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The Expanding Presence of the U.S. Commodity Futures Trading Commission

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The U.S. Commodity Futures Trading Commission (CFTC), and the National Futures Association (NFA), a self-regulatory organization supervised by the CFTC, are the principal regulators of the futures and commodities markets in the U.S. Historically, the public's awareness of the roles of these agencies was limited by the agencies' relatively constrained authority and jurisdiction, and obscured by the much higher regulatory profile of the U.S. Securities and Exchange Commission (SEC) (particularly given the SEC's aggressive enforcement docket over the last several years). However, as a result of material changes to the U.S. regulatory architecture following the passage of the Dodd-Frank financial reform legislation, which resulted in, among other things, an increase in the CFTC's authority and jurisdiction, and the significant number of enforcement matters brought by the CFTC following the market turmoil which started in 2007, the CFTC has established a considerably more visible and dynamic regulatory presence in the markets.

This presence may be especially notable for broker-dealers and investment advisers who are registered with the CFTC as commodity pool operators (CPOs), commodity trading advisers (CTAs), or in other capacities. A large number of these firms had limited, if any, substantive interactions with the CFTC or NFA prior to 2010. But several recent CFTC and NFA rule proposals, the CFTC's increasingly aggressive enforcement agenda, and the consistent growth in the amounts recovered by the CFTC in enforcement cases, now suggest strongly that SEC-registered broker-dealers and investment advisers should not expect "business as usual" from the CFTC—instead, these firms should assure that they have developed and implemented robust policies, procedures, and programs, supported by

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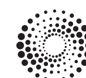
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investments in professional staffing and technology, to comply with the agencies' requirements.

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Privacy "Best Practices"

One area in which the CFTC has recently made an important announcement regarding broadening regulatory obligations is privacy. As background, Title V of the Gramm-Leach-Bliley Act (GLBA), passed in 1999, imposed requirements on "covered financial institutions" to protect the non-public personal information of their customers. Under the GLBA, federal financial regulators, including the CFTC, were required to adopt rules to carry out the GLBA's objectives. The CFTC adopted the required rules in 2001. However, earlier this year, in its Staff Advisory No. 14-21 (Staff Advisory), the CFTC communicated a series of "recommended best practices" that the agency expects covered financial institutions, including CPOs and CTAs, to comply with.[1] While not, on its face, having the force of a regulation that has been adopted following notice-and-comment rule-making procedures, the Staff Advisory makes clear that the standards referenced in the document reflect the CFTC's interpretations of the privacy rules adopted in 2001. Accordingly, CFTC registrants should be able to demonstrate that their privacy and information-security policies and practices incorporate the CFTC's "best practices."

In summary form, the CFTC's "best practices" relate to the "security safeguards" that the agency expects registrants to erect. The agency explained that under Part 160 of the CFTC's regulations, agency registrants (which include not just CPOs and CTAs, but also futures commission merchants, swap dealers, major swap participants, and retail foreign exchange dealers) are required to "adopt policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information." A registrant's policies and procedures must therefore "insure the security and confidentiality of customer records and information;" "protect against any anticipated threats" to the "security or integrity" of records containing confidential information; and protect against "unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer."

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With these broadly-stated requirements as context, the CFTC articulated its view that each registrant should develop and implement a written security and information privacy program (Privacy Program) customized to the registrant's business, that specifically takes into account the nature of the registrant's market activities and the risks that those activities create. Moreover, the Privacy Program should designate a particular employee of the registrant who is responsible for managing the program, periodically reviewing and assessing the program, and reporting to senior management regarding the performance of the program. The Staff Advisory also states that the Privacy Program should be based on a written assessment of "all reasonably foreseeable internal and external risks" to the "security, confidentiality, and integrity of personal information and systems processing personal information." The agency further expects that each registrant will train relevant staff regarding the requirements imposed on the firm under the CFTC's privacy

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rules and the terms of the Privacy Program, and "regularly test or otherwise monitor" the effectiveness of the program. As part of the latter requirement, the Staff Advisory states that "at least once every two years" the registrant should contract with "an independent party" to test the effectiveness of the Privacy Program, and that appropriate written records relating to that testing be retained by the registrant. The CFTC expects that each registrant, as part of the maintenance of its Privacy Program, will at least annually report to the registrant's board of directors regarding the outcome of any assessment of the program, and any "instances during the year of unauthorized access or disclosure of personal information." Finally, the agency noted that it expects to enhance, where necessary, its internal examination standards to ensure that the CFTC's and NFA's staff are trained to detect instances in which a registrant is not, or has not been, in compliance with the privacy "best practices" referenced in the Staff Advisory.

Proposed Capital-Related/ "Customer-Protection" Requirements

In the first quarter of 2014, the NFA proposed a number of potential new capital and customer-protection measures applicable to CPOs and CTAs. Each of the concepts announced by the agency included a brief description of its objective, followed by a series of questions to which market-participants were solicited to reply with guidance and comments. The deadline to respond to those questions passed recently, and the agency is currently considering the responses that it received from the industry.

