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Bridging the Week: March 27 to 31 and April 3, 2017 (Regulation Through Enforcement; Produce Or Be Fined; Spoofing; Undisclosed Mark-Ups)

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Bridging the Week

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An international cheese and food ingredient company settled an enforcement action brought by the Commodity Futures Trading Commission that it acted as a futures commission merchant without being registered, as required under law, in connection with a risk management program it administered for its milk suppliers. However, the settlement order raised many questions, including what precisely the firm did wrong. Separately, the Financial Industry Regulatory Authority and 10 exchanges brought an enforcement action against a broker-dealer and its principal owner for aiding and abetting manipulative trading through layering, spoofing and cross-market manipulation by one of the firm’s customers. The case echoed the same themes as an enforcement action filed by the Securities and Exchange Commission against the same two respondents two weeks earlier. As a result, the following matters are covered in this week’s edition of *Bridging the Week*:

- Price Protection Is Price Protection Is Price Protection – Unless It's FCM Activity Says CFTC ;
- CME Settles With FCM for Failure to Timely Produce Documents; Other Disciplinary Actions Allege Disruptive Trading and Violations of Position Limits and EFRP Requirements;
- Following SEC Action, Broker-Dealer and CEO Also Charged by FINRA and 10 Securities Exchanges With Aiding and Abetting Client's Layering, Spoofing and Cross-Market Manipulation;
- Inter-Dealer Broker Cannot Charge Commissions and Undisclosed Mark-Ups and Mark-Downs Says SEC Enforcement; and more.

Video Version:

Article Version

Briefly:

- **Price Protection Is Price Protection Is Price Protection – Unless It's FCM Activity Says CFTC**: Davisco Foods International, Inc., an international cheese and food ingredient company headquartered in Le Sueur, Minnesota, agreed to settle a complaint filed by the Commodity Futures Trading Commission that it acted as a futures commission merchant without being registered as required by law in connection with a hedging program it administered for its milk suppliers. According to the Commission's complaint, since 2011, Davisco has entered into arrangements with its milk suppliers (termed Milk Patron Agreements) that contained an option to enter into a "Futures Milk Contracting Program." Pursuant to this program, claimed the CFTC, the suppliers placed orders with

Davisco for CME milk futures contracts that Davisco then executed for its own trading account. Suppliers subsequently received “debits and credits” to their accounts with the firm. The CFTC said, “While [Davisco] solicited and accepted funds, [it] did so only as a pass-through, and any profit and loss was reflected in the Milk Patrons’ accounting.” The CFTC acknowledged that Davisco did not charge any fees in connection with the futures orders and did not profit from the transactions. However, Davisco “received a benefit from offering the FCM services to its clients,” said the CFTC. Davisco resolved this matter by agreeing to pay a US $150,000 fine, but did not admit or deny any of the CFTC’s findings or conclusions in its settlement order. Davisco is a business unit of Agropur, a Canada-based dairy cooperative.

My View: Just last week in a speech before the US Chamber of Commerce, CFTC Chairman nominee J. Christopher Giancarlo said that market enforcement “will remain aggressive and assertive under the Trump Administration.” To support this, he appointed James McDonald, an assistant US Attorney based in New York City, as the next Director of the Commission’s Division of Enforcement (click here for details of Mr. Giancarlo’s most recent speech, and here for details of his appointment of Mr. McDonald).

Hopefully, however, this enforcement action by the CFTC against Davisco is not an example of the type of tough enforcement to come, which aims to make derivatives markets more liquid and investors better protected. That is because, on its face, it is not clear from the Davisco settlement order what the firm did wrong. The settlement order engenders confusion among end-users and agricultural cooperatives that today offer valuable price protection and similar types of risk management programs to our nation’s farmers and livestock growers.

It is Futures 101 that a person acting as a futures commission merchant must be registered as such with the CFTC. However, it is not clear from the CFTC’s settlement order where Davisco crossed the line, if at all.

As best a reader of the settlement order can tell, through its Milk Patron program, Davisco bought milk from its suppliers and offered them an opportunity to obtain a price that was impacted by settlement prices of the relevant CME milk futures contract. It appears that at least some milk suppliers placed orders for futures with Davisco; however, this was for Davisco’s account – although individual suppliers received debits and credits to accounts somehow related to this. Davisco “solicited and accepted funds” for this program from its suppliers – “but only as a pass-through.” Huh? Did the milk suppliers have individual accounts or not? Did they deposit with Davisco funds for margin or something else? Were there marked-to-market payments? Or was Davisco solely offering a commodity option or price protection product of some type based on the CME futures contract? Not clear!

