in Investing Clients’ Funds: The Commodity Futures Trading Commission and the Securities and Exchange Commission both filed and settled enforcement actions naming JPMorgan Chase Bank, N.A. over alleged non-disclosed conflicts of interest. The lawsuits were brought over JPMorgan’s alleged failure to notify clients of the bank’s wealth management business of its preference—because of economic incentives—to invest client funds in certain commodity pools, hedge funds and mutual funds managed and operated by an affiliate, or in similar third-party-managed vehicles that provided payments to the bank—termed “retrocessions.” The SEC action also named J.P. Morgan Securities LLC in connection with similar conduct for non-wealth management clients. J.P. Morgan resolved both actions by agreeing to pay an aggregate fine of US $167.5 million, disgorgement of US $127.5 million and almost US $12 million in prejudgment interest. The two agencies claimed that JPMorgan’s alleged wrongful conduct occurred from at least 2008 through January 2014, in connection with its proprietary funds, and from at least 2008 to August 2015, in connection with third-party entities. In connection with the SEC action, J.P. Morgan also agreed to take certain remedial actions, including providing notice to clients and prospective clients about the SEC’s proceedings. Separately, the SEC granted J.P. Morgan a waiver from an automatic prohibition to make certain private offerings going forward. This potential prohibition was triggered by the SEC’s enforcement action. As a condition for obtaining this waiver, J.P. Morgan additionally agreed to appoint an independent compliance consultant to conduct “a comprehensive review of the [Bank’s] policies and procedures relating to compliance [with its] … activities as an investment manager and placement agent to private funds.” Moreover, for five years, the consultant must prepare and certify an annual report to be provided to the
SEC for “public dissemination” regarding the firm’s compliance with its obligations regarding private offerings.

- **Broker-Dealer Fined US $1.25 Million for Not Fingerprinting Non-Registered Employees**: Merrill Lynch, Pierce, Fenner & Smith, Incorporated, agreed to pay a fine of US $1.25 million to the Financial Industry Regulatory Authority to resolve charges that it failed to fingerprint or properly screen 4,500 of persons associated with it (“associated persons”) from January 1, 2009 through October 28, 2013. According to FINRA, this oversight was attributable, in part, to Merrill’s acquisition by Bank of America Corporation on January 1, 2009. FINRA members are obligated to screen potential associated persons for potential statutory disqualifications under FINRA’s by-laws and rules (click here to access FINRA By-laws Article III, Section 3(b)) and to fingerprint potential associated persons under applicable federal law and SEC rule (click here to access SEC Rule 17f-2). Merrill was also charged with failing to have established and maintained an adequate supervisory system and not to have implemented and enforced written supervisory procedures reasonably designed to achieve compliance with the relevant securities laws and regulations.

- **CFTC Proposes Enhanced Cybersecurity Rules for Exchanges, Clearing Houses, and Data Repositories**: The Commodity Futures Trading Commission proposed rules aimed to enhance cybersecurity at designated contract markets, swap execution facilities, derivatives clearing organizations and swap data repositories. All such entities would be required to conduct five types of testing on an ongoing basis, consistent with best practices, subject to minimum frequencies specified by the Commission: vulnerability testing, penetration testing, controls testing, security incident testing and enterprise technology testing. The CFTC will accept comments to its proposed new rules through 60 days following their publication in the Federal Register. (Click here for more details.)

**Compliance Weeds**: All National Futures Association members must adopt and enforce written policies regarding cybersecurity by March 1, 2016. Under the NFA’s recently published NFA’s Interpretive Notice on Information Systems Security Programs, NFA members must institute formal, written information systems security programs (ISSP). 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 members should be, by now, conducting 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. (Click here for details.)

- **CME Group Amends Clearing Member Audit Trail Retention Requirements for Direct Access Clients—or Does It?**: CME Group revised its Rule 536B.2 (click here to access) that currently authorizes a clearing member not to keep the electronic audit trail of its direct access clients that are other clearing members or equity member firms. Under the same rule, clearing members guaranteeing a client that has direct market access are ordinarily “responsible for maintaining or causing to be maintained the electronic audit trail” for such client. These audit trails must be kept for at least five years. Although the CME Group is retaining its rule provision that authorizes a clearing member “to notify [a] client Clearing Firm or Equity Member firm that it is their obligation to maintain the electronic audit trail” (emphasis added)—thus excusing the clearing member from maintaining the record—the exchange is amending its rule to make clear this ability does not relieve a clearing member “...from compliance with the applicable recordkeeping provisions of CFTC Regulations, including Regulation 1.31 or 1.35” (the CFTC’s recordkeeping provisions; click here to access CFTC Rule 1.31 and here for CFTC Rule 1.35). CME Group’s rule amendment is effective December 29, 2015.

**My View**: The artful wording of this new sentence seems to imply the CFTC may believe that clearing member FCMs have an obligation to retain electronic audit trails they otherwise are not required to keep under the applicable exchange rule—a trick even the great Harry Houdini likely could not master! A few weeks ago the CFTC published a comprehensive set of proposed rules governing algorithmic trading that, if adopted, would increase recordkeeping requirements on algorithmic traders and clearing member FCMs handling their accounts.

