Trading Compliance

Schulte Roth & Zabel

26TH ANNUAL PRIVATE INVESTMENT FUNDS SEMINAR

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Investment Management
Regulatory & Compliance
Private Equity
Hedge Funds
Energy
Cybersecurity

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Brian advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organizational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the National Futures Association. Brian also regularly represents clients in enforcement actions, regulatory examinations, trading inquiries, and in seeking no-action or similar relief. Having spent nearly a decade in-house as general counsel and chief compliance officer of several prominent investment management firms, Brian is well-versed in the wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisers.

Brian is a recognized leader in advising alternative investment fund managers on regulatory and compliance matters and is well-known for his thought leadership in this area. He also regularly represents managers in examinations, investigations, and enforcement actions in both the securities and the commodity futures sectors. *Chambers Global* and *Chambers USA* list Brian as a "leading individual" in investment funds, noting that he is "especially skilled at assisting clients with the development of strategic compliance programs." Interviewees also praise him for knowing "what it's like on the ground" and for providing "practical and meaningful advice." In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring *SRZ Client Alerts* and *SRZ White Papers*, he authored "New Form ADV: The Impact on Private Fund Advisers" and "The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers," published in *The Hedge Fund Journal*. His recent speaking engagements addressed topics including current trends and challenges in systematic and quant strategies, and managing attorney-client privilege. Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel. He is a chair of the Steering Committee for the Managed Funds Association's CTA/CPO Forum and a member of the CFTC Working Group for the Alternative Investment Management Association, as well as the New York City Bar Association's Private Investment Funds Committee. He formerly served as co-chair of the MFA's General Counsel Forum, its CTA, CPO & Futures Committee, and as a steering committee member of its Investment Advisory Committee.

Brian received his J.D., *with distinction*, from Stanford Law School, his M.A. from the University of Hawaii, and his B.A., *magna cum laude*, from Catholic University of America.

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Complex Commercial Litigation

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Regulatory & Compliance

Securities Enforcement

Securities Litigation

White Collar Defense & Government Investigations

Harry S. Davis

Harry focuses his practice on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, introducing brokers and interdealer brokers, and auditors and administrators. He has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, U.S. Attorneys' offices, DOJ, CFTC, FTC, state attorneys general, state securities regulators and self-regulatory organizations. Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent victory for an inter-dealer broker in an arbitration brought by one of its competitors for alleged misappropriation of trade secrets as well as in a 4-1/2 month jury trial in a raiding case, and his successful representation of a prime broker in a high-profile jury trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of a career spanning more than 25 years, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, market timing and late trading, misconduct involving PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty, employee raiding and other employment issues, misappropriation of trade secrets and other business torts, and breach of contract, among other claims.

Harry is recognized as a leading lawyer by *The Legal 500 United States* and by *New York Super Lawyers*. He is a member of the American Bar Association, the New York State Bar Association, the New York County Lawyer's Association, the New York City Bar Association, the Federal Bar Council, the Federalist Society and Securities Industry and Financial Markets Association's Compliance and Legal Division, and he is the former chair, co-chair and vice chair of the Trade Regulation Committee. A prolific author and speaker, Harry is the editor of and author of several chapters in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute), a definitive treatise written in question and answer format and designed to help educate and protect clients from regulatory exposure. He is also the author of a chapter in *Private Fund Dispute Resolution*, which serves as a primer regarding U.S. and U.K. regulatory inquiries, investigations and examinations of private investment funds, and he recently published an article concerning short selling under Rule 105. He has presented on a wide range of topics, including SEC examinations and enforcement actions, how hedge funds can protect themselves against insider trading, limiting liability for compliance officers, and civil litigation relating to securities enforcement.

Harry holds a J.D., *magna cum laude*, from Cornell Law School, where he was Order of the Coif, and a B.A. from Johns Hopkins University.

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Jacob Preiserowicz

Jacob focuses his practice on counseling commodity pool operators, commodity trading advisors, other commodity professionals and private investment fund managers on operational, regulatory and compliance matters. He regularly advises hedge and private equity fund managers with respect to futures and swaps trading; the U.S. Commodity Futures Trading Commission's (CFTC) exemptions, registration and reporting requirements; and compliance with the requirements of the National Futures Association, as well as CFTC and exchange rules concerning OTC and listed derivatives. Jacob conducts training sessions with respect to regulatory compliance matters and helps guide firms through regulatory examinations. He also has expertise in the formation and ongoing operational needs of hedge funds and other private investment funds and provides guidance on a variety of regulatory, compliance and risk management issues related to the implementation of the Dodd-Frank Act. Jacob joined Schulte Roth & Zabel from the CFTC, where he served most recently as Special Counsel in the Division of Swap Dealer and Intermediary Oversight. At the CFTC, he drafted new regulations and worked on a broad range of matters relating to CFTC registration and compliance.

