

A close-up photograph of an hourglass with blue sand, set against a solid blue background. The hourglass is positioned vertically, with the top bulb containing a small amount of sand. The sand is falling through the narrow neck into the bottom bulb. The lighting is soft, highlighting the texture of the sand and the glass.

This webinar will begin shortly.

FIA



Supervise This!



14 December 2023



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Introduction / Topics

- What is the scope of CFTC registrants' obligation diligently to supervise the handling of accounts by, and activities of, their employees relating to their businesses?
- How do exchange supervision requirements compare to the CFTC's supervision requirements?
- How does the text of the CFTC's supervision regulations compare to the scope of the CFTC's findings in settlements or positions in litigated cases?
- Do the supervisory policies and procedures of CFTC registrants expand the scope of their supervision liability beyond what is required by the text of the CFTC's regulations?

Overview of the CFTC's Supervision Regulations

– Rule 23.602 and 166.3

- The text of the CFTC's supervision regulations differs depending upon whether the registrant is acting as an agent or advisor (e.g., FCM, CTA, IB), or as a principal (swap dealer)
- Regardless of the capacity in which a registrant is acting, the regulations apply to tasks performed by the registrant's partners, members (in the case of a swap dealer), officers, employees and agents



Regulation 166.3 – Registrant Diligent Supervision Requirement

Each CFTC registrant must diligently supervise:

- the handling by its partners, officers, employees and agents of all commodity interest accounts carried, operated, advised or introduced by the registrant; and
- all other activities of its partners, officers, employees and agents relating to its business as a CFTC registrant.



Regulation 166.3 – Registrant Diligent Supervision Requirement

- When the CFTC adopted Reg. 166.3, it explained that “[t]he . . . purpose of the rule is to protect customers by ensuring that their dealings with the employees of . . . registrants will be reviewed by other officials in the firm.” 43 Fed. Reg. 31,886, 31,889 (1978) (Emphasis added).
- The focus of the regulation, therefore, is on the conduct of employees of registrants, not on the conduct of their customers.



Regulation 23.602 – Swap Dealer Diligent Supervision Requirement

- Must establish and maintain a system to supervise, and must diligently supervise, all “activities” relating to “its business performed by its partners, members, officers, employees, and agents.”
- Supervisory system must be reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and CFTC regulations.
- The CFTC has said in settlement orders that, because the language in Regulation 23.602 is “similar” to the language in Regulation 166.3, cases decided under the latter are “instructive” when applying the former.



Regulation 23.602 – Swap Dealer Diligent Supervision Requirement

Supervisory system must provide, at a minimum, for:

- The designation of at least “one person with authority to carry out the supervisory responsibilities” for all activities relating to its business as a swap dealer.
- The use of “reasonable efforts” to determine that supervisors are qualified and meet the “standards of training, experience, competence.”



Regulation 23.602 – Swap Dealer Diligent Supervision Requirement

Regulations 166.3 and 23.602 appear to focus on supervising the conduct of registrant employees, as well as establishing supervisory controls designed to achieve compliance.

- Are there any other aspects of the rules that should be emphasized?



Comparison of Exchange Supervisory Requirements with CFTC Supervisory Requirements

- U.S. DCMs and SEFs (e.g., CME / ICE US)
 - CME Rule 432.W imposes an obligation for any party engaged in business on the exchange “to diligently supervise its employees and agents in the conduct of their business relating to the Exchange.” See CME Rule 432.W.
 - ICE Futures U.S. similarly requires firms engaged in business on the exchange “diligently supervise the Exchange-related activities of such Person's employees and agents. . . . includ[ing] any Exchange-related activities associated with automated trading systems that generate, submit and/or cancel messages without human intervention.” See ICE Rule 4.01(a).
 - ICE Futures U.S. also requires each firm to “establish, administer and enforce supervisory systems, policies and procedures, based on the nature and size of its Exchange-related activities, which are reasonably designed to achieve compliance with Exchange Rules.” See ICE Rule 4.01(b).



U.K. / E.U. Exchanges (e.g., ICE Futures Europe)

ICE Futures Europe requires market participants to establish appropriate systems and controls to monitor their own business *as well as customer trading activity*.

Each Member of ICE Futures Europe, along with any individual registered to conduct Exchange business for that Member (“Responsible Individual”), must ensure that:

- All of its Responsible Individuals and employees are fit and proper, suitable, adequately trained and properly supervised;
- All business conducted on the Market complies with obligations under Exchange Regulations; and
- Any business conducted by it, or by or through any of its employees, shall not cause the Member to be in breach of any applicable laws and regulations.



