



K&L GATES

CHICAGO INVESTMENT MANAGEMENT CONFERENCE

SEC, CFTC, NFA and FINRA – Examinations and Enforcement

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OVERVIEW OF PRESENTATION

- SEC Enforcement Trends and Significant Matters
- Examination Initiatives and Activities
 - OCIE Examination Priorities
 - NFA Exams
 - FINRA Examination Priorities
- Recent CFTC and Futures Exchange Enforcement Actions
- Recent FINRA Enforcement Actions
- Looking Ahead





SEC Enforcement Trends and Significant Matters

ENFORCEMENT TRENDS

- Amendments to administrative proceedings rules went into effect:
 - Extended prehearing periods, up to a maximum of 10 months for 120-day initial decision proceedings
 - Granted the right to hold depositions in 120-day proceedings
 - Expanded admissibility exclusions for “unreliable” evidence
 - Simplified the appeal request procedure
- Focus on cybersecurity failures:
 - R.T. Jones Capital Equities Management, Advisers Act Rel. No. 4204 (Sept. 22, 2015)
 - Craig Scott Capital, Exchange Act Rel. No. 77595 (Apr. 12, 2016)
 - Morgan Stanley Smith Barney LLC, Exchange Act Rel. No. 78021, Advisers Act Rel. No. 4415 (June 8, 2016)

ENFORCEMENT TRENDS (CONT.)

- Continued use of the admissions policy, including against advisers
 - JPMorgan Chase Bank, N.A. et al., Advisers Act Rel. No. 4295 (Dec. 18, 2015)
- Emphasis on whistleblower anti-retaliation enforcement
 - Merrill Lynch, Exchange Act Rel. No. 78141 (June 23, 2016)
 - BlueLinx Holdings, Exchange Act Rel. No. 78528 (Aug. 10, 2016)
 - Health Net, Exchange Act Rel. No. 78590 (Aug. 16, 2016)
 - Anheuser-Busch InBev, Exchange Act Rel. No. 78957 (Sept. 28, 2016)
 - International Game Technology, Exchange Act Rel. No. 78991 (Sept. 29, 2016)
 - SandRidge Energy, Exchange Act Rel. No. 79607 (Dec. 20, 2016)
- Emphases on fiduciary duties of advisers and conflicts of interest (discussed below)



PRIVATE EQUITY ENFORCEMENT FOCUS

In a May 2016 speech, Andrew Ceresney, former Director of the Division of Enforcement, highlighted three types of “problematic conduct” involving private equity fund advisers:

1. Advisers that receive undisclosed fees and expenses
2. Advisers that impermissibly shift and misallocate expenses
3. Advisers that fail to adequately disclose conflicts of interest, including conflicts arising from fee and expense issues

1. UNDISCLOSED FEES AND EXPENSES

- WL Ross & Co. LLC, Advisers Act Rel. No. (Aug. 24, 2016)
 - Action involving management fee offsets for such things as break-up, origination, commitment, broken deal, cancellation, banking and monitoring fees (“Transaction Fees”)
 - The governing documents provided for offset of the Transaction Fees against management fees but did not address how the allocation would occur when multiple funds and co-investment vehicles were investing in the same portfolio company. The adviser allocated fees pro rata across funds and co-investment vehicles based on their ownership of the underlying portfolio company
 - Because the firm construed the ambiguity in its favor and did not disclose the methodology, it received about \$10.4 million more in management fees than it would have by simply allocating the transaction fees pro rata among the funds
 - The adviser paid a \$2.3 million civil penalty, and reimbursed \$11.8 million in fees with interest

UNDISCLOSED FEES AND EXPENSES (CONT.)

- Apollo Management V, L.P., et al.,
Advisers Act. Rel. No. 4493 (Aug. 23, 2016)
 - The SEC found that, while Apollo had disclosed that it had entered into monitoring agreements with portfolio companies and would receive fees under these agreements, Apollo had not disclosed adequately that it would receive accelerated monitoring fees upon the termination of these agreements until after the limited partners had committed capital to the funds and the fees were paid
 - The SEC noted that, because of the conflict of interest associated with the decision to accelerate the monitoring fees, Apollo could not have effectively consented to the acceleration on behalf of the funds. The SEC also found that the payment of the accelerated monitoring fees by portfolio companies ultimately reduced the returns to the limited partners
 - \$37.5 million disgorgement, \$12.5 million civil penalty, and \$2.7 million interest

UNDISCLOSED FEES AND EXPENSES (CONT.)