To begin with, the NFA indicated that it is considering a capital-adequacy requirement to be imposed on CPOs and CTAs. As the NFA acknowledged, currently there is no requirement that a CPO or CTA maintain a minimum amount of capital (unlike, for example, SEC-registered broker-dealers, which are required to have a minimum amount of regulatory capital and to regularly report that figure, as adjusted, to the SEC). However, the NFA also noted that CPOs and CTAs are fiduciaries with respect to the customer assets that they manage, and, consequently, they should be required to maintain "adequate funds to operate and ensure that they are a going concern." On this basis, the NFA asked market-participants, for example, what the minimum dollar amount of the capital requirement should be; how the capital figure reported by registrants should be calculated; how (that is, through what mechanism or technology) a registrant's capital should be reported to the agency; and how frequently the minimum capital figure should be reported to the NFA. The NFA also solicited comments from the industry on whether there exist practical alternatives to the minimum capital requirement which it is considering.

In addition, the NFA proposed certain measures that the agency views as protecting customers of CPOs and CTAs. As a threshold point, the agency noted the relatively large number of recent enforcement matters that involved CPOs or CTAs misstating or misrepresenting pool or account performance information or asset valuations, or misusing customer funds. The agency then noted its customer-protection initiatives. Among others, the NFA stated that it is considering whether to require that a third-party, retained by each CPO and CTA, review and authorize any disbursement by the CPO or CTA of assets from a pool or account. The agency also stated that it is considering whether to require that each CPO and CTA retain a third-party to prepare or verify the monthly or quarterly performance and asset-valuation figures reported by the registrants. Finally, the NFA stated that it is considering the development of a system by which pool assets would be verified on a much more frequent basis – including possibly daily – through the collection of pool-asset information directly from registrants; those data would then be reviewed and reconciled with pool- or account-related data provided to the agency by custodians and depositaries (such as banks) retained by the registrants.

Enforcement

Perhaps in no other area has the CFTC so clearly articulated its intention to be a more ag-

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gressive regulator than in the enforcement arena. Strictly in numerical terms, since approximately the end of 2009, the CFTC has brought an increasingly larger number of enforcement actions, and has imposed an increasingly larger aggregate amount of financial sanctions. Consider, for example, that in 2009, the CFTC filed 50 enforcement cases, and imposed $636 million in financial sanctions, and that in 2013 the CFTC brought 82 actions and imposed $1.7 billion in financial sanctions (as a further benchmark, consider the relevant 2006 data: 33 enforcement actions and $446 million in financial sanctions, respectively). Indeed, the aggregate number of enforcement actions filed in 2011 and 2012 was almost as large as the number of all such actions filed in the previous five years combined. But the agency has gone beyond relying on its enforcement data, and has unambiguously communicated its intentions: the CFTC's chairman and senior staff have made clear that "Dodd-Frank expand[ed] the CFTC's arsenal of enforcement tools," and that the agency would use those "tools to be a more effective cop on the beat,"[2] as it strives to live up to its "unwavering commitment to hold those who seek to undermine the integrity of the U.S. financial markets responsible for their actions."[3] On a less colorful but more practical level, the agency has communicated that it will continue to allocate more staff and other resources to investigations and other pre-enforcement and enforcement matters, and that it will carefully investigate individual managers at firms suspected of wrong-doing to determine whether a failure to "diligently supervise" has occurred, and whether one or more individual managers, alone or in addition to the firm, should be personally charged.

Conclusion

Prior to the enactment of the Dodd-Frank reform legislation, a significant number of broker-dealers and investment advisers subject to SEC jurisdiction were able to avoid any requirement that they be registered with the CFTC, in any capacity. With the passage of Dodd-Frank, however, and the promulgation of new rules by the CFTC, the exemptions from the agency's registration requirements were greatly narrowed or eliminated. As the agency's jurisdiction expanded, these firms became subject to requirements with which they were entirely unfamiliar. For these broker-dealers and investment advisers, already subject to the jurisdiction of the SEC, the CFTC's expanded jurisdiction means new and substantive reporting, trading, testing, and investor-protection requirements (among others), and more rigorous levels of regulatory scrutiny. In other words, it means new and significant types of regulatory risks that, if not mitigated through the adoption and implementation of appropriate policies and procedures, directed and managed by experienced staff and supported by relevant technology, could result in potentially material financial and reputational damages as the CFTC continues to pursue an aggressive enforcement agenda.

NOTES

1. Staff Advisory No. 14-21, U.S. Commodities Futures Trading Commission (February 26, 2014), http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-21.pdf.
2. "Enhanced Oversight after the Financial Crisis, The Wall Street Reform Act at One Year: Hearing before the Senate Committee on Banking, Housing and Urban Affairs, 112th Congress, (2011) (statement of CFTC Chairman Gary Gensler), *available at* http://www.cftc.gov/pressroom/speechestestimony/opagensler-87.
3. "CFTC Charges RP Martin Holdings Limited and its Subsidiary, Martin Brokers (UK) Limited, with Manipulation and Attempted Manipulation of Yen Libor," U.S. Commodities Futures Trading Commission, CFTC Release PR6930-14 (May 15, 2014) (Statement of Gretchen Lowe, Acting Director of the Division of Enforcement), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6930-14.

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