fia law & compliance event

We're not exactly along the Potomac this week, but mostly along the Chesapeake Bay, really, at the FIA Legal & Compliance Jamboree in Baltimore. The event was uuge. And oddly enough, the national election cycle predicament we find ourselves in at the moment was not the leading subject of conversation at FIA's big show. Not even close. We counted roughly 120 speakers (true, that's just the speaker list) from across the futures and securities landscape, across agency land, and from across the globe. The total head count was closer to 1,000. It was a big show. Spoofing, Regulation AT, cross-border harmonization, leverage and a myriad of liabilities, all the good stuff was in there. And, the former head of Seal Team 6, Robert O'Neill, perhaps the luckiest man in the world, revved everybody up at lunch with a speech about never quitting, stressing out over the little stuff isn't worth it (compared to being shot at by 50 screaming Taliban, it's all little stuff) and keeping your sense of humor. If FIA taped the presentation, we recommend you have a look. O'Neill went through 11 tours in Afghanistan, Iraq and elsewhere, including 400 combat missions. Quite a hero … Meanwhile, we focused our time on panels dealing with "Responding to an Investigation or 4G Request," moderated deftly by SocGen's Patricia Corley, "What is Spoofing?" and "Automated Trading Requirements," both moderated by Robert Klein, MD and counsel, Citigroup Global markets. Later we picked up on the Regulation AT panel, hosted by Allison Lurton, FIA's general counsel. The subjects touched a nerve; we saw standing room only in these sessions. Like others, this FIA event is all off the record, unless you get permission to write something, from the folks on the panels. We did. We'll give you the gist, though some of it is not for attribution. The Spoofing panel featured ICE Futures Assistant General Counsel Jason Fusco, DOJ's assistant U.S. Attorney Renato Mariotti, and the home team's Chuck Marvine, CFTC deputy director of enforcement, and Dan Walfish, special counsel with Milbank Tweed. The opening salvo by Klein was simple: Everybody offer their own definition of spoofing. Fusco kept it straight, verbatim with the statute mostly, and all agreed. Except one. The final comment on what spoofing means, was "whatever the government says it is …" It set the panel on a nice course. Moderator Klein noted that there are issues with vagueness in the statute's language, and what did everybody think about that? The regulators didn't see it. Mariotti said it would be difficult to challenge the constitutionality of the statute. One nonregulator on the panel noted that the statute was so vague that "even simple stop-loss orders" could indeed be "misconstrued as spoofing." And we thought, not likely. We called this particular panelist out on this point of art – did he really think regulators would ding a guy for a stop-loss order? No, not really. Did the regulators have any problem discerning between stop-loss orders or fill or kill orders and spoofing? Nope, they said, we get it. Stop-loss orders are not a prob. At several points during this panel and others (in particular the "responding to an Investigation" panel), we heard all sorts of hypothetical questions from panelists and from the floor that often tested the bounds of patience or lunacy. We were reminded several times of that great sketch by the late George Carlin, splitting hairs on what exactly a sin was. "So, you're in the middle of the ocean, during a hurricane, and you must get to confession, because if you miss it, it's a sin. But, you're 1,000 miles from shore, the only priest on board just went over the side, and the captain is a Buddhist. But, you really want to have confession. Under these circumstances, is it still a sin to miss it?" We recalled that sketch later on with Chuck Marvine, and he noted that he hears stuff like that all the time. He seemed confident though that his people had a good handle on what spoofing is or is not, and that in any case, as the decisions and case files stack up around this statute over time, clarity will be evermore raised. We asked Marvine and Mariotti about source code and whether either agency would come to require source code from algos more often than not going forward, as part of the investigations. We noted that unlike people, algo source code can't change its mind; it does what it's told. Instant smoking gun, right? Not so much, they said. While source code is good, it's only "one tool" they use to prosecute (or press to settle). Both enforcers noted that they would much rather find dubious emails or texts between algo designers and traders, detailing how they should barrage a bunch of orders in one market to hopefully convince traders in this other market to buy or sell, but cancel them a Nanosecond later, and then slam the first group, or some such. No intent to actually trade, in other words. They said they would also prefer – over source code –finding a bunch of dusty files named "spoofing 1, 2 & 3 … " Much more preferable, they said, to dragging out a couple software geeks to describe to regular folks how an algo strategy works and why it might be breaking a really arcane law. "We need to always think about how the evidence will play to a jury," they said. Others we spoke to on the subject noted that source code could be and always should be the final smoking gun, in any case. So long as regulatory staff has the chops to decipher the strategies embedded in the code, we reckon perps will undoubtedly be pushed to settle, more often than not, regardless of the clarity of code geeks' testimony. "Algos don't change their mind, they only do what they are told," a regulatory source once told us. The exchange rep on the panel, Jason Fusco of ICE, noted that the vast majority of spoofing he sees out there – and he seemed to be speaking for the two big DCMs in the market -- "agree on what it (spoofing) is,

(Continued)

and what it is not." He talked about watching patterns mostly, much like regulators. He says that when his shop sees something weird, they call the trader first, and if they not satisfied, the case is elevated. "Traders know what they're doing," he says. "So if they can't explain behaviors easily, well … Human traders are one thing, ATs/ algos are something else. One of the panelists noted that 90 percent of all orders are cancelled before execution. Huh? Fusco also noted that the exchange had not yet brought a case against an algo. Each panelist noted that strong compliance is key, in any case, and is the best defense of all, since we should never expect "traders to be forthcoming with a compliance officer." We don't recall who made the comment, but we recall everybody nodding in agreement. Complicated stuff, for sure. Thousands of algos operating at lightning speed, plus humans, who are largely supported by algos, and eventually, you get a problem. One panelist noted that the big get these days is, "How do you design an algo to stay out of trouble." Hmm. We reckon it's about as easy as hiring an aggressive trader who manages to always stay out of trouble too. Sounds like a pattern …

Klein asked Marvine how big a factor spoofing really is in the markets. He noted it was something they get "numerous complaints about." Also, just to be clear, neither the DOJ nor CFTC thinks "pinging" constitutes a disruptive trade practice.

On the Automated Trading Requirements panel, pre-trade risk controls were discussed, kill switches, and the like, and generally, everybody agreed that none of this stuff was any sort of panacea in keeping markets safe from runaway algos. "Sometimes a kill switch can make things worse," one panelist said.

The panel on Responding to an Investigation was cleverly run. A hypothetical scenario was raised, and panelists were asked to respond. The session went in stages, as the investigation elevated and heated up on what folks should do and not do. Another full-house session moderated by SocGen's Patricia Corley. Former CFTC enforcement Chief Steve Obie offered a litany of good advice for how not to respond when the enforcement office comes knocking. Stalling or taking your own sweet time, for example, isn't so smart. Requests can be both wide and deep, he said, so at the outset, send over the easy stuff, the manuals and telephone records, whatever might be close at hand, but send them something, stat. That sort of good will sounds like it's worth gold. "Keep feeding the beast," as one panelist put it. Also, front-running the regulator isn't a bad idea either; if counsel finds something bad during discovery, pass it on. "You don't want regulators to find bad stuff before you do," another panelist noted. The discussion led to a fascinating discussion on the obligation of outside counsel and privilege waiver. That is, what happens when the CFTC asks for a client privilege waiver? "It's a dance," Obie noted. We must have looked confused by this exchange. The person sitting next to us leaned over and described the discussion as "when a lawyer finally decides to toss the client under the bus." Ah. "If the firm is in too deep," a panelist said, "the decision needs to be made." More on the FIA event next time.