- Blackstone Management Partners L.L.C., et al., Advisers Act Rel. No. 4219 (October 7, 2015)
- Blackstone was charged with two distinct breaches of fiduciary duties:
 - First, Blackstone terminated certain portfolio company monitoring agreements between Blackstone and its funds' portfolio companies and accelerated the payment of future monitoring fees. Although Blackstone disclosed that it might receive monitoring fees from portfolio companies, it failed to disclose that it might accelerate future monitoring fees upon termination of the monitoring agreements
 - Second, fund investors were not informed about a fee arrangement that provided Blackstone with a substantially greater discount on legal services provided by an outside law firm than the discount that the law firm provided to the funds. In doing so, Blackstone secured greater benefits for itself than the funds it advised, without properly disclosing and obtaining informed consent for the arrangement
 - Blackstone paid nearly \$39 million to settle charges with \$29 million being distributed to investors

2. EXPENSE SHIFTING

- Lincolnshire Management, Inc.,
Advisers Act Rel. No. 3927 (Sept. 22, 2014)
 - This matter involved a “horizontal misallocation” of expenses across two funds. Lincolnshire had integrated two portfolio companies, each owned by a different fund with different investors, and managed as a single company. Lincolnshire intended to integrate the two companies and sell them together
 - However, Lincolnshire caused one of the portfolio companies to pay a disproportionate share of the companies’ joint expenses
 - “[W]hen an adviser manages multiple funds, it must be mindful of the fact that it owes a separate fiduciary duty to each fund and must ensure that its actions do not fraudulently benefit one fund at the expense of another”
 - The SEC focused on the failure of documented policies for the consistent allocation of expenses
 - The cases settled for approximately \$2 million, including a \$450,000 penalty

EXPENSE SHIFTING (CONT.)

- Cherokee Investment Partners, LLC, et al.,
Advisers Act Rel. No. 4258 (Nov. 5, 2015)
 - This matter involved “vertical misallocation.” Cherokee adviser entities improperly allocated their own consulting, legal, and compliance-related expenses to their private equity fund clients in contravention of the funds’ organizational documents
 - While the funds’ organizational documents disclosed that the funds would bear expenses arising out of the operation and activities of the funds, the documents did not indicate that the funds would be charged for the advisers’ legal and compliance expenses
 - The adviser entities reimbursed the funds \$455,698 in misallocated expenses and paid a \$100,000 penalty

3. FAILURES TO DISCLOSE CONFLICTS

- Fenway Partners, LLC et al.,
Advisers Act Rel. No. 4253 (Nov. 3, 2015)
 - The SEC charged Fenway and four executives with failures to disclose several conflicts of interest:
 - First, Fenway Partners and four executives replaced monitoring agreements, for which fees received offset Fenway Partners' management fee with respect to its fund, with consulting agreements entered into with an affiliated entity called Fenway Consulting Partners LLC. The consulting agreements provided similar services, often through the same employees, but the fees paid were not offset against the management fee. This altered arrangement was not disclosed to the LPAC or investors
 - Second, Fenway Partners and three respondents asked fund investors to provide \$4 million in connection with an investment in a portfolio company without disclosing that \$1 million of the investment would be used to pay its affiliate, Fenway Consulting

FENWAY PARTNERS, LLC (CONT.)

- Third, without disclosure to the LPAC or investors, Fenway Partners and two respondents caused three former Fenway Partners employees to receive \$15 million in incentive compensation from the sale of a portfolio company for services that they had almost entirely provided when they were Fenway Partners employees
- Finally, Fenway Partners failed to disclose each of these payments as related-party transactions in the financial statements they provided to investors
- The parties paid approximately \$10.2 million, including a \$1.5 million penalty

FAILURES TO DISCLOSE CONFLICTS (CONT.)

- JH Partners, LLC,
Advisers Act Rel. No. 4276 (Nov. 23, 2015)
 - The SEC charged JH Partners with failing to disclose and obtain fund advisory board consent for a series of transactions, including: (a) a series of working capital loans (totaling \$62 million) by JH Partners to the funds' portfolio companies, resulting in the adviser obtaining interests in portfolio companies that were senior to the interests held by the funds; (b) causing more than one of its funds to invest in the same portfolio company at differing priority levels, potentially favoring one fund client over another; and (c) causing certain of the funds' investments to exceed concentration limits set forth in the funds' governing documents
 - JH Partners agreed to a cease and desist order and a \$225,000 penalty as part of its agreement to settle the case

FAILURES TO DISCLOSE CONFLICTS (CONT.)

