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The Financial Markets Lifecycle: From Rulemaking to Enforcement

K&L GATES CHICAGO INVESTMENT MANAGEMENT CONFERENCE

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TODAY'S PROGRAM

- Welcome and Introduction
- Keynote Speech and Q&A
- Regulatory Developments: Capital Markets and Derivatives
- Compliance and Inspections
- Enforcement and Litigation Developments
- Popcorn!

Keynote:
Joshua Sterling, Director, CFTC Division of Swap Dealer and Intermediary Oversight

Regulatory Developments: Capital Markets and Derivatives

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REGULATORY DEVELOPMENTS: CAPITAL MARKETS AND DERIVATIVES

- Speakers:
  - Stephen Humenik, K&L Gates – Moderator
  - Daniel S. Konar II, Associate General Counsel of the Options Clearing Corporation
  - Bella Rozenberg, Senior Counsel/Head of Regulatory and Legal Practice Group ISDA
  - Jason Silverstein, Managing Director & Associate General Counsel, SIFMA AMG
  - Derek Steingarten, K&L Gates

MARGIN FOR UNCLEARED SWAPS

- CFTC and U.S. Prudential Regulators proposed rules to delay implementation of IM for Phase 5 smaller market participants until **September 1, 2021**
  - **Phase 4**:
    - Qualifying level: $.75 trillion
    - Effective Date: September 1, 2019
  - **Phase 5:**
    - Qualifying level: currently $8 billion [proposed change to $50 billion]
    - Effective Date: September 1, 2020
  - **Phase 6: [Proposed]**
    - Qualifying level: $8 billion
    - Effective Date: September 1, 2021
- On July 9, 2019, the CFTC issued a Staff Advisory to clarify documentation requirements for uncleared swaps will not apply until a firm exceeds a $50 million IM threshold

CROSS-BORDER & CROSS-AGENCY DEVELOPMENTS

January 2019

ISDA

Regulatory Driven Market Fragmentation

It has been 10 years since policy-makers came together through the Group of 20 (G-20) to agree a globally consistent regulatory agenda for derivatives. Since then, substantial progress has been made at the national level to implement rules on clearing, margin, trading, capital in line with the G-20 standards. Derivatives markets are safer, more transparent and more resilient as a result.

But while this progress is unmistakable, these regulatory reform efforts often differ in substance, scope and timing across jurisdictions. This has led to inefficiencies and higher costs for derivatives users, and ultimately results in increased risk.

This paper identifies examples of differences in how global standards have been implemented in individual jurisdictions, and recommends a series of steps that can be taken to address this issue. In particular, ISDA believes that global standard-setting bodies have a role to play in ensuring greater consistency in how rules are implemented, and in achieving a predictable, consistent and timely substituted compliance framework.

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- Market Fragmentation
- Brexit
- Cross-Border Clearing
- CCP Rules
- SEC-CFTC Harmonization (Cross-Agency)

FUND AND ASSET MANAGER DEVELOPMENTS

- The ETF Rule
  - On September 25, 2019, the SEC approved Rule 6c-11 under the Investment Company Act of 1940 (the “Rule”) and related amendments to Form N-1A (“Disclosure Amendments”)
  - The Rule will rescind previously-issued exemptive orders of ETFs that are “permitted to rely” on it one year from its December 23, 2019 effective date
  - Allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order
- Fund of Funds Rule – Rule12d1-4 proposed December 2018
- Expedited Exemptive Applications – Rule 0-5 (proposed October 2019)

SEC PROXY GUIDANCE

- Advice from proxy advisory firms must be commiserate with one's fiduciary duties
- Proxy voting advice provided by proxy advisory firms is generally considered a "solicitation"
  - Firms can still rely on exemptions from federal proxy filing requirements
  - Firms are still subject to Rule 14a-19
- Firms can avoid Rule14a-19 in the following ways:
  - Disclose methodology used to formulate voting advice
    - Identify groups that helped create voting advice methodology
    - Identify why this group was chosen
    - Identify why this group is different than that selected by the registrant
  - Disclose private information used
    - This is information other than that provided by the issuer
  - Disclose conflicts of interest

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QUESTIONS

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Compliance and Inspections

COMPLIANCE AND INSPECTIONS

- Speakers:
  - Stephen Humenik, K&L Gates – Moderator
  - Stephen Montgomery, Managing Director, FCM and Swap Dealer Compliance, Wells Fargo
  - Derek Steingarten, K&L Gates
  - Regina Thoele, Senior Vice President, Compliance, NFA

