Spoofing, Surveillance, & Supervision

Thursday, January 17, 2019

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Spoofing, Surveillance, & Supervision

"As our developing spoofing case law demonstrates, this duty to supervise includes ensuring that employees receive sufficient training and that their activities are monitored through adequate systems and controls to detect spoofing."

Remarks of Commissioner Rostin Behnam before Energy Risk USA, Houston, Texas: *Delivering a Message on Relationship Patterns* (May 15, 2018).

A Review of Spoofing Regulations

- Commodity Exchange Act Section 4c(a)(5)
  - Unlawful for "[a]ny 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)."

- CME Rule 575/ICE Rule 4.02(l)
  - Prohibits (among other actions) entering 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.
  - ICE Rule does not require the intent at the time of order entry, only entering an order with the intent to cancel it prior to execution.

Failing to Supervise Overview

- CFTC Rule 166.3 – Failure to Supervise
  - Requires a firm to employ diligent supervision of its employees and activities:
    - Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.

Failing to Supervise Overview (Cont.)

CME

- 432.W – It shall be an offense: for any party to fail to diligently supervise its employees and agents in the conduct of their business relating to the Exchange.

ICE

- 4.01(a) – Every Person shall diligently supervise the Exchange-related activities of such Person's employees and agents. For purposes of this Rule, the term "agent" includes any Exchange-related activities associated with automated trading systems that generate, submit and/or cancel messages without human intervention. Every Person shall also be responsible for the acts and omissions of such employees and agents.

Failing to Supervise Overview (Cont.)

- CFTC Rule 166.3 – Failure to Supervise
  - 166.3 is violated when:
    - A registrant's supervisory system was generally inadequate; or
    - A registrant failed to perform its supervisory duties diligently. (*See In re Forex Capital Markets LLC*, [2012-2013 Transfer Binder] Comm. Fut. L. Rep. (CCH) ii 32,658, at 73,166 (Oct. 3, 2011))
  - Evidence of violations that "should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly" is probative of a failure to supervise.
  - Violation under 166.3 is an independent violation for which no underlying violations is necessary. *See In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ii 27,194 at 45,744 (CFTC Dec. 10, 1997).
    - Unlike the SEC's rule on failure to supervise, which requires an underlying substantive violation in order to establish a failure to supervise charge. *See* Section 15(b)(4)(E) of the Securities Exchange Act of 1934.

Failing To Supervise Regarding Spoofing

- Within a month of settling a high-profile spoofing enforcement case against a trader and his firm, the CFTC announced an action against a futures commission merchant for failing to supervise traders who engaged in spoofing. (*See In the Matter of Citigroup Global Markets, Inc.*, CFTC Docket No. 17-06).

  – The CFTC found that the firm's supervisory system was inadequate in two respects:
    - First, it did not sufficiently train the traders about spoofing; and
    - Second, it did not have in place systems and controls designed to prevent and detect spoofing.

  – The settlement order listed a series of required undertakings, including two specifically related to the firm's training and surveillance inadequacies:
    - *<u>Procedures and Controls to Detect Spoofing Activity</u>: [Respondent] shall maintain systems and controls reasonably designed to detect spoofing activity by its traders, such as the systems and controls Citigroup developed and implemented in response to the Traders' spoofing activity. These systems and controls shall, at a minimum, be designed to detect and generate a report regarding patterns of trading that might constitute spoofing activity (e.g., the placement and rapid cancellation of large-lot futures orders). Citigroup personnel shall promptly review such reports and follow up as necessary to determine whether spoofing activity has occurred.*
    - *<u>Training</u>: [Respondent] shall provide annual training addressing the legal requirements of the Act with regard to spoofing, to be given to Citigroup employees who submit any orders on U.S. futures markets and their supervisors.*

Failing To Supervise Regarding Spoofing (Cont.)

- Several months after releasing the above settlement, the CFTC announced and touted its first "non-prosecution agreements" with three former traders from this firm. (*See* CFTC Release Number 7581-17).
- They emphasized the traders' "material assistance provided to the CFTC's investigation."
- In a unique twist of events – the CFTC charged the firm and fined it $25 million – but allowed three of the traders who engaged in spoofing to "walk" with non-prosecution agreements.
- The message sent appears to perhaps incentivize traders being investigated for spoofing to point at their firms for failing to train and supervise them regarding spoofing.

Failing To Supervise Regarding Spoofing (Cont.)

- As referenced, an underlying violation is not required.
- Later in 2017, the CFTC charged another firm with a stand-alone failure to supervise case. (*See In the Matter of Logista Advisors LLC*, CFTC Docket No. 17-29).
- Underlying spoofing activity occurred on a foreign exchange.
- This settlement focused on the firm failing to give the trader adequate:
  - training, direction, and supervision,
  - which resulted in him repeatedly engaging in spoofing.
- Notably, the firm's compliance department detected the misconduct in August 2014.
- However, the firm failed to satisfy its obligation to supervise an appropriate investigation into the trading misconduct.

Failing To Supervise Regarding Spoofing (Cont.)