Jacob has spoken at a series of SRZ workshops and seminars on CFTC registration, NFA examinations, trade compliance and hedge fund and management company structures. He co-authored "The CFTC Brings (and Settles) Its First Insider-Trading Case: Implications for All Private Fund Managers," published in *The Hedge Fund Journal*, and is a contributor to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

Jacob earned both J.D. and M.B.A. degrees from Fordham University. He was the Notes & Articles editor of the *Fordham Journal of Corporate & Financial Law* and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

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David S. Sieradzki

David focuses his practice on representing broker-dealers, investment advisers and hedge funds in connection with matters arising under federal and state securities laws and self-regulatory organization rules. His practice encompasses a wide range of regulatory issues affecting financial services firms and institutional investors, including market access; equity and fixed-income trading practices; order handling and execution issues; market making; broker-dealer and alternative trading system registration; outsourcing; audit trail and trade reporting requirements; and creation and distribution of research reports and other communications with the public. He also advises clients in connection with mergers and acquisitions involving broker-dealers. In addition to regulatory counseling, David represents clients in enforcement proceedings and conducting internal investigations. He has played an important role in matters involving, among other things, specialist trading, market making, agency trading, market access, research, broker-dealer registration and the self-regulatory function of securities exchanges. Prior to entering private practice, David was a special counsel at the U.S. Securities and Exchange Commission's Division of Trading and Markets and counsel to Commissioner Isaac C. Hunt, Jr.

Recognized as a leading financial services regulation lawyer by *Chambers USA*, David is the co-author of "The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers," published in *The Hedge Fund Journal*.

David received his J.D. from New York Law School, where he was articles editor of the *New York Law School Journal of International and Comparative Law*, and his B.B.A. from Hofstra University.

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Peter H. White

Pete concentrates his practice on representing corporations and executives in criminal and related civil and administrative matters, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. Pete has litigated disputes involving accounting and securities fraud, Foreign Corrupt Practices Act violations, government program fraud, false claims and statements, antitrust violations, public corruption, tax evasion, insider trading, environmental violations and other claims. A former Assistant U.S. Attorney for the Eastern District of Virginia and the District of Columbia, Pete has served as lead counsel in over 80 federal and local jury trials and many more bench trials, and has had the distinction of serving as a law clerk to the Honorable Richard L. Williams of the Eastern District of Virginia.

Pete is the recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney and has performed with comparable skill as a private practitioner. Over the past 17 years, Pete has been lead trial counsel for individuals charged with federal fraud charges in public corruption, government programs and public company accounting. He has prevailed on over 95 percent of all charges that have gone to trial, and in three of his last four trials, all fraud charges have resulted in dismissal or acquittal. In 2015, he represented an individual charged with 60 federal fraud felony counts. The defendant was acquitted of all charges by the jury. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America*, *Chambers USA*, *Ethisphere: Attorneys Who Matter*, *The Legal 500 United States*, *Washington DC Super Lawyers*, *Washingtonian's* "Washington's Top Lawyers" and *The Washington Post*. Pete was recently featured in "Trial Pros: Schulte's Peter White," published by *Law360*, and co-authors the "Civil and Criminal Enforcement" chapter of the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). He has spoken widely on insider trading, securities enforcement and related civil litigation, and FCPA enforcement.

Pete obtained his B.A., *with high honors*, from University of Notre Dame and his J.D. from The University of Virginia School of Law, where he was Order of the Coif and on the management board of the *Virginia Law Review*.

Trading Compliance

I. SROs

A. Authority

1. The regulatory role of a national securities exchange was established in Section 6 of the Securities Exchange Act of 1934 (the "Exchange Act"), which required all existing securities exchanges to register with the SEC and to function as their own self-regulatory organization ("SRO").[1]

2. Section 19 of the Exchange Act, as amended in 1975, gives the SEC broad authority to regulate all SROs. SROs are responsible for promulgating rules that govern trading in their markets; however, the SEC retains the authority to approve or repeal SRO rules. Section 19 also charges SROs with establishing the necessary systems and procedures to enforce their rules, monitor trading, identify instances of suspicious trading, and enforce the Exchange Act. Although SROs have the authority to take final disciplinary actions against their members, SROs are required to notify the SEC of such actions. SRO final disciplinary actions are subject to review by the SEC or any other appropriate regulatory authority.[2]

3. The SEC has statutory authority to institute enforcement proceedings against SROs that fail to comply with their statutory obligations. Such enforcement actions may give rise to sanctions such as censure, suspension or in the most extreme cases, revocation of the SRO's registration.[3]

B. Jurisdiction

Section 19 of the Exchange Act specifies that SROs have jurisdiction to enforce their rules only over their members.[4] If an SRO identifies potential misconduct involving persons or entities within its jurisdiction, the SRO is responsible for investigating and, when appropriate, bringing a disciplinary action. If an SRO identifies potential misconduct involving persons or entities outside its jurisdiction, it is responsible for making referrals to the Commission or the appropriate agencies and assisting those agencies with their investigations.[5]

Although an SRO's statutory jurisdiction extends only to its members, it may seek information from nonmembers when investigating potential misconduct. In such a case, a nonmember may voluntarily submit to an SRO's authority to resolve the matter and avoid a referral to the Commission.