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MARKET PARTICIPANTS

Swap Dealers

- Holds itself out as **a dealer** in swaps;
- **Makes a market** in swaps;
- Regularly enters into swaps with counterparties as an **ordinary course of business** for its own account; or
- Engages in any activity causing it to be commonly known in the trade as a **dealer or market maker in swaps**
- Also referred to as "Dealers" or "Liquidity Providers."
- 107 Provisionally Registered
  - *Examples:*
    - *Bank of America*
    - *Goldman Sachs*
    - *JPMorgan*
    - *Mizuho*
    - *Morgan Stanley*
    - *Wells Fargo*
    - *BP*
    - *Shell*
    - *Cargill (Limited Designation)*

Major Swap Participants

- Not a swap dealer, **and**
- Maintains a **substantial position** in swaps

Intermediaries

- **Futures Commission Merchants (FCMs)**
  - engaged in **soliciting or in accepting orders** for the purchase or sale of futures and swaps;
  - **accepts any money**, securities, or property to **margin**, guarantee, or secure any trades
  - FCMs are also referred to as Clearing Firms or Clearing Members of a Derivatives Clearing Organization or Clearinghouse.
- **Introducing Brokers (IBs)**
  - engaged in **soliciting or in accepting orders** for the purchase or sale of futures and swaps;
- **Commodity Pool Operators (CPOs)**
- **Commodity Trading Advisors (CTAs)**
- **Registered Investment Advisors (RIA)**
- **Broker/Dealers**

Financial Entities

- Swap dealer or security-based swap dealer;
- Major swap participant or major security-based swap participant;
- Commodity pool;
- Private fund;
- Employee benefit plan;
- Banks (total assets of $10 billion or more)
- *Examples*
  - *Hedge funds*
  - *Commodity pools*
  - *Insurance companies*

Commercial End Users

- Not a financial entity;
- Using swaps to hedge or mitigate commercial risk; and
- Notifies the CFTC how it meets its financial obligations associated with entering uncleared swaps
- *Examples*
  - *General Mills*
  - *Commodity producers*
  - *Energy companies*

REGULATORY OVERSIGHT

Capital Markets and Derivatives Markets are subject to oversight from multiple Federal authorities, as well as the SROs.

CPO INTERNAL CONTROLS SYSTEM

- NFA Compliance Rule 2-9 provides that Commodity Pool Operators ("CPO") diligently supervise its employees and agents in all aspects of their commodity interest activities
- Per NFA Interpretive Notice 9074 (CPO Internal Controls System), NFA requires that a CPO "implement an internal controls system that is designed to deter fraudulent activity by employees, management, and third parties in order to address the safety of customer funds and provide reasonable assurance that a CPO's commodity pool's financial reports are reliable and that the Member is in compliance with all CFTC and NFA requirements"
- A CPO must demonstrate compliance with NFA Compliance Rule 2-9 and NFA Interpretive Notice 9074 through its internal controls system
  - Means of compliance include the CPO's policies and procedures and related training to its employees
- A CPOs ongoing compliance program should be designed to detect and remediate issues of noncompliance, in order to demonstrate compliance with applicable policies and procedures

INTERNAL CONTROLS - PRINCIPLES

A CPO's internal controls framework must demonstrate compliance with the following principles set forth in NFA Interpretive Notice 9074, as follows:

- **Separation of Duties**
  - Avoid a scenario where a single employee is in a position to carry out and conceal errors or fraud or have control over any two phases of a transaction or operation.
- **Risk Assessment**
  - Control objectives relate, in part, to compliance with the requirements related to pool subscriptions, redemptions and pool transfers and provides an examination of the controls in place to safeguard participant and pool assets.
- **Recordkeeping**
  - Maintain an internal controls report and other documentation that demonstrate compliance with the internal controls systems

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DEVELOPMENTS AND TRENDS

- CPOs/CTAs
- Swap Dealers
- FCMs
- Registered Investment Advisors/Registered Funds

DEVELOPMENTS AND TRENDS

- CFTC action is expected in the next six months on the following:
  - the swap dealer capital rule
  - the cross-border rule for swap dealers
  - position limits
  - enforcement penalty guidance
  - swap data reporting
  - bankruptcy rules
  - guidance on digital assets
- The new Director of the Division of Swap Dealer and Intermediary Oversight (DSIO), Joshua Sterling, has set forth five building blocks for DSIO, including:
  - (1) The Examination Program
  - (2) The Reporting Framework
  - (3) The Guidance Program
  - (4) The Relationship to Enforcement
  - (5) The Rulemaking Function