- The Robare Group, Ltd. et al., Advisers Act Rel. No. 4566 (Nov. 7, 2016)
 - Robare, a separate account manager, received revenue sharing payments from Fidelity for investments in certain no-load mutual funds, which were initially not disclosed, then were not adequately disclosed as a conflict
 - Notably, the ALJ found credible the principals' testimony that they did not know which funds caused the fees to be generated.
 - Five key takeaways:
 - First, firms need to be extremely careful in drafting Form ADV disclosures
 - Second, the SEC may act on minor conflicts that effect customers minimally
 - Third, the SEC may regard ambiguous wording about conflicts as misleading
 - Fourth, do not assume that reliance on consultants or other experts to draft disclosures will protect the firm from an enforcement action
 - Fifth, expect the SEC to move easily from a finding that a disclosure was not adequate to a finding that it was negligent and thus actionable



CERESNEY'S OBSERVATIONS

- The SEC is purportedly not sympathetic to arguments about:
 - The fairness of charging advisers for disclosure failures in organizational documents drafted before the SEC began its focus on private equity and before many advisers were required to register
 - Whether investors benefited from conflict-of-interest services that an adviser provided in the absence of full disclosure. Such an argument is only a factor to consider when assessing the potential remedy
 - Whether the adviser received advice from counsel before taking an action. The adviser is still ultimately responsible for its conduct



OTHER SIGNIFICANT CASES

- False Performance Claims
- Back-Tested / Third Party Performance
- Failure to Supervise
- Custody
- Broker-Dealer



FALSE PERFORMANCE CLAIMS

- Sweep of investment advisory firms following 2014 enforcement actions against investment manager F-Squared Investments, which admitted inflating performance data for its strategy for trading ETFs
- 13 firms sanctioned for violating §§ 204 and 206(4) of the Advisers Act by adopting F-Squared inflated performance data and passing it along to their own clients
- Advisers were negligent in not seeking sufficient documentation to substantiate advertised performance
- “When an investment adviser echoes another firm’s performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact.” *Andrew Ceresney, August 25, 2016*
- Sanctions ranged from \$100,000 to \$500,000 in penalties
- More of these cases may be brought

BACK-TESTED / THIRD PARTY PERFORMANCE

- Raymond J. Lucia Companies, Inc. et al.,
Advisers Act Rel. No. 4190 (Sept. 3, 2015)
 - The SEC found that Lucia in marketing data labeled as “backtested” (i) had used performance data based on certain assumptions when historical rates of inflation and rates of return were available, (ii) did not deduct advisory fees or clarify that they were not accounted for, and (iii) failed to calculate the data in a manner that fully followed the investment strategy that the performance data was designed to support
 - Dissent of Commissioners Gallagher and Piwowar for “rulemaking by opinion”:
“[t]he majority opinion creates from whole cloth specific requirements for advertisements that include the word “backtest.” Despite the lack of any statutory or regulatory definition of what constitutes a “backtest,” the majority opinion finds it fraudulent or deceptive practice if a backtest fails to use actual historical rates — even if the slideshow presentation specifically discloses the use of assumed rates for certain components”

LUCIA (CONT.)

- Sanctions: (i) Lucia barred permanently from associating with an investment adviser, broker or dealer; (ii) advisory entity's registration status revoked; (iii) civil penalties of \$250,000 against the advisory entity and \$50,000 against Raymond Lucia (i.e., no proof of investor harm)
- In August 2016, the D.C. Circuit denied Lucia's petition for appeal, and, in so doing, delivered the first court decision directly addressing the use of back-tested performance. The Court found that there was "substantial evidence" (a deferential standard) to support the Commission's finding that the presentation in question promised to provide "an historical-data-only backtest" not using assumed data

FAILURE TO SUPERVISE

- Cambridge Investment Research Advisors, Inc.,
Advisers Act Rel. No. 4361 (Apr. 5, 2016);
Alexander R. Bastron, Advisers Act Rel. No. 4362 (Apr. 5, 2016)
 - Cambridge decided to place a new employee on heightened supervision given his poor credit and a FINRA investigation into his prior termination. The employee's supervisor failed to implement the supervision plan
 - From 2009 – 2011, the employee misappropriated more than \$300,000 by forging signatures on and adding costs to financial planning agreements
 - The compliance department lacked systems to verify that its supervisory plan was implemented. Cambridge and the supervisor paid penalties of \$225,000 and \$20,000, respectively, and the supervisor was barred for one year
 - The Commission considered remedial efforts, including self-reporting, refunding misappropriated funds, reviewing and improving compliance and supervision policies and procedures, and the retention of a compliance consultant