II. CFTC Futures Exchanges

A. The Commodity Futures Exchange Commission ("CFTC") is the agency tasked with enforcing the laws regarding market manipulation, fraud and alleged misconduct in most derivatives markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") has expanded the CFTC's enforcement opportunities significantly by prohibiting manipulation and fraud in connection with "any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or

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[1] 15 U.S.C. 78f.

[2] 15 U.S.C. 78s.

[3] 15 U.S.C. 78s(h)(1).

[4] 15 U.S.C. 78s(g).

[5] *Available at* www.sec.gov/rules/concept/34-50700.htm#IVC.

subject to the rules of any registered entity."[6] The CFTC also obligates many of the designated contract markets ("Futures Exchanges") to enforce many of the CFTC rules and to implement many of their own rules as well.[7]

B. Many of the Futures Exchanges are owned by the Chicago Mercantile Exchange ("CME") Group. The CME Group is comprised of the CME, Chicago Board of Trade ("CBOT"), New York Mercantile Exchange ("NYMEX") and Commodity Exchange Inc. ("COMEX"), and is tasked with the regulation and enforcement of its members and market activity (of even nonmembers).

1. CME Jurisdiction

(a) Unlike SRO exchanges, anyone who initiates or executes a trade on any of the CME Group exchanges, even a nonmember, directly or through an intermediary, consents to the CME Group's jurisdiction (including any disciplinary actions brought by a CME exchange). CME Group Rule 418 specifies that:

"Any Person initiating or executing a transaction on or subject to the Rules of the Exchange directly or through an intermediary, and any Person for whose benefit such a transaction has been initiated or executed, expressly consents to the jurisdiction of the Exchange and agrees to be bound by and comply with the Rules of the Exchange in relation to such transactions, including, but not limited to, rules requiring cooperation and participation in investigatory and disciplinary processes."[8]

(b) If a party violates one of the CME Group rules, the CME Group, under Rule 402.B., has the authority to impose sanctions including:

(i) A fine of up to $5 million per violation;

(ii) Order a party to make restitution to the account of anyone damaged by the conduct; and/or

(iii) Order a party to disgorge any monetary benefit resulting from a violation, whether by that party or another party. "Benefit" includes, without limitation, profit, whether realized or unrealized, and avoided losses.

2. CFTC Oversight of Futures Exchange

Futures Exchanges, including the CME Group exchanges, are subject to oversight and periodic review of its programs by the CFTC. One of the catalysts for increased enforcement by the Futures Exchanges in recent years are these periodic reviews by the CFTC.

(a) In 2014, the CME Group was subject to a review by the CFTC of its disciplinary program for the one-year period from April 1, 2012 to March 31, 2013. As part of that review, the CFTC's Division

[6] *Available at* www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-17549.

[7] 17 CFR § 38.150.

[8] See CME Rule 418, CBOT Rule 418 and NYMEX Rule 418 (NYMEX rules apply to COMEX). CME, CBOT, NYMEX and COMEX are independent exchanges with their own sets of rules. To provide a common regulatory framework for market users, the rulebooks have been substantially harmonized, making the rules parallel in structure, numbering and language where possible. (*Available at* www.cmegroup.com/market-regulation/rulebook.html.)

of Market Oversight critiqued the CME Group's enforcement efforts, specifically citing a shortage of enforcement staff at the CME.[9]

(b) In 2016 NYMEX and COMEX, wholly owned subsidiaries of the CME Group, were subject to a review by the CFTC of its market surveillance program for the one-year period from March 1, 2014 through March 1, 2015. The CFTC found that both exchanges have adequate market surveillance programs, including sufficient staff for the programs under review. The CFTC made only one recommendation regarding the exchanges' programs for monitoring position limit exemptions.[10]

3. Many of the rules of the Futures Exchanges involve highly technical matters, such as Exchanges for Related Position ("EFRPs"). These rules are often very specific and can present traps for the unwary. In 2015 and 2016, many of the enforcement actions (and settlements) brought by the Futures Exchanges involved EFRPs and other technical rules.

(a) Exchange for Related Positions ("EFRP") transactions allow investors to exchange futures contracts for their related physical instruments, derivative positions, options or other OTC contracts with similar characteristics.[11] In response to CFTC pressure, EFRPs have recently been the focus of regulatory actions by the Futures Exchanges.

(b) In 2016, Futures Exchanges continued to request documentation to verify that EFRP transactions were "bona fide transactions" and that any EFRP transactions entered into were in accordance with exchange rules. Understanding the various types of EFRPs, having policies in place that distinguish between permitted and impermissible EFRPs, and having effective training with trading and investment personnel are some key components to preventing EFRP infractions. Due to the highly technical nature of EFRP rules, strict liability is generally imposed on violators. It is important to note that even in instances where a fund engages in an EFRP in reliance on advice that it received from its broker (even highly regarded brokerage firms), such good faith reliance on the broker's advice will not excuse the fund in the event that the resultant transaction does not adhere strictly to the EFRP rules.