OCIE AND EXAMINATIONS

- Number of exams has increased under Chairman Clayton (but are more “business as usual” exams)
  - Use of data analytics is a key driver

- Exam priorities and initiatives include:
  - Advisory fees and expenses (e.g., mutual fund share class selections, consistency of advisory practices with disclosures)
  - Conflicts of interest
  - Portfolio management
  - Digital assets

2019 EXAMINATION PRIORITIES

- OCIE's annual priorities statement articulates six themes:
  - Main Street Investors (including seniors and those saving for retirement)
    - Exam focus areas include: fees and expenses (including disclosure of investing costs), conflicts of interest, senior investors and retirement accounts/products, and portfolio management processes
  - Registrants Responsible for Critical Market Infrastructure (clearing agencies)
  - FINRA and the MSRB
  - Digital Assets (crypto, coins, and tokens)
  - Cybersecurity
  - Anti-Money Laundering Programs

EXAMINATION PRIORITIES AND FACTS

- 3,150 examinations were completed in FY18 (10% increase from FY17)
- 17% of registered advisers were examined in FY18 (compared to 15% in FY17, and only 8% about five years ago)
- In 2018, number of registered advisers grew by 5%, assets increased to $84 trillion, 35% of registered advisers managed private funds, and more than 50% of registered advisers retained custody of client assets
- OCIE's Private Funds Unit remains active

EXAMINATION PRIORITIES AND FACTS

- Exams are risk-based (routine), sweep, or for cause
  - OCIE is increasingly leveraging data analytics and technology to select exam candidates
- Use of correspondence exams is increasing
  - More newly registered advisers are being examined
  - Correspondence exams can evolve into onsite exams
- Examiners are spending less time onsite during exams (however, supplemental requests and other correspondence by examiners are increasing)
- Importance of and need to be transparent, and organized, with examiners

EXAMINATION PRIORITIES AND FACTS

- OCIE's deficiency letter review project has identified the 'Top 10' list of adviser deficiencies:
  - Custody
  - Compliance program rule
  - Regulatory filings
  - Code of Ethics
  - Books and records
  - Best execution
  - Cash solicitation rule
  - Advisory fees and expenses
  - Advertising
  - Conflicts of interest

EXAMINATION PRIORITIES AND FACTS

- Percentage of investment advisers, investment companies and broker-dealers examined during the year

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Plan	FY 2018 Actual
Investment advisers	9%	10%	10%	11%	15%	15%	17%
Investment companies	11%	10%	15%	17%	11%	11%	15%
Broker-dealers	46%	49%	51%	50%	48%	48%	48%

Source: U.S. SEC FY 2018 Annual Performance Report

EXAMINATION PRIORITIES AND FACTS

- Percentage of exams that identify deficiencies, the percentage that result in a "significant finding" and the percentage referred to the Division of Enforcement

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Actual
Percentage that identify deficiencies	80%	76%	77%	72%	72%	69%
Percentage that result in a "significant finding"	35%	30%	31%	27%	20%	20%
Percentage referred to the Division of Enforcement	13%	12%	11%	9%	7%	6%

Source: U.S. SEC FY 2018 Annual Performance Report

NATIONAL EXAM PROGRAM: RISK ALERTS

- Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018)
- Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018)
- Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019)
- Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features (May 23, 2019)
- Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019)
- Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019)

RISK ALERT (1 OF 6)

Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018)

- Encourages advisers to review the adequacy and effectiveness of their solicitation agreements and client acknowledgements
- Frequently found deficiencies include:
  - Inadequate disclosures and missing terms in solicitor disclosure documents (e.g., nature of relationship to the adviser, compensation arrangements, and additional costs to the client)
  - Advisers failing to timely receive client acknowledgements
  - Payments of cash fees to solicitors without any solicitation agreements (or agreements lacking required provisions)
  - No bona fide efforts by advisers to ascertain solicitor compliance

RISK ALERT (2 OF 6)

Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018)

- Focuses on advisers' compliance with the Books and Records Rule for electronic communications, such as use of personal devices, social media and texting/IM
- Practices that can assist advisers in meeting their record and retention obligations include:
  - Permitting or prohibiting certain forms of electronic communication
  - Monitoring social media, emails and websites that employees use for business purposes, and retain/archive such communications
  - Load security apps or other software on employee devices

RISK ALERT (3 OF 6)

Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019)