- **Swap Dealers and MSPs Reminded by CFTC Staff to Report Uncleared Swaps Timely and Accurately—or Else**: Staff of the Commodity Futures Trading Commission’s Division of Swap Dealer and Intermediary Oversight published a *Staff Advisory* reminding swap dealers and major swap dealers of their obligations to report certain swap data timely and accurately. Staff noted “diverse reporting issues and failure,” with certain types of errors occurring “with some frequency”: readily apparent errors; incomplete reporting; duplicative swap reporting; calculation errors; and reporting delays. Staff recommended utilizing certain measures or processes to enhance reporting quality: data gatekeepers; automated review of reported data; erroneous record checks; and improved changed management practices. Staff also
reminded SDs and MSPs that if they utilize third-party service providers to report swap data, they still remain “responsible” for complying with applicable requirements.

**Compliance Weeds:** Swaps dealers and major swap participants should be routinely monitoring the accuracy and timeliness of their data reporting. Staff’s warning at the end of their advisory is not just ominous sounding: “This advisory should not be construed in any way as excusing past violations or limiting the CFTC’s ability to pursue any actions for reporting violations.” Recently, the CFTC filed and settled charges brought against Deutsche Bank AG, a provisionally registered swap dealer, for alleged reporting errors in connection with its swaps reporting. Deutsche Bank agreed to pay a fine of US $2.5 million and to enhance controls around its swaps reporting to resolve this matter.

And more briefly:

- **FCA Consults on Roll-Out of MiFID II in UK:** The Financial Conduct Authority issued a consultation paper seeking view on its proposed rollout of MiFID II in the United Kingdom. Although it is expected that MiFID II’s effective date will be extended beyond its currently schedule January 3, 2017, currently, European member states must change their laws and regulations by July 3, 2016 to implement provisions of MiFID II that are in a directive and not automatically applicable. FCA will accept comments through March 8, 2016.

- **ESMA Consults on CCPs’ Margin Requirements for Client Accounts:** The European Securities and Markets Authority is seeking comments on its proposal to permit European-based clearing houses (CCPs) to set margin requirements anticipating a one-day liquidation period, provided clearing members post client funds on a gross basis. Currently, EU CCPs must set margin requirements anticipating a two-day liquidation period; however clearing members are required to post client funds on a net basis only. ESMA recommends that CCPs would, going forward, be permitted to utilize either of the two approaches. If the EU were to adopt ESMA’s recommendation, it would be easier for the EU to recognize US CCPs as subject to equivalent regulatory oversight as EU CCPs. A determination of equivalency is necessary for US CCPs to offer clearing services in Europe. ESMA will consider comments submitted through February 1, 2016.

- **CFTC Lowers Record-Keeping Burden on End Users:** The Commodity Futures Trading Commission has amended its recordkeeping rule, CFTC Rule 1.35 (click here to access) to require unregistered members of designated contract markets or swap execution facilities to keep only certain transaction records, and not to keep written pre-trade communications or transaction records transmitted as text messages. They are also not required to keep their records in any particular form or manner. Under the amended rule, commodity trading advisers that are members of a DCM or SEF are excluded from the requirement they record and keep oral pre-trade communications. Currently, the CFTC recordkeeping rule requires unregistered members of DCMs and SEFs and impacted CTAs to generate and retain such records in a prescribed format—although they presently are acting under CFTC staff no-action relief excusing them from compliance (click here to access). In voting for the new rule, CFTC Commissioner J. Christopher Giancarlo noted the anomaly that although text messages are excluded from the recordkeeping requirement of unregistered members of DCMs or SEFs, communications through internet-based messaging services are not. Mr. Giancarlo also pondered about the possible-short lived benefit some unregistered members of DCMs might receive, if they are soon required to be registered as floor traders under newly proposed CFTC Regulation AT.

- **25 Investment Management Firms Promise to Clear Single-Name Credit Default Swaps:** The International Swaps and Derivatives Association, the Managed Futures Association and SIFMA’s Asset Management Group announced that 25 investment management firms promised to begin voluntarily clearing their single name credit default swaps. No time frame was provided.

**Compliance Weeds:** Even though single name credit default swaps are securities under applicable law, they are most likely going to have to be cleared in a futures environment for some time. Only the Commodity Futures Trading Commission has set up a practical regime for the handling of such products—utilizing a cleared swaps account—subject to ordinary CFTC protections. (Click here to access January 14, 2013 order regarding the treatment of funds held in connection by CDS cleared by ICE Clear Credit.)

- **Swiss Regulator Bans Six Managers and Traders for Employer’s Market Infractions in Foreign Exchange and Precious Metals Trading:** The Swiss Financial Market Supervisory Authority banned six managers and traders formerly associated with UBS’s foreign exchange and precious metals business. Previously FINMA required UBS to disgorge approximately Swiss Franc 135 Million (approximately US $135 million) because of the bank’s alleged attempted manipulation of foreign exchange benchmarks “over an extended period of time” (click here for details). FINMA said these individuals were “directly responsible” for serious breaches in UBS’s business. The individuals’ bans run from one to five years.

- **‘Tis the Season to Be Jolly—But Not Too Jolly Says the CME Group:** CME Group issued its annual
reminder that members, member firms and broker associations, as well as employees of such entities and individuals, may not give or receive gifts or gratuities in excess of $100 within any 12-month period to or from any employee of any such other organization or individual.

My View: CME Group’s requirement is similar to a standard securities industry requirement set forth in Rule 3220 of the Financial Industry Regulatory Authority (click here to access). Two years ago, FINRA sought comments on this rule to assess its continued relevance. FINRA subsequently issued a report confirming its ongoing usefulness, but acknowledged that the $100 threshold was likely antiquated since it was first adopted last century, in 1992 (click here to access the report). However nothing has changed yet either regarding the FINRA rule or the relevant CME rule. Even the Board of Governors of the Federal Reserve System finally increased its benchmark interest rate last week!

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