C. CFTC Enforcement.

1. In FY 2015, the CFTC brought 69 enforcement actions and collected $3.14 billion in penalties, the largest amount the CFTC has collected in its history.[12]

2. Similar to FY 2015, in FY 2016, the CFTC brought 68 enforcement actions. The CFTC also obtained orders totaling approximately $1.29 billion in restitution, disgorgement and penalties.[13]

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[9] *Available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rernymex_comex101116.pdf.

[10] *Available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rernymex_comex101116.pdf (The CFTC recommended that the Exchanges consider implementing a formal review process by which market surveillance staff can verify that a market participant who has a position larger than a position limit is, in fact, making use of an exemption consistent with the strategy described in their exemption application.).

[11] CME Group, Exchange for Related Positions ("EFRPs"), *available at* www.cmegroup.com/clearing/trading-practices/efp-efr-eoo-trades.html.

[12] Press Release, Commodities Futures Trading Commission, CFTC Releases Annual Enforcement Results for Fiscal Year 2015 (Nov. 6, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7274-15.

[13] *Available at* www.cftc.gov/PressRoom/PressReleases/pr7488-16.

III. SEF Enforcement

A. A Swap Execution Facility ("SEF") is a regulated facility, trading system or platform in which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants in the facility. In November 2013, U.S. persons trading swaps on a "multi-to-multi" platform were required to begin trading through SEFs. In February 2014, U.S. persons were required to trade through a SEF for any made available to trade ("MAT") transaction.[14] By providing price competition that comes from trading platforms on which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants, SEFs are intended to promote pre-trade price transparency in the swaps market.

B. SEFs are subject to SEC and CFTC regulation as a result of the Dodd-Frank Act. In 2014, the CFTC critiqued the CME Group for its enforcement program.

C. SEFs such as BSEF (a SEF operated by Bloomberg)[15] and trueEX,[16] incorporate Dodd-Frank rules into their rulebooks. Much like SROs, every SEF has its own enforcement regime. Like other SEFs, Bloomberg and trueEX's rules on jurisdiction differ from the jurisdictional rules of SROs, such as FINRA, which have jurisdiction only over their members.

1. Bloomberg SEF LLC Rule 311(a) states:

   "Any market participant that directly or indirectly effects a transaction on the SEF operated by BSEF, or any participant, authorized trader, clearing member or other person accessing or entering any RFQ or order or submitting any swap into the SEF operated by BSEF or executing any trade pursuant to the Rules (i) is bound by, and shall comply with, the BSEF rules and obligations, the clearing house rules, swap specifications and applicable law, in each case to the extent applicable to it, (ii) submits to the jurisdiction of BSEF with respect to any and all matters arising from, related to, or in connection with, the status, actions or omissions of such participant, authorized trader or other person, and (iii) agrees to assist BSEF in complying with its legal and regulatory obligations, cooperate with BSEF, the CFTC and any governmental body with jurisdiction over BSEF or the SEF operated by BSEF in any inquiry, investigation, audit, examination or proceeding."

2. trueEX LLC Rule 301 states:

   "Any person initiating or executing a transaction on or subject to the rules of the Exchange directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed, expressly consents to the jurisdiction of the exchange and agrees to be bound by and comply with all applicable rules of the exchange to the extent applicable to it, including those applied pursuant to applicable law."

IV. Position Limits

A. Equity Options

1. U.S. options exchanges have rules regarding the maximum number of options that a single investor or a group of investors acting in concert or common control may hold. While the rules are generally

[14] Press Release, The Commodity Futures Trading Commission Staff Announces Trade Execution Mandate for Certain Interest Rate Swaps (Jan. 16, 2014), *available at* www.cftc.gov/PressRoom/PressReleases/pr6831-14.

[15] *Available at* https://data.bloomberglp.com/professional/sites/4/BSEF-Rulebook-December-15-2016.pdf.

[16] *Available at* www.trueex.com/rules-and-notices.

directly applicable to exchange members such as a fund's brokers, and not the funds themselves, brokers may contractually obligate their customers to stay below these thresholds. Brokers may also be required to reduce any positons that they believe are above such thresholds.

2. FINRA Rule 2360 sets out applicable position limits for options.[17] The rule classifies equity options as standardized, conventional or FLEX. Standardized and FLEX equity options are exchange-traded and conventional options trade OTC.[18] FINRA Rule 2360(b)(3)(A) imposes a position limit on the number of equity options contracts in each class,[19] on the same side of the market that are held or written by a firm, a person associated with a firm, a customer or a group of customers.[20] If a person or group of persons holds an aggregate position in option contracts in excess of the allowed position limits, no broker or dealer may effect an opening transaction on behalf of that entity or group without an exemption from the applicable position limit.