CUSTODY

- Fortius Financial Advisors, LLC, et al.,
Advisers Act Rel. No. 4483 (August 15, 2016)
 - This matter involved several allegations, including unsuitable investments, misappropriation, failure to supervise, failure to adopt and implement policies and procedures. The client in question was elderly and in deteriorating health
 - An employee was a named trustee and signatory with the ability to effectuate transactions in all of the client's accounts. Fortius, as a result, had custody, but it did not engage an independent public accountant to conduct a surprise examination of any of the client accounts
 - Expect to see more of these cases, where violations of the custody rule are appended to allegations of failure to supervise and misappropriation

BROKER-DEALER

- Blackstreet Capital Management, LLC, et al.,
Advisers Act Rel. No. 4411 (June 1, 2016)
 - The SEC found that a private equity fund adviser performed brokerage services for and received brokerage fees from portfolio companies, instead of using investment banks or registered broker-dealers to provide such services, and that Blackstreet and engaged in conflicted transactions, improperly used fund assets and failed to adequately disclose certain fees and expenses that were charged to the funds and/or the portfolio companies
 - Settlement included disgorgement of transaction fees of \$1,877,000, related prejudgment interest and a civil monetary penalty of \$500,000
 - Although the action includes several Advisers Act violations, the SEC's press release emphasizes the failure to register
 - Proceeding reopens the debate on the scope of comfort provided the January 2014 M&A no-action letter, which some had thought might be a harbinger of good news for private equity fund sponsors



Examination Initiatives and Activities



OCIE Examination Priorities

SEC EXAMINATION PRIORITIES

- OCIE's stated 2016 Examination Priorities included:
 - Conflicts / fiduciary duty
 - Fee selection and reverse churning
 - Liquidity controls
 - Focus on private fund advisers
 - Cybersecurity
- Recent relevant National Exam Program Risk Alerts included:
 - 2015 Cybersecurity Examination Initiative
 - Advisers and Funds That Outsource Their Chief Compliance Officers
 - Supervision Practices at Registered Investment Advisers [for disciplined employees]
 - Whistleblower Rule Compliance [Rule 21F-17]





NFA Exams

RISK FACTORS THAT MAY PROMPT AN EXAMINATION

- Customer complaints
- Business background of principals
- Concerns noted during a review of the firm's promotional materials, disclosure documents and/or filings
- Referrals received from other agencies/members
- Use PQR and PR data
- Time since registration or last exam
- Generally, NFA examines IBs, CPOs and CTAs every 4-5 years
- More frequent exams if risk factors deem necessary

AREAS OF FOCUS

- Governance – Committees, responsibilities, frequency of meetings, procedures, reporting and escalation of issues
- Administrators and Custodians – due diligence, ongoing supervision/validation and conflicts of interest
- Counterparty Risk and Concentration Risk – how is it assessed and managed
- Liquidity Policies – portfolio repositioning, stress testing and sources of liquidity. Extra challenges with illiquid investments – how are they managed to meet redemption requests and pay fees/expenses
- Disclosure and Performance Reporting
- Handling of Pool Funds
- Financial Reporting and Valuation of Assets
- Internal Controls – policies and procedures, separation of duties, access, backgrounds of key personnel
- Due Diligence and Risk Management – governance, administrators and custodians, counterparty risk, concentration risk, liquidity policies
- Promotional Materials and Sales Practices – procedures, review and approval; balanced presentation
- Registration, Common Deficiencies – unlisted principals and branch offices; unregistered APs; APs not terminated; failing to update registration records

DISCLOSURE DOCUMENTS AND PERFORMANCE REPORTING DEFICIENCIES

- Operations inconsistent with disclosure
 - Fees and expenses
 - Redemptions
 - Trading strategy
 - Conflicts of interest
 - Banks, carrying brokers, custodians
 - General Partner and/or CTA ownership interest
- Performance Recordkeeping
 - Supporting worksheets
 - Notional funding documentation