Do U.K. / E.U. Requirements Establish the Baseline for Registrants that Operate in International Markets?

- What is the relationship between the CFTC's and the exchanges' supervision requirements?



Update on CFTC Enforcement Actions Involving Supervision Violations

Between 1992 and September 2023, the CFTC has brought almost 80 cases alleging supervisory violations by registrants.

Major themes include:

- Improper handling of customer accounts, funds, orders and records (25 cases or settlements)
- Inadequate systems and internal controls (29 cases or settlements)
- Failure to detect fraudulent activity by employees and customers (12 cases or settlements)
- Unlawful trading by employees of the CFTC registrant (4 cases or settlements)



CFTC Settlement with Advantage Futures

- In September, the CFTC sanctioned Advantage Futures, a registered FCM, for failing to diligently supervise “the handling of commodity interest accounts” resulting in “incomplete and inadequate oversight of its surveillance of customers’ trading activity” for disruptive trading in violation of Regulation 166.3. In re Advantage Futures LLC, CFTC Docket No. 23-45 (2023).
- Advantage’s policies and procedures stated “that it ‘utilize[d] an electronic system to monitor for potential client disruptive trade practices’ and that the ‘system analyze[d] both orders and executions with full depth-of-market data and provide[d] output based on prior day activity.’”
- They also stated that Advantage “would surveil customer orders and executions for several types of disruptive trading, including spoofing.”



CFTC Settlement with Advantage Futures

- In fact, Advantage failed to provide a third-party surveillance vendor with customer order and execution data for various exchanges for about two and one-half years.
- In at least one case, this was due to a third-party surveillance vendor dropping an exchange's data feed, which Advantage failed to detect.
- In total, over a 4 year period between July 2018 – June 2022, Respondent's failures caused over 12.8 million cleared contracts not to be processed or surveilled, which represented 1.5% of Advantage Futures total trade volume.]



CFTC Settlement with Advantage Futures

- The Commission concluded that Advantage failed to ensure that:
 - it “followed its procedures for surveillance;” and
 - “its customers’ order and execution data was processed for surveillance for disruptive trading.”



Implication of CFTC Settlement with Advantage Futures

- The Advantage settlement raises a number of important questions:
 - Does the “handling of an account” require surveilling a customer’s trading in an account?
 - Does trading in a customer account relate to an FCM’s business as a Commission registrant?
 - If an FCM adopts policies and procedures that go beyond the requirements of Regulation 166.3, and then fails to enforce them, has it failed diligently to supervise the handling of commodity interest accounts carried by the FCM?



Implication of CFTC Settlement with Advantage Futures

Does the Advantage Futures settlement break new ground, i.e., does it expand the supervision obligations of CFTC registrants?

Do the supervisory policies and procedures of CFTC registrants expand the scope of their potential liability for supervision violations?

Does the duty of supervision extend to every policy / procedure? Or is it targeted at specific policies / procedures that cover a defined group of people?



Culture Trumps Policies and Procedures

Policies and procedures should document a strong compliance culture that the registrant lives in practice.

- Align interests of employees with interests of the company
- Train often and in small bites
 - Limit training to two or three related topics
 - Training should be interactive and competitive
 - Train employees to identify issues and ask questions
 - Teach supervisors about what and how to supervise



Culture Trumps Policies and Procedures (cont'd)

Make sure you are capable of performing the documented policies / procedures.

Document various decisions in a policy and the rationale, so that a process can be easily explained to the regulator.

Review policies and procedures for updates, but also assess compliance.



Culture Trumps Policies and Procedures (cont'd)

Consider limiting policies and procedures to CFTC and exchange regulatory requirements

- Policies and procedures should be reasonably designed and implemented to promote compliance and to prevent and detect violations.
- If you elect to implement policies and procedures that exceed regulatory requirements, make sure you are prepared to own them.
 - Advantage Futures and other precedent show that regulators treat violations of policies and procedures as evidence of regulatory violations and failure to supervise.



Questions?

The image features a stylized logo for 'FIA' centered on a white background. The logo is composed of three letters: 'F', 'I', and 'A'. The 'F' is a solid dark grey. The 'I' is a solid dark grey. The 'A' is a stylized, geometric shape composed of two overlapping triangles: a light blue triangle on the left and a darker blue triangle on the right. The background is divided into several large, overlapping geometric shapes in shades of light green, light blue, and a darker green. The overall aesthetic is modern and minimalist.

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