3. It is important to note that position limits for standardized (exchange-traded) and conventional (OTC) options are calculated independently.

4. Position Limit Exemptions

    (a) Some strategies and options positions for standardized options render the position exempt from position limits. The same strategies and positions for conventional options increase the positon limit to five times the default limit.

    (b) Examples of strategies and positions that affect positon limits:

        (i) Back-to-back options are listed as option positions hedged on a one-for-one basis with OTC option positions on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

        (ii) Box spreads are long call positions accompanied by short put positions with the same strike price and short call positions accompanied by a long put position with a different strike price.

        (iii) A collar is a short call position accompanied by a long put position, where the short call expires with the long put and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

        (iv) Conversions are short call positions accompanied by long put positions where the short call expires with the long put, and the strike price of the short call and long put is equal, and where each short call and long put position is hedged with 100 shares (or other

[17] FINRA Rule 2360(a)(21) defines an option as "any put, call, straddle or other option or privilege, which is a "security" as defined in Section 2(1) of the Securities Act, as amended, but shall not include any (A) tender offer, (B) registered warrant, (C) right, (D) convertible security or (E) any other option in respect to which the writer (seller) is the issuer of the security which may be purchased or sold upon the exercise of the option."

[18] *See* SEC, Release No. 34-70619 at 2-3, Oct. 7, 2013, *available at* www.sec.gov/rules/sro/finra/2013/34-70619.pdf.

[19] FINRA Rule 2360(a)(3) defines a "class of options" to mean all option contracts of the same type of option covering the same underlying security or index.

[20] *See* SEC, Release No. 34-70619 at 12.

adjusted number of shares) of the underlying security or securities convertible into such underlying security.

(v) Reverse collars are long call positions accompanied by short put positions where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

(vi) Reverse conversions are when a long call position accompanied by a short put position expires with the short put and the strike price of the long call and short put is equal and each long call and short put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

(vii) Where each option contract is covered by 100 shares of the underlying security or securities convertible into the underlying security, or, in the case of an adjusted option, the same number of shares represented by the adjusted contract: (1) long call and short stock; (2) short call and long stock; (3) long put and long stock; or (4) short put and short stock.

B. Futures

1. Exchange-based trading in derivative instruments is often subject to position limit rules. Throughout 2016, U.S. futures and options exchanges continued to aggressively pursue enforcement actions against fund managers and others for position limit violations. Fines and penalties also continued to increase during the year.

2. Proposed Expansion of CFTC Position Limits

(a) The CFTC rules currently impose position limits for nine futures and commodity options contracts. Found in Part 150 of the CFTC Regulations, these "Legacy Contracts" apply to the following nine contracts: corn and mini-corn, oats, soybeans and mini-soybeans, wheat and mini-wheat, soybean oil, soybean meal, hard red spring wheat, cotton no. 2 and hard winter wheat.[21] The U.S. commodity interests position limits regime, however, is much broader than the nine Legacy Contracts, as the CFTC (in CFTC Rule 150.5) requires the Futures Exchanges, such as the CME Group Futures Exchanges and ICE Futures U.S., to implement limits on non-Legacy Contracts. The CFTC rules do specify precise limits for non-Legacy Contracts, but the CFTC has provided certain maximum limits and formulas that the Futures Exchanges must use when determining commodity interests position limits.

(b) In December 2016, the CFTC re-proposed rules that would expand the scope of the existing federal position limits regime for exchange-traded futures contracts (the "Re-Proposal").[22] The Re-Proposal would:

(i) Establish federal limits on speculative positions in 25 core physical commodity futures contracts (instead of the current nine); and

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[21] 17 CFR §§ 150 *et seq*. (2011).

[22] *Position Limits for Derivatives:* Re-proposal (Dec. 5, 2016), *available at* www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister120516.pdf.

(ii) Require their economically equivalent "referenced contracts" (i.e., options and swaps) to count towards such limits.

(c) It will fall to the new CFTC administration (in 2017 or later) to take any action with respect to finalizing those rules. The Re-Proposal requested comments on the possibility of delaying the compliance date of any final rule to Jan. 3, 2018, which would align the expanded CFTC position limits rules with new EU position limits rules scheduled to go into effect on that date.

3. New CFTC Aggregation Rules

(a) In 2013[23] and in 2015,[24] the CFTC proposed amendments to the CFTC Rule 150.4 aggregation rules, the rules concerning what accounts a trader must consider when determining compliance with position limits. On Dec. 5, 2016, the CFTC adopted new final rules on aggregation (the "New Aggregation Rule"). Taking into account the current and new aggregation requirements in the New Aggregation Rule, a person will now need to aggregate with their other commodity interest positions all commodity interest positions:

(i) That are deemed to be controlled by such person (e.g., makes trading decisions);

(ii) In each account in which such person has a 10-percent or greater ownership interest;

(iii) Held by a third party acting pursuant to an express or implied agreement with such person;

(iv) Held by a fund in which: (i) such person is a 25-percent or larger investor; and (ii) that is managed by a commodity pool operator that is exempt from registration pursuant to CFTC Rule 4.13; and

(v) That a person directly or indirectly (e.g., through an investment in a fund operated by an unaffiliated commodity pool operator) holds within a trading strategy that is "substantially identical" to a trading strategy overseen by such person.