BYLAW 1101 DEFICIENCIES: DUE DILIGENCE AND WHERE TO LOOK

- Due Diligence
 - Does the account appear to require registration?
 - If not, why not (exemption, offshore)?
 - If yes, why and is it registered?
 - Is the pool operator an NFA member?
 - Annually, review exempt entities (exemption affirmation for CTFC Regulations 4.5, 4.13(a)(3) and 4.14(a)(8))
- Where to Look
 - BASIC-Registration Status
 - Part 4 Exemption Look-Up in ORS and BASIC
 - Ask client for copy of exemption
 - In all cases, document findings



OTHER DEFICIENCIES

- Incomplete Account Statements
 - Information only included for the individual pool participant
 - Statements must include information for the pool as a whole
- Pool Expenses
 - What do certain payments represent?
 - How was this information disclosed to pool participants?
- Affirmations
- Bunched Orders
- NFA Compliance Rule 2-45: loans to CPO or affiliates





FINRA Examination Priorities

2017 EXAMINATION PRIORITIES

- High-risk and Recidivist Brokers
- Sales Practices
 - Senior Investors
 - Product Suitability and Concentration
 - Excessive and Short-term Trading of Long-term Products
 - Outside Business Activities and Private Securities Transactions
 - Social Media and Electronic Communications Retention and Supervision
- Financial Risks
 - Liquidity Risk
 - Organizational Risk Management
 - Credit Risk Policies, Procedures and Risk Limit Determinations Under FINRA Rule 4210



2017 EXAMINATION PRIORITIES (CONT.)

- Operational Risks
 - Cybersecurity
 - Supervisory Controls Testing
 - Customer Protection/Segregation of Client Assets
 - Regulation SHO – Close Out and Easy to Borrow
 - AML and Suspicious Activity Monitoring
 - Municipal Advisor Registration
- Market Integrity
 - Manipulation
 - Best Execution
 - Audit Trail Reporting Early Remediation Initiative and Expansion
 - Tick Size Pilot
 - Market Access Rule
 - Trading Examinations
 - Fixed Income Securities Surveillance Program



TARGETED EXAMINATIONS AND SWEEPS

- Review of Cross Selling Programs (October 2016)
 - Reviewing extent to which broker-dealers are promoting bank products of affiliated or parent companies to retail customers and adding different features to retail customer accounts such as securities-based loans, or opening additional broker-dealer accounts
- Unit Investment Trust (“UIT”) Rollover Review (September 2016)
 - Focused on assessment of early rollovers, defined as the sale of a UIT 100 days or more prior to the portfolio ending date
- Non-Traded Business Development Companies (“BDCs”) (August 2016)
 - Focused on due diligence that firms conduct of the BDCs (initially and ongoing) and due diligence of participating broker-dealers with which the firm has selling agreements
- Mutual Fund Waiver (May 2016)
 - Focus on controls to ensure mutual fund sales charge waivers are provided to eligible accounts, including retirement plans and charitable accounts
- Cultural Values (February 2016)
 - Focused on assessment of how firms establish, communicate and implement cultural values, and whether cultural values are guiding business conduct.





CFTC and Futures Exchange Enforcement Issues

FUTURES ENFORCEMENT OVERVIEW

- The Market *is* The Regulator
- Position Limits
- Something New From the CFTC: “Insider Trading”
- Block Trades and “Insider Trading”
- Looking Ahead



THE MARKET *IS* THE REGULATOR

- The exchanges themselves are the front line regulators of listed futures and futures options
- The CFTC grants the exchanges their licenses to operate, and polices how they police traders
- CFTC Regulations require the exchanges to require market participants to consent to the exchanges' jurisdiction as a condition of market access
- If you access the futures markets, you are subject to exchange discipline – membership *not* required
- The exchanges have their own form of legal system, made up of investigators, prosecutors, and courts



THE MARKET *IS* THE REGULATOR

- It is a federal crime to lie to the exchange
- The increasing specter of criminal prosecution for “disruptive” or “disorderly” trading now can make the decision whether to speak to exchange investigators much more difficult, depending on the circumstances
- Be thoughtful. Be careful. Take exchange interviews very seriously.
- Exchange interviews will be shared with the CFTC upon request
 - And with the Justice Department

THE MARKET *IS* THE REGULATOR

- The exchanges can suspend or terminate access to the market for failure to provide records or testimony
- It is an exchange violation for a firm to not diligently supervise its agents
- Firms face strict liability for the acts of their agents
- Exchanges can impose significant monetary penalties – the CME recently increased its maximum fine from \$1 million to \$5 million *per violation*
- Though exchanges can issue warning letters, the CFTC recently told one futures exchange, “issuing a warning letter for a substantive trading violation is never appropriate.”