The CFTC’s choice of words is confusing at best, and at worst sends an unclear message as to what was problematic. Was there fundamental wrongdoing with an intent to evade registration requirements? Or was there simply an inadvertent mistake in administration or marketing? If the latter, why bring the case at all? Wouldn't it be better to privately warn the company to stop engaging in the problematic conduct and issue public guidance to the industry overall?

Aggressive and assertive enforcement is appropriate when there is real wrongdoing – not to articulate new expectations of regulators or to engage in "gotcha" with otherwise law-abiding persons who might have made a good faith mistake with no real harm to anyone – particularly when enforcement budgets are tight. In any case, at a minimum, all regulatory settlement orders should make it clear what was wrong so the industry can continue to conduct an important business for customers while structuring it to avoid a regulator's wrath. In no case, should there ever be regulation by settlement order.

- **CME Settles With FCM for Failure to Timely Produce Documents; Other Exchange Disciplinary Actions Allege Disruptive Trading and Violations of Position Limits and EFRP Requirements**: Wedbush Securities Inc. agreed to pay a fine of US $55,000 to resolve a disciplinary action brought by the Chicago Mercantile Exchange for failing to respond timely to numerous requests for records, documents and other information related to exchange inquiries from March 2015 through January 2016. CME said that the firm acted "principally through its former Chief Compliance Officer" in connection with these failures.

  Separately, Isaiah Kingston and Alexander Perelberg were charged with unrelated instances of engaging in disruptive trading practices. According to a business conduct committee of the New York Mercantile Exchange, Mr. Kingston, a non-member, placed a series of large stops orders in the NY Harbor low sulfur heating oil futures contracts on several trade dates in June and July 2015 "in close proximity to each other." When executed, said the BCC, the orders caused "a disruptive and rapid price movement" in the futures contract and prompted an automatic temporary suspension of trading – known as a stop logic event. To resolve this matter, Mr. Kingston agreed to pay a fine of US $100,000 and be suspended from trading any CME Group contract for six months.

  Similarly, CME BCC claimed that, from December 12, 2014, through January 31, 2015, Mr. Perelberg, a CME member, "engaged in a pattern of activity" on several dates where he manually entered large orders for March 2015 E-Mini NASDAQ 100 futures contracts solely to observe the market's response and to induce market participants to trade opposite his smaller iceberg orders on the other side of the market. After receiving fills on his iceberg orders, Mr. Perelberg allegedly cancelled his resting large orders. Mr. Perelberg resolved his CME disciplinary action by agreeing to pay US $7,329 in disgorgement and a fine of US $5,000, and to serve a three-month CME Group trading ban.

  Unrelatedly, Consolidated Trading Futures agreed to pay a fine of US $40,000 for purportedly violating Chicago Board of Trade position limits on parts of two days, while Two Sigma Investments, LP consented to pay a fine of US $25,000 for also violating CBOT positions limits for parts of two days. Frere Hall Capital Management LLP agreed to pay a fine of US $25,000 for allegedly exceeding

NYMEX position limits on multiple days.

Additionally, Oakley Fuels Inc. on NYMEX and Flow Traders on CBOT agreed to resolve disciplinary actions charging that they engaged in exchange for related position transactions without an exchange of a related position; while National Bank of Canada consented to paying a fine of US $75,000 for allegedly entering into a "series of trades" opposite each other for accounts the firm owned and controlled. These constituted impermissible wash trades said the NYMEX BCC.

Finally, Guosheng Li, a non-member, agreed to pay the Commodity Exchange, Inc. US $25,000 and serve a one-year CME Group trading ban for allegedly pre-arranging round-turn transactions on two days in May 2015 between an account he traded for his employer and an account over which he exercised discretion, whereby his account made US $8,350 and his employer's account lost US $10,738. Mr. Li previously reimbursed his employee for this trading, acknowledged the Comex BCC.