(b) Aggregation Exemptions

Following the adoption of the New Aggregation Rule, there are five CFTC aggregation exemptions available to fund managers. These exemptions (other than the "fund investor" exemption) require a filing with the CFTC.[25]

(i) Three of these were preserved by the New Aggregation Rule:

(1) The "independent account controller" exemption (which would still require aggregation during the "spot month");[26]

(2) The "fund investor" exemption;[27] and

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[23] 78 Fed. Reg. 68946, Nov. 15, 2013.

[24] 80 Fed. Reg.58365, Sept. 29, 2015.

[25] The CFTC also provides aggregation exemptions not applicable to fund managers, such as exemptions for broker-dealers and FCMs. While the information-sharing exemption is discussed below, it will most likely have limited usefulness for fund managers.

[26] The independent account controller exemption permits a firm to disaggregate trading units within the same firm from each other, provided that certain conditions are met.

(3) The "insider" fund investor exemption.[28]

(ii) While two are new:

(1) The owned-entity exemption;[29] and

(2) The information-sharing exemption.[30]

(c) It is important to note that since the position limits rules were not finalized, the New Aggregation Rules only apply to Legacy Contracts (and to other futures contracts, to the extent that the Exchanges track the CFTC rules). Should the CFTC finalize its position limits rules in the future, the Final Aggregation Rules will also be applicable to any new contracts subject to CFTC limits.

(d) Many of these aggregation exemptions will now require a filing once the rules go into effect on Feb. 14, 2017.

C. EU

1. A new position-limits and position-reporting regime will be introduced in the EU by MiFID II from January 2018. Managers should be aware that the London Metals Exchange (the "LME") has already implemented its first limit for an aluminum premium contract and may contemplate doing the same for other contracts if necessary.

2. MiFID II introduces new position limits, position management powers and position reporting regimes for commodity derivatives traded on EU trading venues and "economically equivalent" OTC contracts. Managers who trade commodities derivatives or emission allowances should assess the impact of these reforms on their trading strategies.

V. Spoofing

A. In General

Spoofing typically involves a trader placing a large number of non-bona fide buy or sell orders, which the trader has no intention to complete, on one side of the market for the purpose of artificially inflating or lowering the market price of an exchange-traded financial instrument. The government's view is that non-bona fide buy or sell orders of this sort may create a false appearance of artificial buy or sell interest in the security, which may result in a price change. The trader who placed the non-bona fide orders then places bona fide orders on the opposite side of the market for the same stock, in an attempt

[27] As a general rule, fund investors that are not affiliated with the fund manager are not required to aggregate the positions of the fund, even when above 10 percent. The one exception to that rule is a 25-percent or more investor in a fund for which the CPO relies on a Rule 4.13 exemption from registration.

[28] Another situation where a fund investor would be required to aggregate is where the fund investor is also an "insider" (e.g., a principal or affiliate of the commodity pool operator). However, these types of investors are permitted to disaggregate where certain physical and informational barriers are met.

[29] While a 10-percent or more owner is generally required to aggregate the positions of a subsidiary entity (regardless of knowledge of the positions or control), the CFTC has provided an exemption from this requirement, even for wholly-owned entities.

[30] The CFTC also provided a new exemption from aggregation in situations where the sharing of information would create a reasonable risk that either party could violate state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder (so long as one party does not have actual knowledge of the trades). To rely on this exemption, the trader must submit a memorandum of law to the CFTC supporting this conclusion. While it will not need to be a legal opinion, it should contain sufficient information to give CFTC staff the ability to discuss with the relevant regulators. While simply providing a copy of the law or legal authority would be insufficient, a memo prepared in a general matter by a law firm or trade association for a group of similarly affected persons would be sufficient, so long as it is clear from the memo how the risk affects the person.

to take advantage of any price change resulting from the false appearance of buy or sell interest. Once the market moves, the trader quickly cancels his open orders to take advantage of the artificially high or low price with orders on the opposite side of the market.

B. Prohibition of Spoofing

1. Securities statutes do not prohibit spoofing by name but do outlaw market manipulation. The U.S. Supreme Court has explained that market manipulation refers generally to practices that are intended to mislead investors by artificially affecting market activity and "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[31] The SEC and FINRA have both been active in pursuing spoofing cases as types of alleged market manipulation.

2. Dodd-Frank amended Section 6c(a) of the Commodity Exchange Act to make "spoofing" in the commodity futures markets a violation of federal law. The anti-spoofing provision states that 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, 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)."