POSITION LIMITS

- The CFTC imposes limits on the size of speculative positions in futures markets “to protect futures markets from excessive speculation that can cause unreasonable or unwarranted price fluctuations”
- The CFTC has set hard limits on a handful of agricultural futures contracts, and believes that Dodd-Frank required it to set limits on other contracts too – but we won’t dive into that ongoing legal quagmire
- Most position limits are set by the exchanges themselves, and the exchanges may grant exemptions for bona fide hedging activity



POSITION LIMITS

- The exchanges present your day-to-day position limit risk
- Position limits are published on exchange websites, and the exchanges expect market participants to know how many contracts they can trade
- Exchanges tell us that they are surprised at how many sophisticated entities repeatedly violate position limits
- Position limit violations are strict liability offenses, and even a single violation can lead to disciplinary action
- There is helpful guidance out there (see CME Market Regulation Advisory Notice “MRAN” RA1603-5R)



POSITION LIMITS

- When deciding what action to take concerning a position limit violation, CME considers
 - Size of the position in excess of the limit
 - Previous violations
 - Length of the violation
 - Profit resulting from the violation
- Exchange inquiries concerning position limits (or other “routine” violations) can be time-consuming, stressful, and expensive
- Position limit fines can range from four to six figures



POSITION LIMITS

- If you have a bona fide commercial need to trade in excess of position limits, you may seek a “hedge exemption” from the exchange *before exceeding the limit*. (Rule 559) CME requires:
 - Complete and accurate explanations of the underlying exposure
 - Agreement to promptly provide information or documentation regarding the trader’s financial condition
 - Agreement to comply with all terms, conditions, or limitations imposed by CME’s Market Regulation Department
 - Agreement that Market Regulation may, for cause, modify or revoke the exemption at any time
 - Agreement to promptly submit supplemental information if there is a material change
 - Agreement to initiate and liquidate in an *orderly manner*

POSITION LIMITS

- Traders who receive a hedge exemption must annually file an updated application one year following the approval date of the most recent application, and failure to do so will result in expiration of the exemption
- Kraft Foods Group allowed its hedge exemption to lapse, and was charged by the CFTC with position limit violations in a civil lawsuit filed in federal court
- Aggregation – The CFTC and exchanges have complex rules around this, but all positions in a particular contract, even in different accounts or at different firms, must be combined for purposes of position limit compliance unless conditions and exceptions apply

SOMETHING NEW: “INSIDER TRADING”

- Futures traders have long traded on the basis of material non-public information - a permissible and even necessary practice in those markets (with exceptions) to promote the price discovery function of the markets
- Another primary purpose of futures markets is to allow hedgers to protect against price risk, and hedgers are not required to publicly disclose their view of the price risks against which they seek to protect themselves
- This was not “insider trading” because in futures trading there are no company insiders and no shareholders
- So what changed?



SOMETHING NEW: “INSIDER TRADING”

- Dodd-Frank amended the Commodity Exchange Act to add a new “SEC-like” section prohibiting the use of “any manipulative or deceptive device or contrivance” in violation of a rule to be written by the CFTC in the future
- That rule was CFTC Regulation 180.1 which became effective in August 2011. The rule mirrored SEC Rule 10b-5, the SEC’s weapon against insider trading, with two important exceptions. CFTC Regulation 180.1:
 - Expressly described the required mental state to include mere *recklessness*; and
 - Prohibited *attempted* fraud and deception as well as actual fraud and deception

SOMETHING NEW: “INSIDER TRADING”

- Elements:
 - Engaging in deceptive or manipulative conduct in connection with futures, swaps, or commodities
 - Mental state: knowingly or *recklessly*
 - Deceit: misappropriation of material non-public information in breach of a pre-existing duty
 - Trading or attempting to trade futures, swaps, and commodities on the basis of material non-public information
- “Recklessly attempting” sure seems like a low bar



SOMETHING NEW: “INSIDER TRADING”

- The CFTC now has the tool to prosecute trading based on material non-public information
- Since the enactment of Regulation 180.1, CFTC officials have publicly stated that the agency would prosecute those who traded on the basis of material non-public information, if done in violation of a pre-existing trust or duty to a client
- And so they have ...



