

2015 CFTC Year-in-Review and a Look Forward

February 10, 2016

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Overview

Regulatory Initiatives

- Proposed Regulation Automated Trading (AT)
- Proposed Rule on Cybersecurity for DCOs, Trading Platforms, and SDRs

Finalizing Dodd Frank

- Final Margin Rule for Uncleared Swaps
- Position Limits

Enforcement

- Spoofing
- Benchmark Manipulation
- Insider trading
- Anti-manipulation



The Year Ahead

- Regulatory Initiatives
- CFTC Proposed Rules
 - Regulation Automated Trading (AT)
 - Rules on Cybersecurity for Derivatives Clearing Organizations, Trading Platforms, and Swap Data Repositories



Regulatory Initiatives

- Clearinghouse resiliency
 - Stress testing, recovery and resolution
- Governance
- Swap Execution Facilities
 - Made Available to Trade Process
 - Codifying no-actions
- Reporting



Regulation AT

Regulation AT would impose risk controls and other regulatory requirements on:

- AT Persons, who are
 - CFTC registrants engaged in “Algorithmic Trading” and
 - Proprietary traders who have direct access to DCMs and are engaged in Algorithmic Trading. This includes a new registration requirement for proprietary traders with direct electronic access as Floor Traders;
- Clearing member FCMs whose customers are AT Persons; and
- DCMs executing orders from AT persons.

Regulation AT: Pre-Trade Risk Controls

- Message and execution throttles;
- Order price parameters;
- Maximum order size limits;
- Natural person monitoring;
- Order Cancellation Systems;
- Connectivity Systems ;
- Algorithmic Trading Notifications to DCMs and FCMs;
- Self-Trade Prevention Tools;
- Periodic reviews of such controls



Regulation AT: Other Measures

Source Code Repositories (Only AT Persons)

- Required to make all of the information in the source code repository available to any representative of the CFTC or the U.S. DOJ upon request

Development and Testing

- Backtesting, stress tests, testing of algorithmic trading code

Monitoring

- Continuous, real-time monitoring; automated alerts; ability to disengage

Compliance

- Policies and procedures reasonably designed to ensure compliance

Training

- Procedures for designating and training all staff involved in the design, testing, and monitoring of algorithmic trading

Annual Reports

- Requires CEO or COO certification



Regulation AT: DCM Requirements

Disclosure and Transparency in DCM Trade Matching Systems

- DCMs must disclose the rules or specifications of its electronic matching platform or trade execution facility, including those that “materially affect the time, priority, price, or quantity of execution, or the ability to cancel, modify, or limit display of market participant orders.”

DCM Market and Trading Incentive Programs

- DCMs must disclose to the public specific information concerning the purpose of the trading incentive program, its rules, and the benefits it provides participants, among other information
- DCMs must disclose to the CFTC upon request program agreements, participants, benchmarks achieved, and payments to participants

Self-Trading Measures

- DCMs must have rules to prevent self-trading
- DCMs must apply, or provide and require the use of, self-trade prevention tools
- DCMs must identify, or require market participants to identify, which accounts should be prohibited from trading with each other



Cybersecurity for DCOs, Trading Platforms (DCMs and SEFs), and SDRs

Requirements

- Specified Cybersecurity Testing
- Minimum Testing Frequency
- Use of Independent Contractors
- Testing Scope
- Internal Reporting, Review, and Remediation
- Enterprise Risk Management and Governance



Cybersecurity: Applicable Entities

- All DCOs
- All SDRs
- All SEFs
- All DCMS
 - Some testing requirements, however, only apply to “Covered DCMs”
 - “Covered DCM”: Total annual trading volume is 5% or more of total annual trading volume of all DCMs regulated by Commission



Cybersecurity: Types of Cybersecurity Testing

All DCMs, DCOs, SDRs, and SEFs must, generally, conduct these tests at a frequency determined by an appropriate risk analysis

- Vulnerability testing—covered DCMs quarterly (2 quarters by independent contractors)
- Penetration testing (covered DCMs, at least annually)
- Controls testing (every two years by independent contractors)
- Security incident response plan testing (annually)
- Enterprise technology risk assessments (annually)



Cybersecurity: Testing Scope

- All testing and assessment required by Commission regulations must be broad enough to include all testing of automated systems and controls necessary to identify any vulnerability which, if exploited or accidentally triggered, could enable an intruder or unauthorized user or insider to:
 - Interfere with the registrant’s operations or with fulfillment of its statutory and regulatory responsibilities;
 - Impair or degrade the reliability, security, or capacity of the registrant’s automated systems;
 - Add to, delete, modify, exfiltrate, or compromise the integrity of any data related to the registrant’s regulated activities;
 - Undertake any other unauthorized action affecting the registrant’s regulated activities or the hardware or software used in connection with those activities.