   In 2013 the CFTC released an interpretive guidance on what it considers spoofing. Significantly, the CFTC's guidance recognizes that intent is an essential element of any spoofing claim. As such, the CFTC does not interpret "reckless trading, practices, or conduct as constituting a 'spoofing' violation." Moreover, the CFTC stated that, "orders, modifications, or cancellations" submitted as part of a "legitimate, good-faith attempt to consummate a trade" would not be considered "spoofing."[32]

3. CME Rule 575 also prohibits spoofing. That rule specifies:

   (a) "No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

   (b) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants."

C. Enforcement and Criminal Prosecutions Concerning Spoofing.

1. *United States v. Coscia*, No. 14-cr-00551 (N.D. Ill. Nov. 3, 2015). This was the first-ever criminal charge and conviction for spoofing. Michael Coscia, a high-frequency trader, was charged by the DOJ and convicted on six counts of market manipulation and six counts of spoofing for manipulating commodity futures contract markets on various CME Group Markets and ICE Futures Europe, a futures exchange based in London. Although those transactions generated only $1,070 of profits, prosecutors felt the matter was significant enough to warrant indictment and trial.

2. Following his criminal conviction, Coscia appealed to the U.S. Court of Appeals for the Seventh Circuit. Although the court has not yet issued an opinion, the oral argument before the court produced some interesting exchanges between counsel and the judges who will decide the appeal.

[31] *Ernst & Ernst v Hochfelder*, 425 US 185, 199 (1976).

[32] *Available at* www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf.

(a) Coscia's counsel argued that the statute is unconstitutionally vague because it does not adequately define the conduct that constitutes the crime of spoofing and thereby failed to give him notice of what actions were prohibited. His counsel also noted that the relevant provision of law did not define spoofing and prior to the time of Coscia's alleged wrong conduct, the CFTC provided no guidance on prohibited spoofing.

(b) Some of the court's questions indicated skepticism about the ability to distinguish between legitimate and illegitimate orders in an industry where computerized algorithms place and cancel offers in milliseconds. A main focus of the oral arguments was on the algorithm Coscia used and the difference between contingent orders and orders that constituted spoofing. Contingent orders, such as stop-loss orders, seem to fit the statutory definition of spoofing yet no one would consider those illegal. When a trader places a stop-loss order, he does not intend the order to be executed, because presumably that would mean the market is trending in a direction opposite his expectation, but would accept an execution if the conditions of the stop-loss order were realized.

3. On Dec. 20, 2016, the U.S. District Court for the Northern District of Illinois approved a settlement between the CFTC and defendants Igor B. Oystacher and his firm, 3Red Trading LLC, who were accused of engaging in "a manipulative and deceptive spoofing scheme while trading at least five different futures contracts on four exchanges for more than two years."[33] Under the terms of the settlement, Oystacher and 3Red agreed to pay a $2.5-million penalty and have all their futures trades be overseen by an independent monitor for the next three years. Oystacher and 3Red are also required to employ certain compliance tools with respect to futures trading on U.S. exchanges for a period of 18 months.

VI. Systematic Trading Considerations

A. Wash-trades

Managers (particularly quantitative and systematic managers) should consider examining their wash-trading and cross-trading policies, procedures and surveillance methods to ensure that inadvertent wash- or cross-trading is not occurring in violation of exchange rules or federal regulations. Managers with ERISA accounts have to be particularly cognizant of this issue.

B. Tag 50s

The CME released additional guidance in 2016 on the use of Tag 50 IDs in the Globex environment. Managers should determine if they are appropriately employing enough Tag 50 IDs; under the current CME guidance, many automated trading strategies will require a manager to obtain multiple "team" or even "individual" Tag 50 IDs.

VII. Miscellaneous Issues in Trading Compliance

A. Rule 105 of Regulation M[34]

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[33] *Available at* www.cftc.gov/PressRoom/PressReleases/pr7504-16.

[34] 17 CFR § 242.105.

1. In General

Rule 105 makes it unlawful for any person to purchase equity securities in a firm commitment equity offering from an underwriter or broker-dealer participating in the offering if that person shorted the security that is the subject of the offering during the Rule 105 restricted period, absent an available exception.

(a) Firm commitment underwritten offering: One or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public.

(b) Best efforts offering: An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities.

2. The Rule 105 Restricted Period[35]

(a) The restricted period is the shorter of the period: (i) five business days before the pricing of the offered securities through the day of pricing; and (ii) the day of initial filing of the registration statement through the day of pricing.

(b) Calculating the Five Business Days:

(i) A "business day" refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, including a complete trading session for that market.

(ii) If pricing occurs after the principal market closes, then the day of pricing is included in the five-business-day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday (assuming no intervening holidays and that the market was open on each of those days) and end at pricing on the following Thursday.