SOMETHING NEW: “INSIDER TRADING” Arya Motazedo – December 2, 2015

- Proprietary trader of energy futures for a large, publicly-traded company in Chicago
- Among other violations, Motazedo allegedly misappropriated material proprietary or confidential information of his employer in order to
 - Place trades between his personal accounts and his employer’s accounts at prices favorable to himself
 - Trade ahead of his employer’s orders
- This was the CFTC’s first use of Regulation 180.1 to prosecute “insider trading” though those words are not found anywhere in the press release or the order itself

SOMETHING NEW: “INSIDER TRADING” Arya Motazedo – December 2, 2015

- Sanctions:
 - Restitution of \$216,955 to his former employer
 - Civil monetary penalty of \$100,000
 - Permanent CFTC trading ban
 - NYMEX sanction of five-year trading suspension



SOMETHING NEW: “INSIDER TRADING” Jon Ruggles – September 29, 2016

- Proprietary trader of energy futures for a large airline company
- Among other violations, Ruggles allegedly misappropriated material proprietary or confidential information of his employer in order to
 - Place trades between his personal accounts and his employer’s accounts at prices favorable to himself
 - Trade ahead of his employer’s orders
- This was the CFTC’s second use of Regulation 180.1 to prosecute “insider trading” though those words are not found anywhere in the press release or the order itself

SOMETHING NEW: "INSIDER TRADING"

Jon Ruggles – September 29, 2016

- Failed to appear for an exchange interview which NYMEX found to be an offense
- Litigated an evidentiary hearing at NYMEX
- Sanctions:
 - Disgorgement of \$3,000,000
 - Civil monetary penalty of \$1,750,000
 - Permanent CFTC trading ban
 - Permanent ban from CME exchanges, including NYMEX

BLOCK TRADES AND “INSIDER TRADING”

- Block trades are privately negotiated futures or options transactions that meet certain quantity thresholds which are permitted to be executed apart from the public auction market, yet still on the exchange
- “Privately negotiated” and “apart from the public auction market” usually means – *wash trades*. Block trades are permitted only if done in strict compliance with exchange regulations
- Before October 2016, the exchanges expressly prohibited pre-hedging and anticipatory hedging in connection with block trades



BLOCK TRADES AND “INSIDER TRADING”

- The exchanges prohibited trading on the basis of knowledge that a block trade *would be done* because that information was material and non-public
- CME action against SG Americas Securities (as successor to Newedge USA, LL) – June 23, 2016
- After receiving solicitation of a block trade, but prior to consummation, traders executed a separate block trade with a liquidity provider in the same product and on the same side of the market as the customer’s proposed block trade to hedge the trade ultimately executed opposite the customer, realizing \$19,502.50 in profits.
- \$100,000 fine and \$19,502.50 disgorgement.

BLOCK TRADES AND “INSIDER TRADING”

- In October 2016, CME, ICE Futures U.S., and NASDAQ Futures, Inc. revised their block trading rules to permit, for the first time, pre- or anticipatory hedging *except in circumstances where an intermediary takes the opposite side of its own customer order*
- The exchanges take a broad view of the term “intermediary”

BLOCK TRADES AND “INSIDER TRADING”

- A party is an intermediary if they receive the order for a block trade, rather than if they engage in a discussion or negotiation concerning a potential principal-to-principal transaction
- The prohibition against pre- or anticipatory hedging by an intermediary applies to any account which is owned or controlled, or in which an ownership interest is held, including the proprietary account of the intermediary’s employer



BLOCK TRADES AND “INSIDER TRADING”

- The exchanges continue to prohibit “front running” of a block trade when acting on material non-public information regarding an impending block trade by another person
- They continue to prohibit acting on non-public information obtained through a
 - Confidential employer/employee relationship (like Motazed and Ruggles)
 - Broker/customer relationship
 - In breach of a pre-existing duty

BLOCK TRADES AND “INSIDER TRADING” COMPLIANCE TIPS

- CME MRAN RA1613-5R
- November 21, 2016 presentation by the three exchanges: “Firms need to ensure that their employees understand when pre-hedging is and is not permitted – training is paramount. Once training is completed, firms should have controls reasonably designed to detect violations and protocols in place to deal with breaches.”
- Remember CFTC Regulation 23.410(c) concerning swap dealer and major swap participant duty to keep counterparty information confidential
- CFTC Regulation 3.3