- 2018 – The CFTC and the Dept. of Justice announced their most significant and aggressive actions against spoofers and their firms for failing to supervise.

- The CFTC filed settled actions against three firms for supervisory violations and the CFTC charged six individuals with alleged commodities fraud and spoofing schemes. (*See* CFTC Release Number 7681-18; in the parallel criminal actions, the DOJ charged eight individuals (the six charged by the CFTC plus two others)).

Failing To Supervise Regarding Spoofing (Cont.)

- For one of the failure to supervise matters, the CFTC found that while the firm had a surveillance system and policies and procedures to detect and deter spoofing, the firm (*See In the Matter of Deutsche Bank AG and Deutsche Bank Securities, Inc.*, CFTC Docket No. 18-06 at 7):

  – "did not follow up on the majority of potential instances of misconduct identified by its electronic surveillance system."

  – [Respondent] also failed to perform its supervisory duties diligently because the surveillance system's alerts put it on notice of potential misconduct yet it failed to take adequate steps to address or remedy the issues."

- Each of the firms agreed to:
  – continue to maintain surveillance systems to detect spoofing;
  – ensure personnel "promptly" review reports generated by such systems and follow-up as necessary if potential manipulative trading is identified;
  – and maintain training programs regarding spoofing, manipulation, and attempted manipulation.

Exchange Failure to Supervise Actions

- CME has brought a number of disciplinary actions against both member and non-member firms for failing to supervise traders engaging in activity in violation of rule 575.A. (*See*; CME-17-0640-BC-1, CME-15-00334-BC, COMEX 17-0646-BC-1, CME 16-9693-BC-3, COMEX 16-0513-BC-1, COMEX 15-0261-BC-1).
  – Many of the Disciplinary Actions are exclusively for supervisory (Rule 432) failures, with no underlying violation of 575, even while stating the trading activity at issue involved entering orders with the intent to cancel prior to execution.
  – Often, the Disciplinary Notice states the party failed to provide instruction or guidance to traders regarding disruptive trading.

- The CME continues to investigate and charge firms with failing to supervise when firms fail to provide their traders with guidance and training re exchange rules regarding spoofing.

The Evolving Nature of Firm Exposure

- In September 2018, the CFTC settled an action against a proprietary trading firm that was a member of the CME, but not a CFTC registrant. In the order, the CFTC mandated similar undertakings as outlined above. (*See In the Matter of Geneva Trading USA, LLC*, CFTC Docket No. 18-37).
  - While the firm was not eligible for a 166.3 violation, the undertaking language mirrored the undertakings in other CFTC spoofing failure to supervise actions:
    - *Procedures and Controls to Detect Spoofing Activity: Respondent shall maintain systems and controls reasonably designed to detect spoofing activity by its traders, including, but not limited to, the systems and controls Respondent developed and implemented in response to the spoofing activity that is the subject of this Order. These systems and controls shall, at a minimum, be designed to detect and generate a report regarding patterns of trading that might constitute spoofing activity. Respondent's personnel shall promptly review such reports and follow up as necessary to determine whether spoofing activity has occurred. procedures and controls reasonably designed to detect spoofing, including the employment of a dedicated full-time CCO and utilization of internal trading surveillance and compliance systems.*
    - *Training: Respondent shall maintain its training program that provides training, at least annually, addressing the legal requirements of the Act with regard to spoofing, manipulation and attempted manipulation, to be given to employees and agents trading on behalf of or in their capacity as employee or agent of Respondent or other affiliated entities who submit any orders on futures markets, and their supervisors. training regarding spoofing, manipulation, and attempted manipulation.*

- The day before, the CFTC settled an action with a CPO/CTA and a trader, and charged the firm as liable for the manipulative trading of the trader, based on the conduct being "within the course and scope of his employment." (*See In the Matter of Victory Asset, Inc.* CFTC Docket No. 18-36).
- The CFTC credited its Spoofing Task Force for both matters.

Failing To Supervise Re Spoofing - Undertakings

- Procedures and Controls to Detect Spoofing
  - Respondents required to maintain “systems and controls reasonably designed to detect spoofing activity by its traders
  - The Systems and Controls must, at a minimum:
    - Detect and generate a report regarding patterns of trading that might constitute spoofing
    - Firm personnel must promptly review such reports, and follow up as necessary to determine whether spoofing activity has occurred.

- Training
  - Maintain training program that provides training, at least annually, addressing the legal requirements of the Act with regard to spoofing, manipulation, and attempted manipulation
  - Such training must be given to all employees trading on behalf of Respondents or other affiliated entities who submit any orders on futures markets, and such employees Supervisors.

Surveillance Systems - Background

- Diligent Supervision requires the maintenance of surveillance systems *reasonably* designed to detect spoofing activity.

- At a minimum, surveillance must generate reports regarding patterns of trading that might constitute spoofing.

- Surveillance systems should provide the rapid and accurate detection of spoofing activity, in order to avoid enforcement actions, large fines, and reputational damage.

Surveillance Systems – Background (Cont.)

- Historically, surveillance systems involved rule based parameter models with selected thresholds to generate “alerts” that may (after further investigation) reveal an instance of potential spoofing activity.