(iii) Common Pitfall

(1) In calculating the restricted period, mistakes in the calculation are common when holidays come into play. If the principal market is closed for a holiday, then such date will not count as a business day within the five-business day period.

(2) Using the example above, if pricing occurs on a Thursday after the principal market closes but Monday was a holiday (and the principal market was closed that day) then the restricted period would begin at the close of trading on the Wednesday of the previous week.

(c) Calculating the Day of Initial Filing of the Registration Statement:

(i) The period begins with the issuer's initial filing of a registration statement for secondary offerings. Oftentimes this is done well in advance, sometimes years before the secondary offering at hand. But sometimes it is done by well-known seasoned issuers ("WKSIs")

[35] 17 CFR § 242.105(a).

(because they can file an automatic shelf registration statement) right before the offering, in which case, this period may be shorter than the five-business day period.

(ii) Common Pitfall

Oftentimes, a prospectus supplement containing the specific information with respect to the offering is filed right before the offering. This is not the initial registration statement.

3. The Bona Fide Purchase Exception to Rule 105[36]

(a) The bona fide purchase exception permits a person who established a short position in the offered security during the restricted period to purchase in the offering if the person covered the short position prior to the pricing of the offering by entering into a bona fide purchase of the security. In order to qualify for the exception, the pre-pricing covering purchase must be:

(i) For a quantity at least equal to the amount of the pre-pricing period short sales;

(ii) Effected during regular trading hours;

(iii) Reported pursuant to an effective transaction reporting plan; and

(iv) Effected at least one business day prior to the pricing of the offering. If the bona fide purchase is made on the business day prior to pricing (the last permissible day), the purchase must occur before the final 30 minutes of regular trading hours.[37]

(b) Common Pitfall

The first criteria to come within the exemption requires a person to purchase, after its last restricted-period short sale, at least as many subject securities as it has shorted during the entire restricted period. No credit is given for covering purchases that occurred between restricted-period short sales. For example, if during the Rule 105 restricted period a firm sold short 15,000 shares of XYZ security on Oct. 1, covered 5,000 shares of XYZ on Oct. 2 and sold short 10,000 shares of XYZ on Oct. 3, the firm would need to cover 25,000 shares following its Oct. 3 short sale to qualify for the exception. The 5,000 share cover on Oct. 3 is not considered for purposes of the exception because it took place before the last of the restricted-period short sales.

4. Separate Accounts Exceptions[38]

(a) Under the separate accounts exception, Rule 105 does not prohibit a person from purchasing the offered securities if the person sold short during the Rule 105 restricted period in a separate account. Separate accounts are those that operate without coordination of trading or cooperation. Indications of separate accounts include:

(i) Separate and distinct investment and trading strategies and objectives;

[36] 17 CFR § 242.105(b)(1).

[37] *Available at* www.sec.gov/divisions/marketreg/tmcompliance/regmrule105-secg.htm.

[38] 17 CFR § 242.105(b)(2).

(ii) Personnel for each account that do not coordinate trading among or between the accounts;

(iii) Information barriers in place so investment decisions are not shared between accounts;

(iv) Separate profit and loss statements;

(v) No allocation of securities between or among accounts; and

(vi) Persons with oversight over the accounts who do not have authority to execute trades or pre-approve trading decisions.[39]

(b) The SEC has denied the "separate accounts" exception, even though there were two separate accounts with different strategies and portfolio managers, where information about securities positions and investment decisions was available to all of the firm's employees and sometimes communicated between strategies, the chief investment officer exercised oversight over the firm's multiple strategies and influenced trading decisions within the strategies, and the firm did not prohibit its personnel from coordinating trading between or among strategies.[40]

5. Rule 105 Liability

(a) Rule 105 is not intended to catch only systematic "scams" — even a single violation can lead to charges. Charges can be brought for even trivial amounts, but penalties can constitute a significant percentage of the overall disgorgement. Rule 105 violations fall under the category of "market manipulation" and can also lead to censure, suspension or a lifetime ban of being associated with an investment adviser or broker-dealer.[41]

(b) Virtually all the settlements of Rule 105 cases describe the violations of the rule as "willful." It is important to note that "willful" in the context of Rule 105 does not mean the rule was intentionally violated but that "the person charged with the duty knows what he is doing."[42] There is also no requirement that the actor "also be aware that he is violating one of the Rules or Acts."[43] What this means is that the actor who made the trade knew that he was making a trade and that the trade constituted the violation (even if the actor did not know that the trade constituted a violation at the time he made the trade). In other words, because Rule 105 does not require proof of scienter, whether the person knew the conduct violated any securities law or rule is irrelevant.

[39] *Available at* www.sec.gov/divisions/marketreg/tmcompliance/regmrule105-secg.htm.

[40] *Available at* www.srz.com/images/content/5/7/v2/57894/IMHT-051211-Booklet-Website.pdf.

[41] *Available at* www.srz.com/images/content/5/7/v2/57894/IMHT-051211-Booklet-Website.pdf.

[42] *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

[43] *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

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