LOOKING AHEAD

- Regardless of what direction the new CFTC takes, the exchanges will continue to be the “cop on the beat.” The exchanges tell us that they will continue to examine any trading that appears to be done with the intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading or the fair execution of transactions. (CME rule 575.D)
- What is “orderly conduct” and “fair execution”?
- Per the CFTC, holding a large position nearing the expiration of a contract could be considered to be “disruptive trading or use of a manipulative device”

LOOKING AHEAD

- Trading firms are required to supervise their employees and agents, including Automated Trading Systems
- December 23, 2016 – ICE Futures U.S. fined Marquette Partners, LP \$20,000 because its ATS malfunctioned and entered and deleted excessive orders
- October 27, 2016 – CME fined Aardvark Trading LLC \$205,000 because its ATS malfunctioned and entered excessive orders causing price and volume aberrations
- October 27, 2016 – CME fined Nataxis \$75,000 because its ATS malfunctioned and entered progressively increasing bids and offers resulting in price aberrations





Recent FINRA Enforcement Decisions

EXCESSIVE TRADING AND SUITABILITY

- Dep't of Enforcement v. Newport Coast, Douglas A. Leone and Andre V. Labarbera, Disciplinary Proceeding No. 20120305647-01 (10/17/16)
 - For churning the accounts of customers, engaging in quantitatively unsuitable trading in the accounts of customers, recommending qualitatively unsuitable investments to customers, misrepresenting the value of a customer's account, and failing to supervise this activity, Newport was expelled from FINRA membership and Leone and Labarbera were barred from association with any FINRA member firm; the firm and two brokers were also ordered to pay restitution and a fine
 - In light of FINRA's emphasis on protecting investors from predatory brokers who seek to enrich themselves at the expense of customers, this case highlights the type of misconduct Enforcement will focus on and the harsh sanctions that will be imposed if the evidence is sufficient

EXCESSIVE MARK-UPS

- Dep't of Market Regulation v. Bharminder Singh, Disciplinary Proceeding No. 20100226911-02 (8/24/16)
 - Singh suspended 30 business days and fined \$50,000 for violating NASD Rule 2440 (superseded by FINRA Rule 2121) and its related guidance on markups and markdowns; fraud charge dismissed
 - New to distressed debt offerings to retail customers in volatile market conditions (2008-2009), Singh admittedly did not attempt to find the prevailing market price as required by NASD IM-2440-2 because he was not aware of the applicable requirements; all 384 transactions at issue involved markdowns of 10% or more (41 were 40% or more)
 - Ignorance of the applicable rules is no excuse for their violation; each participant in the industry is responsible for understanding applicable regulatory obligations
 - Notably, the Hearing Panel rejected the proposition that the size of the markdown alone is sufficient to establish fraud; refusing to find “per se fraud” the Panel reiterated well-settled law that fraud violations require scienter

BROKER'S FAILURE TO DISCLOSE

- Dep't of Enforcement v. Joseph N. Barnes, Sr.,
Disciplinary Proceeding No. 2013038418201 (6/28/16)
 - Barnes was suspended from associating with any FINRA member firm in any capacity for six months and fined \$5,000 for his willful failure to timely update his Form U4 to disclose two bankruptcy petitions
 - Barnes admitted that he failed to timely amend his Form U4, but denied that he acted willfully because he disclosed the bankruptcy petitions to his firm
 - OHO determined that, even if Barnes had informed his firm, which he did not do properly, it was ultimately Barnes's responsibility to amend his Form U4
 - Barnes was statutorily disqualified for his willful failure to omit material information from his Form U4



Looking Ahead



POSSIBLE DEVELOPMENTS

- Increased focus on advisers given realignment of examiners
- Increased focus on adviser safeguards
 - More cybersecurity exams with closer focus on controls
 - Investment management business continuity guidance
- Increasing use of data analytics to identify out-of-cycle exam candidates and subjects for enforcement
- Continued focus on current enforcement priorities, including:
 - Valuation
 - Undisclosed fees and expenses, and misallocated expenses
 - Conflicts of interest



POSSIBLE DEVELOPMENTS (CONT.)

- Heightened focus on high-risk and recidivist brokers and the firms that employ them
- Implementation of reasonable measures to alert firms to potential problems – enhances culture of compliance narrative
 - Welcome relief for HFTs in context of Regulation NMS
 - Publication of summary report outlining key findings from examinations
- Increasing use of cross-market surveillance to detect manipulation
- Continued focus on current enforcement priorities, including:
 - Investor confidence
 - Risk management
 - Supervision and supervisory controls





Q&A



K&L GATES