- Encourages advisers to review their policies and procedures, and their implementation, to ensure the security and confidentiality of client records
- Frequently found deficiencies include:
  - Not properly configuring personal devices to safeguard personally identifiable information (PII) stored on those devices
  - Not requiring outside vendors to keep clients' PII confidential
  - Inadequately training employees on handling client information
  - Disseminating client login credentials to unauthorized personnel
  - Failing to remove former employee access rights after their departures

RISK ALERT (4 OF 6)

Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features (May 23, 2019)

- Focuses on risks with electronic storage of client records in the cloud and on other network storage solutions, such as:
  - Misconfigured security settings on network storage solutions
  - Inadequate oversight of vendor-provided network storage solutions
  - Insufficient data classification in advisers' policies and procedures
- Encourages firms to actively oversee vendors used for network or cloud storage
  - Non-industry specific example: Capital One data breach of 106 million card customers and applicants on Amazon's cloud (July 30, 2019)

RISK ALERT (5 OF 6)

Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019)

- In effort to protect retail investors, SEC conducted Supervision Initiative that focused on advisers':
  - Policies and procedures addressing activities by employees with disciplinary histories
  - Disclosures, including those relating to previously-disciplined employees
  - Conflicts of interests, particularly those regarding compensation arrangements and account management
- Nearly all examined advisers received deficiency letters, and frequently found deficiencies include:
  - No policies and procedures addressing risks associated with hiring/employing individuals with disciplinary histories; overreliance on such persons to self-report their histories
  - Undisclosed compensation arrangements, and other fees charged for services not delivered
  - Insufficient annual compliance program reviews (e.g., documentation, risk assessments)

RISK ALERT (6 OF 6)

Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019)

- Encourages advisers to review their policies and procedures, and their implementation, regarding principal trades and agency cross transactions
- Frequently found deficiencies and weaknesses include advisers:
  - Not recognizing trades as being principal trades, not making sufficient disclosures to clients about conflicts of interest and transaction terms, not obtaining the required consents, or obtaining client consent after completing principal trades
  - Failing to obtain appropriate prior client consent for each principal trade
  - For affiliated private funds, not recognizing that >25% ownership interests lead to principal trades (and not obtaining effective consent from private funds before completing principal trades)
  - Engaging in agency cross transactions while affirmatively stating to clients they would not, and not being able to produce documentation in compliance with written consent, confirmation and disclosure requirements of Rule 206(3)-2

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QUESTIONS

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Enforcement and Litigation Developments

ENFORCEMENT AND LITIGATION DEVELOPMENTS

- Speakers:
  - Clifford Histed, K&L Gates – Moderator
  - Ashley Burden, Trial Attorney, CFTC
  - Andrew Vrabel, Global Head of Investigations, CME
  - Paul Walsen, K&L Gates
  - Jason Yonan, Chief, Securities and Commodities Fraud Section, U.S. Attorney's Office

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

- November 2017—CME disciplined Tower Research Capital, holding it strictly liable for the conduct of three unnamed former traders who entered orders without the intent to trade.
- December 2017—CME disciplined former Tower trader Kamaldeep Gandhi for entering orders without the intent to trade.
- January 2018—CFTC filed an enforcement action in federal court against former Tower trader Krishna Mohan, charging him with spoofing and with violating CFTC Regulation 180.1. Thanked CME and DOJ for assistance.

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

- August 2018—CME disciplined former Tower trader Bruce Mao for entering orders without the intent to trade.
- October 12, 2018—CFTC entered into cooperation agreement with Gandhi, and thanked CME and DOJ.
- October 12, 2018—DOJ announced the indictment of Gandhi, Mao, and third trader Krishna Mohan for fraud, conspiracy to commit fraud, and spoofing. Thanked the CFTC for assistance.
- October 19, 2018—Private plaintiff filed a civil class action lawsuit against Tower and the three former traders alleging, among other things, violation of CFTC Regulation 180.1.

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

- November 2018—Gandhi and Mohan pleaded guilty to conspiracy to commit fraud, and agreed to cooperate with DOJ.
- November 6, 2019—CFTC settled an enforcement action against Tower, charging it with spoofing and with violating Regulation 180.1. Thanked CME and DOJ for assistance.
  - Recognized firm's cooperation and remediation
  - Ordered restitution of $32,593,849
  - Ordered civil penalty of $24,400,000
  - Ordered disgorgement of $10,500,000

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

- November 6, 2019—DOJ charged Tower with criminal commodity fraud, and entered into a Deferred Prosecution Agreement. Credited CFTC for referring the matter and providing assistance.
- DOJ required financial settlement terms identical to and concurrent with CFTC terms. DOJ credited firm for:
  - Immediately terminating the traders
  - Investing in sophisticated trade surveillance tools
  - Enhancing legal and compliance resources
  - Revising corporate governance and changing senior management