- For example, such a system may be centered around large cancels that occur within a certain period of time after small fills are received on orders on the opposite side of the market.

Surveillance Systems - Challenges

- The variety of spoofing patterns that draw regulatory scrutiny can create major challenges for compliance departments who are tasked with choosing the parameter thresholds for dozens of surveillance metrics across multiple exchanges and numerous products.

- Some of these challenges include:
  - what constitutes a “large” order?
  - what constitutes a “small” fill?
  - in what time frame(s) do these events have to occur?

- For parameter-based systems, these reports must be calibrated correctly and reviewed regularly to prevent the system from generating reports with:
  - too few or no alerts;
  - or too many meaningless alerts, based on calibration errors.

Surveillance Systems – Advancing Technologies

Regulatory Advancement

- In the press release announcing the enforcement actions against the three banks and eight individuals discussed above, the CFTC specifically stated that technological enhancements have created new opportunities in today's markets for both legitimate trading and bad actors.

- The CFTC highlighted its realignment of the Market Surveillance Unit, moving it from the Division of Market Oversight to the Division of Enforcement. Building and utilizing sophisticated analytical tools, the Market Surveillance Unit reviews data for instances of fraud, manipulation, and disruption. Moving the unit to the Division of Enforcement "reflects the data-centric approach the Division pursued during the last Fiscal Year, and expects to continue going forward."

Surveillance Systems – Advancing Technologies (Cont.)

Surveillance systems are evolving accordingly.

- Many parameter-based systems have developed advanced, complex, and adjustable parameters based on ratios percentages, etc. for more sophisticated reporting.

- Advancing surveillance systems are also leveraging:
  - artificial intelligence;
  - machine learning; and
  - behavioral analytics.

- The ongoing evolution of surveillance systems allows compliance professionals to more efficiently and thoroughly conduct follow-up investigations into alerted activity.

Supervision

- A surveillance system needs to tie into a firm's overall supervisory system and be tailored to its trading activities.

- Consistent with this principle, firms need to have written policies, procedures, and processes regarding how they detect and deter disruptive trading.

- These policies, procedures, and processes need to be periodically and regularly assessed, tested, revised, and updated.

Supervision – Documentation & Coordination

- The implementation and monitoring of the surveillance system needs to be documented.
- After alert generation, the surveillance reporting needs to follow a diligent process and also be well documented.
- If surveillance is not within the compliance department, but (for example) with a market surveillance group in the risk department, then such a group needs to regularly communicate and collaborate with the compliance department and document these coordinated efforts.
- If there is overlap in surveillance duties, individual responsibility must be made clear to each individual, with clearly defined lines of reporting as well.
- If patterns are detected – by trader, trading desk, strategy, product, etc. – appropriate personnel needs to track and document these patterns for trends.

Supervision - Training, Training, & More Training

- All of the enforcement cases discussed above involve a lack of adequate training.

- In addition to a robust surveillance system and strong supervisory policies, procedures, and processes, firms absolutely must regularly and formally train traders.

- This cannot be "check the box" training where traders are allowed to blow it off or not take it seriously; firms that allow for this in their training culture do so at their own peril.
  - The traders will need to "sign in" to the training.
  - These logs and the training materials need to be preserved by firms.
  - The programs need to be strong and periodically assessed and updated as this area of the industry evolves.
  - All of the traders should also certify that they received copies of the applicable policies and procedures.

- For some organizations, training only traders may not be enough (*See CFTC v. Jitesh Thakkar and Edge Financial Technologies, Inc., C*ase No. 18-cv-00619 (N.D. Ill.)):
  - In 2018, the CFTC charged a software development company and its president with aiding and abetting spoofing and manipulative trading activity.
  - The CFTC further alleged that the software company and its president knew that the trader would use the manipulative software applications to engage in spoofing and inject false information into the market.
  - In its release, the CFTC specifically admonished that "the CFTC will work vigorously to hold accountable not only the individuals who engage in the spoofing, but also those who produce and sell the tools designed to spoof."
  - Thus, firms developing and implementing their own software need to extend the supervision requirements to developers of such software.

Supervision - Escalation

- A firm's escalation policies, procedures, practices, and training need to instruct personnel on how to deal with and escalate internally and externally (if needed and required), red flags of possible spoofing and other types of manipulative trading.

- In the first failure to supervise case discussed above, the CFTC specifically found that the supervisor was alerted to the spoofing activity, yet failed to comply with the firm's existing policies and procedures because he did not alert compliance or escalate to senior management. (*See In the Matter of Citigroup Global Markets, Inc.*, CFTC Docket No: 17-06).

Takeaways

- Regulators investigating firms for failing to supervise spoofing (& other manipulative/disruptive trading) is now routine and will continue to intensify.
- Firms need sophisticated and robust surveillance systems tailored to their businesses.
- Supervision processes, policies, and procedures must include: documentation of implementation and maintenance; tailored and periodic training; and appropriate escalation procedures.
- Finally, investigative efforts related to generated alerts need to be adequately and strategically documented.

Concluding Remarks

QUESTIONS

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