> **Compliance Weeds**: It is unusual for self-regulatory organizations to file charges claiming that a member firm failed to produce documents or cooperate during an examination or as part of a regulatory inquiry. But it happens. Just recently, two firms were barred from membership with the National Futures Association for not cooperating with an examination by staff. (Click here to access the article "CTA and Principal Barred from NFA Membership for Failing to Cooperate in Examination" in the March 12, 2017 edition of *Bridging the Week* and here to access the article "CTA and Principal Barred as NFA Members for Not Cooperating With NFA Examination" in the March 5, 2017 edition of *Bridging the Week*.) Although SRO rules typically require production of documents upon request within certain time periods (e.g., 10 days or less for CME Group;), SRO staff will usually grant reasonable extensions upon advance request – absent exigent circumstances. Ordinarily, broad requests can also be narrowed down too. However, it is always best to identify the need for a delay or narrowing of scope as soon as possible after an SRO request and to ask for the delay or a more fine-tuned request prior to the deadline for the response. You don't have to send flowers (indeed, you shouldn't), but don't ignore regulators' demands for documents or other information!
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> **Legal Weeds**: The Guosheng Li fact pattern resonates of two recent enforcement actions by the Commodity Futures Trading Commission charging persons with insider trading for misappropriating trading information. In the first action brought in 2015, the CFTC alleged that Arya Motazedi, a gasoline trader for an unnamed large, publicly traded corporation, similarly misappropriated trading information of his employer for his own benefit. In the second action, CFTC brought and settled charges against Jon Ruggles, a former trader for Delta Airlines, for trading accounts in his wife's name based on his knowledge of trades he anticipated placing for his employer. Both actions were grounded in a provision of law under the Dodd-Frank Wall Street Reform and Consumer Protection Act and a CFTC rule that prohibit use of a manipulative or deceptive device or contrivance in connection with futures or swaps

trading. (Click here to access CFTC Rule 180.1. Click here for background on these CFTC enforcement actions in the article "Ex-Airline Employee Sued by CFTC for Insider Trading of Futures Based on Misappropriated Information" in the October 2, 2016 edition of *Bridging the Week.*)

- **Following SEC Action, Broker-Dealer and CEO Also Charged by FINRA and 10 Securities Exchanges With Aiding and Abetting Client's Layering, Spoofing and Cross-Market Manipulation**: Less than 20 days after they were sued by the Securities and Exchange Commission for similar violations in a US federal court in New York City, Lek Securities Corporation (LEK), a US-registered broker-dealer, and Samuel Lek, its principal owner and chief executive officer, were named in a disciplinary proceeding by the Financial Industry Regulatory Authority and 10 exchanges (collectively, the "SROs") with aiding and abetting the manipulative trading of a customer, Avalon FA Ltd, a non-US entity, as well as other violations. In addition to charging LEK and Mr. Lek with aiding and abetting Avalon's manipulation thorough layering, spoofing and cross-market manipulation, the SROs also charged LEK with aiding and abetting Avalon in operating an unregistered broker-dealer; failing to retain required electronic communications; improperly paying transaction-based compensation to an unregistered person; and failing to comply "fully and timely" with information requests. In addition, LEK and Mr. Lek were charged jointly with supervisory violations and for violating the SEC's market access rule. The SROs seek findings, disgorgement, the costs of any proceeding and fines against the respondents. The SROs, besides FINRA, are the New York Stock Exchange, NYSE MKT, NYSE Arca, Nasdaq, NASDAQ BX, the four Bats exchanges, and the International Securities Exchange. On March 10, the SEC filed an enforcement action again against LEK and Mr. Lek for facilitating manipulative trading by Avalon. (Click here for details, in the article "US Broker-Dealer, Its CEO and a Non-US Client Sued by SEC for Layering and Other Manipulative Schemes" in the March 12, 2017 edition of *Bridging the Week*.)

- **Inter-Dealer Broker Cannot Charge Commissions and Undisclosed Mark-Ups and Mark-Downs Says SEC Enforcement**: Louis Capital Markets, LP, a registered broker-dealer, settled charges brought by the Securities and Exchange Commission that, from at least October 2012, it charged its institutional customers undisclosed mark-ups and mark-downs on some of their equities purchases and sales, in addition to disclosed commissions. According to the SEC, during the relevant time, LCM typically filled its customers stock orders on an agency basis by executing their trades in the open market. For this it charged commissions of between one and three cents/share. However, on other occasions, the SEC claimed that after executing some orders for customers at one price, the firm confirmed a less favorable price to the customers, locking in a profit for themselves. The firm did not disclose this practice to its customers. According to the SEC, LCM engaged in this practice "opportunistically … [during] times when customers were unlikely to detect them, for example, during periods of market volatility." To resolve this matter, LCM agreed to pay disgorgement of US $2.5 million. The SEC accepted this amount considering "the particular circumstances of this case, including the financial condition of the Respondent." The SEC, in its discretion, will determine to distribute funds collected from LCM or transfer them to the US

Treasury.