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

- Criminal DPA states that if there is a settlement or judgment in the putative class action lawsuit, DOJ will consider, in its sole discretion, whether private plaintiffs can recover from funds paid as restitution in the DOJ and CFTC settlements.
- Pursuant to DPA, Tower agreed to perform ongoing compliance monitoring and improvement, to include:
  - Senior management commitment to compliance
  - Written policies and procedures
  - Periodic risk-based review
  - Corporate oversight and compliance independence

Enforcement and Litigation Developments

Tower Research Capital – Agency Cooperation Timeline

Tower's DPA compliance conditions (cont'd):

- Internal reporting and investigation
- Enforcement and discipline
- Monitoring and testing of trade activity and compliance program

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Enforcement and Litigation Developments

SEC Rule 10b-5 (1948)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

In connection with the purchase or sale of any security.

CFTC Regulation 180.1 (2011)

It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly,

(1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;

(2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;

(3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; or

(4) [… To make false statements concerning market conditions …]

Enforcement and Litigation Developments

Charging Decisions – Department of Justice Guidance

JM 9-27.000 - “Principles of Federal Prosecution”

- Designed to “Promote the reasoned exercise of prosecutorial authority and contribute to the fair, evenhanded administration of the criminal laws.”
- “A determination to prosecute represents a policy judgment that the fundamental interests of society require the application of federal criminal law to a particular set of circumstances – recognizing both that serious violations of federal law must be prosecuted and that prosecution entails profound consequences for the accused, crime victims, and their families whether or not a conviction ultimately results.”

Enforcement and Litigation Developments

Charging Decisions – Department of Justice Guidance

JM 9-27.220 - "Grounds for Commencing or Declining Prosecution"

- "The attorney for the government should commence or recommend federal prosecution if he/she believes that the person's conduct constitutes a federal offense, and that the admissible evidence will probably be sufficient to obtain and sustain a conviction, unless (1) the prosecution would serve no substantial federal interest; (2) the person is subject to effective prosecution in another jurisdiction; or (3) there exists an adequate non-criminal alternative to prosecution."

Enforcement and Litigation Developments

Charging Decisions – Department of Justice Guidance

JM 9-28.000 - "Principles of Federal Prosecution of Business Organizations"

- "The prosecution of corporate crime is a high priority for DOJ. By investigating allegations of wrongdoing and bringing charges where appropriate for criminal misconduct, DOJ promotes critical public interests" which include:
  - protecting the integrity of our economic and capital markets by enforcing the rule of law
  - protecting consumers, investors, and business entities against competitors who gain unfair advantage by violating the law

Enforcement and Litigation Developments

Charging Decisions – Department of Justice Guidance

JM 9-28.000 - "Principles of Federal Prosecution of Business Organizations"

- "Generally, prosecutors apply the same factors in determining whether to charge a corporation as they do with respect to individuals." They also consider:
  - the adequacy and effectiveness of the corporation's compliance program at the time of the offense, as well as at the time of the charging decision
  - the adequacy of remedies such as civil or regulatory enforcement actions, including remedies resulting from the corporation's cooperation with relevant government agencies

Enforcement and Litigation Developments

Charging Decisions – CFTC "Guidance"

Enforcement Manual 5.12 – "Closing Investigations"

- the seriousness and scope of the conduct and potential violations
- the sufficiency and strength of the evidence
- the extent of potential harm if an action is not commenced
- the applicable statute of limitations
- whether there are any prior enforcement actions by the CFTC or other governmental agency or SRO or criminal prosecutions of the individual or entity

Enforcement and Litigation Developments

Failure to Train = Failure to Supervise

- Pursuant to an offer of settlement that McNamara Options LLC presented at a hearing on October 23, 2019, in which McNamara Options neither admitted nor denied, the findings or conclusions or the rule violations upon which the penalty is based, a Panel of the NYMEX Business Conduct Committee found that … McNamara Options submitted multiple block trades … with inaccurate execution times and also failed to report block trades to the Exchange within the required time period following execution. Additionally, the Panel found that McNamara Options failed to properly advise and train its employees as to relevant Exchange rules and Market Regulation Advisory Notices … in a manner sufficient to ensure compliance with the same.
- The Panel found that as a result of the foregoing, McNamara Options violated NYMEX Rules 526.F (“Block Trades”) and 432.W. (“General Offenses – Failure to Supervise”). In accordance with the settlement offer, the Panel ordered McNamara Options to pay a fine of $70,000.

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