Cybersecurity: DCM, SEF, and SDR Systems Safeguards

The Commission proposes to define DCM and SEF responsibilities with respect to the following risk analysis and oversight areas:

- (1) Information security;
- (2) Capacity and performance planning;
- (3) Systems operations;
- (4) Systems development and quality assurance;
- (5) Physical security and environmental controls.
- (6) Enterprise risk management and governance (new), which includes:
 - Assessment, mitigation, and monitoring of security and technology risk.
 - Capital planning and investment with respect to security and technology.
 - Board of directors and management oversight of system safeguards.
 - Information technology audit and controls assessments.
 - Remediation of deficiencies.



Finalizing Dodd-Frank

- CFTC Margin for Uncleared Swaps
- Position Limits and Aggregation



Final CFTC Margin Rule for Uncleared Swaps

Entities Covered

- “Covered Swap Entities” (CSEs): Non-Prudentially regulated Swap Dealers (SDs) and Major Swap Participants (MSPs)
- Financial end users (includes, among others, Security-Based SDs and MSPs)
- Exempt: The Commission published an interim final rule to exempt “commercial end users”

Transactions Covered

- Uncleared swap transactions by a CSE with SDs, MSPs, and financial end-users
- Certain inter-affiliate swaps with non-US financial end user affiliates that are not subject to comparable IM requirements on their own outward-facing swaps

Eligible Collateral

- IM – Cash, specified securities, gold (subject to haircuts)
- VM – Swaps between CSEs – Cash (USD, major currencies, settlement currency)
- Swaps between CSE and financial end user – Same as IM

Compliance Schedule

- VM – Sep. 1, 2016 or Mar. 1, 2017;
- IM – between Sep. 1, 2016 and Sep. 1, 2020



Final CFTC Margin Rule for Uncleared Swaps: Initial and Variation Margin

Initial Margin

- Daily two-way margin to be posted and collected for all uncleared swaps between
 - CSEs and swap dealers/MSPs and
 - CSEs and financial end users that have over \$8 billion in gross notional exposure in uncleared swaps
- CSEs may adopt maximum \$50M IM threshold (on consolidated basis) below which it need not collect IM

Variation Margin

- CSEs must post or collect VM, depending on the value of the VM, daily for all uncleared swaps with SD/MSPs or financial end users

Counting - Material Swaps Exposure Threshold

- Must include uncleared security-based swaps and FX swaps and forwards in determining exposure, but these instruments are not subject to margin



Final CFTC Margin Rule: Inter-affiliate Swaps

- **Posting IM:** CSE not required to post IM to affiliates (consolidated on a financial statement) other than swap entities regulated by prudential regulators, in which case CSE must post IM equal to the amount that the swap entity is required to collect under the rules of the Prudential Regulators.
- **Collecting IM:** CSE not required to collect IM from affiliates (consolidated on a financial statement) if the CSE's swaps are subject to centralized risk management and VM is exchanged.
- **VM:** For swaps between CSE and its affiliates, VM must be exchanged.
- **Foreign affiliates:** CSE must collect IM from a financial end user affiliate that directly or through another affiliate enters into uncleared swaps with third parties in another jurisdiction that does not comparably require IM for uncleared swaps.



Final CFTC and Prudential Regulators' Margin Rules: Major Differences

- Commercial end user counterparty with no end user clearing exemption
 - CFTC: rules do not apply
 - PR: CSE must collect IM and VM as it determines is appropriate
- Financial end user without material swaps exposure
 - CFTC: IM not required, VM required
 - PR: IM required as determined appropriate by CSE, VM required
- Affiliated financial end user with material swaps exposure
 - CFTC: IM generally not required (conditions apply), VM required
 - PR: CSE must collect but need not post IM. CSEs may adopt maximum IM threshold of \$20M per affiliate pair below which it need not collect
- PR rules also apply to security-based SDs and MSPs and uncleared SBS
- PR rules address cross-border, CFTC still considering proposal
- CFTC permits NFA to approve IM models. No SRO approval under PR rules



CFTC Margin and Capital Rules: Remaining Steps

- Finalize cross-border application of the margin rules
- Finalize interim-final rule exempting commercial end users from margin requirements.
- Finalize/re-propose capital rules for SDs and MSPs



Speculative Position Limits

Proposed Rule for 28 Commodities (Futures and Swaps)

- Categories: agricultural, energy, and metal

Calculation of Limits

- Spot-Month Limits:
 - 25% of estimated deliverable supply
 - Limits apply separately to physical-delivery and cash-settled contracts (i.e., no netting)
 - Conditional Spot Month Limit: Traders ONLY in the cash market may hold positions up to 125% of the spot month limit.
- Non-Spot-Month Limits:
 - 10/2.5% formula
 - Applies to positions a trader may have in all contract months combined, or in a single contract month
 - Based on data from reporting pursuant to Parts 16, 20, & 45
 - Can net positions across futures, options, economically equivalent swaps, and linked contracts offered by FBOTs



Position Limits: Bona Fide Hedging

General Bona Fide Hedging Requirements:

- Narrower definition: Purpose of position must be to offset price risks incidental to commercial cash, spot, or forward operations; and
- Fewer enumerated hedges.
- Proposal Being Considered: Delegate responsibility to exchanges to administer non-enumerated hedge exemptions



Position Limits: Aggregation

Proposed Rule on Aggregation:

- Requires aggregation in accounts for which (1) any person directly or indirectly controls trading or (2) holds a 10 percent or greater ownership or equity interest
 - Commission supplemental proposal would simplify the exemption process for greater than 50 percent owners by permitting them to follow the same procedure that would apply for owners of an interest between 10 and 50 percent



Enforcement

- Spoofing
- Benchmark Manipulation
- Insider trading
- Anti-manipulation



Spooing

Section 4c of the CEA: It is unlawful for “any person to engage in any trading, practice or conduct on or subject to the rules of a registered entity that . . . is, of the character of, or is commonly known to the trade as, ‘spoofing’ (bidding or offering with the intent to cancel the bid or offer before execution).”

- 2015: Growing number of spoofing cases from CFTC and DOJ. The statute has withstood its first legal challenge.
- 2016: Expect additional spoofing investigations and coordination between the CFTC and DOJ on these and other trading violations.



Spoofer Cases in 2015

- *United States v. Coscia*, 100 F. Supp. 3d 653 (N.D. Ill. 2015)
 - DOJ and CFTC actions. The civil action was pre-2015.
 - Algorithmic trading in commodity futures
 - Court rejected Coscia’s argument that anti-spoofing provision and the commodity fraud provisions were unconstitutionally vague
 - Jury found him guilty on all counts. Awaiting sentencing.
- *United States v. Sarao*, No. 15 CR 75 (N.D. Ill. Feb. 11, 2015); *CFTC v. Nav Sarao Futures Ltd. PLC*, No. 15-cv-03398 (N.D. Ill. Apr. 17, 2015)
 - DOJ and CFTC actions
 - Algorithmic trading in the E-Mini S&P futures contract
- *CFTC v. Oystacher*, No. 1:15-cv-09196 (N.D. Ill. Oct. 19, 2015)
 - Manual trading in the E-Mini S&P 500, Copper, Crude Oil, Natural Gas, and VIX futures contracts
 - Also subject to several exchange enforcement actions
 - Oystacher has challenged anti-spoofing provision as unconstitutionally vague
- *CFTC v. Khara*, No. 15 cv 03497 (S.D.N.Y. May 5, 2015)
 - Manual Trading in the gold and silver futures market



Benchmark Manipulation

2015: The CFTC continued its efforts against benchmark manipulation. The CFTC levied the largest fine in its history in a benchmark manipulation case.

2016: Expect continued focus on large-scale manipulation cases in 2016. Commission is investigating potential misconduct in Treasury auctions and related futures markets.



Benchmark Manipulation

- *In re Deutsche Bank AG*, CFTC Docket No. 15-20 (Apr. 23, 2015).
 - LIBOR and Euribor manipulation
 - Largest fine in CFTC history – \$800 million
- *In re Barclays PLC*, CFTC Docket No. 15-25 (May 20, 2015)
 - ISDAFIX Benchmark Swap Rates
 - FX benchmark manipulation
 - \$515 million total fines
- *In re Total Gas & Power North America, Inc.*, CFTC Docket No. 16 -03 (Dec. 7, 2015)
 - Natural gas indices manipulation
 - \$3.6 million



Insider Trading

CFTC Regulation 180.1 is patterned after SEC Rule 10b-5.

- (a) 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 . . .

- The CFTC “will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of [Exchange Act] Rule 10b–5.”

First Insider Trading Case: *Motazed*

In re Arya Motazed, CFTC Docket No. 16 -02, at 3 (Dec. 2, 2015)

- Facts: Employee used information about employer's trading in violation of employment terms to trade against employer and personally profit
- CFTC generally applied the misappropriation theory of insider trading developed under SEC Rule 10b-5, but crafted its own materiality standard
 - SEC Standard

Information is material if it would have been “viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”

The “reasonable investor” standard is an objective
 - CFTC Standard

Crafted a broader “materiality” standard than the securities’ law “reasonable investor” standard



Anti-Manipulation

CFTC v. Kraft Foods Group, Inc. and Mondelēz Global, LLC, No. 15-cv-2881 (N.D. Ill. Apr. 1, 2015)

- Alleged manipulation of the wheat market
- U.S. District Court decision on motion to dismiss was the first judicial interpretation of CEA Section 6(c)(1) and Rule 180.1
 - District court held that 180.1 only prohibits fraud, not non-fraud manipulations
 - Relies on securities laws precedent
 - Potential to circumscribe the breadth of 180.1

CFTC v. Wilson & DRW Investments, No. 13-cv-7884 (S.D. NY. Nov. 6, 2013)

- Appropriate standard for attempted manipulation under Regulation 180.2?



QUESTIONS?



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