And more briefly:

- **Former FCM Traders Settle CFTC Charges They Engaged in Spoofing More Than 1,000 Times**: The Commodity Futures Trading Commission resolved charges against Stephen Gola and Jonathan Brims, former associated persons of a futures commission merchant that recently settled its own CFTC charges, for engaging in spoofing activities from July 16, 2011, through December 31, 2012. According to the CFTC, the individuals engaged in spoofing conduct on more than 1,000 occasions by placing bids or offers for US Treasury futures products with an intent to cancel the orders before execution. The traders, claimed the CFTC, placed small opposite-side orders in the same products or cash markets, prior to placing large spoofing orders for at least 1,000 contracts. The spoofing orders were cancelled immediately after the opposite-side orders were executed, or whenever the traders believed they might be executed in the marketplace. Mr. Gola agreed to pay US $350,000 and Mr. Brims, US $200,000 to resolve their CFTC enforcement action, as well as to be precluded from trading all CFTC-regulated market for six months after they fully pay their fines.

- **UK Regulator Issues Near Final Rules on Markets and Commodity Position Limits**: The UK Financial Conduct Authority issued a policy statement and near final rules in connection with its roll-out of the Markets in Financial Instruments Directive II on January 3, 2018. Topics addressed included not extending the Markets in Financial Instruments Regulation transaction reporting obligations to managers of collective investment undertakings and pension funds; maintaining a specific chapter in its rules addressing high-frequency trading firms, direct electronic access providers and general clearing members; and not mandating that non-financial entities submit applications for position limit exemptions. According to FCA, a market participant approaching a position limit may apply for an exemption or modify its trading to avoid a breach. In issuing its near final rules, FCA cautioned that firms requiring authorization for the first time or a variation from current permissions should be submitting applications now to ensure qualification by January 3.

- **ESMA Publishes Final Rules to Promote Accuracy and Integrity of Financial Benchmarks**: The European Securities and Markets Authority published a final report containing draft final rules regarding behaviors and standards expected of administrators and contributors to European Union Financial Benchmarks. Among other things, the new rules require an oversight function at administrators to oversee benchmark contributions and a managing of conflicts of interests between administrators and contributors. The goal of the draft final rules is to minimize the likelihood of manipulation of benchmarks. A level playing field across different member states is also required for the registration of benchmark administrators. ESMA already has submitted the draft final rules to the European Commission for its consideration; the EC has three months to decide to adopt them or not. The EC previously issued a Benchmarks Regulation that will be fully effective on January 1, 2018.

- **LME Sanctions Member for Position Reporting Errors**: China Merchants Securities (UK) Limited and Société Générale International Limited (formerly Société Générale Newedge UK Limited) each agreed to pay fines to the London Metal Exchange to resolve disciplinary actions alleging they did not file daily position reporting files accurately and timely. SGN's errors allegedly occurred on 10 days in 2016 and 2017, while CMS's mistakes happened on three days in 2016. SGN agreed to pay a fine of GBP 5,000 (US $6,272) while CMS agreed to pay a fine of GBP 2,000 (US $2,509).

- : The Securities and Exchange Commission will be hosting a meeting of its Equity Market Structure Advisory Committee on April 5. Among topics to be discussed will be the impact on market fragmentation possibly caused by the SEC's trade through rule . Separately, the Commodity Futures Trading Commission will be hosting a meeting of its Market Risk Advisory Committee on April 25. How well derivatives markets currently are operating will be a topic at this meeting.

- **ICE Futures Proposes to Empower Its VP of Market Regulation to Taketh Away and Giveth Back Too**: ICE Futures U.S. has amended its rule that authorizes the Vice President of Market Regulation to issue summary fines of up to US $10,000 without a hearing for certain minor offenses, including recordkeeping violations and not including proper trader identification on electronic orders. Currently, participants may not appeal such fines. Under the ICE Futures amended rule, however, a participant may bring relevant information to the exchange's attention within 15 calendar days after receipt of notice of a fine to request that the fine be reduced or eliminated. The amended rule will be effective April 11 absent objection by the Commodity Futures Trading Commission.

- **Introducing Broker Charged by NFA With Not Conducting Annual AML Review**: Long Leaf Trading Group, Inc., a registered introducing broker, agreed to pay a fine of US $12,500 to file charges brought by the National Futures Association that it failed to conduct an independent audit of its anti-money laundering program in 2012, 2014 and 2015, and only conducted such an audit in 2013 after being advised by NFA to do so. NFA requires all futures commission merchant and IB members to maintain an AML program that includes an annual independent annual review of the AML to be conducted by member personnel or by a qualified third party.