drums along the potomac

So we called it right that this Fall season will be "sweeps season" for regulators. It seems now that the various agencies we cover simply can't get stuff done fast enough, or if not done, at least soundly placated in such a way that everybody can now safely move on to the next really important policy issue that's been hanging for the past two or three years. Chatter around the quad is that the Clinton Camp will undoubtedly return to the White House in January, and that there is a very long laundry list of stuff hanging out there that the new management wants out of the way before settling in. One source we spoke to noted that though he's been around the beltway for decades and has seem many administrations come and go, the current level of "phantom' coordination" between the old and the new has been accentuated. Particularly on regulatory matters, the pipeline connecting the campaign, the DNC, the White House and agency appointees has been fairly concerted, smooth and effective. That's not to say that the next administration mirrors the current one, but it's close. We believe the incoming folks, for example, are much more sensitive to voter outcry on things like high energy prices. The current folks don't seem to listen. We continue to believe that the presumed incoming folks are more tolerant of at least one fossil fuel – natural gas – in a broad sense and are willing to see its expansion and export carry on. There is no way we can ever be independent of Middle East energy, according to Hillary, unless our "bridge fuel" is easily accessible, plentiful and cheap. True. That said, what of the current duel between FERC and the EPA over the adequacy of FERC's environmental review of greenhouse gas emissions in relation to several eastern pipeline projects? We believe this battle has more to do with the fact that it's fossil fuel infrastructure we're talking about here, and the EPA isn't a fan, by design. In the next administration, we see less EPA carte blanche. Delays for these pipeline projects will actually cause prices to ratchet higher in the areas affected. Voters don't like that sort of thing. So, just another EPA land grab? It looks like EPA flexing its muscles, real or imagined, in this shoulder period of chaos. We have faith that higher prices will eventually put the agency back in the corner, where it belongs.

But, the vagueness of the EPA's jurisdiction and its raison dêtre certainly needs to be tightened up. Now, there's a common theme for this regulatory season, tightening up vagueness in jurisdiction, policy and rules. In his speech (page 9) attorney Greg Mocek talks at length about vagueness in spoofing policy. And manipulation policy. We're hoping that this CFTC plows forward on the topic, but to do so means making very tough decisions. Many decisions that the market may not be so keen to accept. However, if there's one thing we've learned in this era of Dodd-Frank, bad policy is sometimes better than vague policy. Regulatory certainty seems to be the new mission statement for the fast-moving Massad CFTC right now, and, by and large, this is a very good thing. *–the editor*

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More Lawless Interpretation? Nah, Just Strict Liability

Earlier this week we noted a blog on the Neurensic site. If you don't know the firm, check them out – high-tech AI surveillance for modern markets. Anyhow, the blog is about something called 'strict liability' and CME Rule 433. We're told this week that all exchanges have some form of Rule 433 in their operator's manual, though it's not commonly dusted off. This may be changing. Call it regulatory creep? Seemed like it to us. We pinged a number of folks on the matter, and whether this is a huge development or just a development? The blog went like this: "In US tort law there is a rigid legal doctrine known as 'strict liability,' which is frequently used by consumers to hold manufacturers of defective products legally responsible for any harm caused by their products. Consumers who bought and used the product and were injured are able to file suit against the manufacturer and seek damages without having to prove that the manufacturer had reckless, negligent or bad faith intent in producing the product (hence, the rigidity of the doctrine).

"Much to the dismay of trading firms, this legal doctrine has now found its way into the world of financial regulation. The CME Group recently announced that it held Geneva Trading strictly liable for the actions of two of its traders who had allegedly engaged in spoofing-like activity, and ordered the firm to disgorge trading profits of $91,241.

"The disciplinary action against Geneva Trading marked the first time that CME Group has ordered disgorgement of profits based on strict liability. The CME utilized its powers under CME Rule 433 and Market Regulation Advisory Notice ("MRAN") RA1517-5 to prosecute the enforcement action, and has thereby set a new precedent where the exchange is not required to prove fault, negligence or intention in order to hold trading firms liable for manipulative trading activity that occurred within their four walls.

"Trading firms should be aware that CME's MRAN RA1517-5 requires not only the supervision of natural persons, but also "any automated trading systems … operated by any party." As a result, trading firms may also be held strictly liable for failing to supervise manipulative or disruptive trading activity generated by automated

(Continued)

trading systems ("ATSs") that they employ. "How should trading firms that want to avoid be held strictly liable respond to this development? (So, yeah, the next bit is a pitch for better surveillance (their business after all), but the point is valid). "They should dedicate the time and resources necessary to implement effective pre-trade risk controls and software change management programs that are in line with the FIA's recommended best practices. They should also utilize a modern trade surveillance system that enables compliance staff to efficiently identify potential manipulative trading activity so that they may take action before such activity develops into a huge regulatory nightmare … "

Bob Zwirb (golly we leaned on him a lot this week) tells us that in holding Geneva Trading strictly liable for the alleged spoofing of two of its traders, CME relied the rule (below) which actually parallels Sec. 2 of the CEA, which imposes liability upon principals for the acts of agents, and which has long been interpreted as a strict liability provision.

433. STRICT LIABILITY FOR THE ACTS OF AGENTS

Pursuant to Section 2(a) (1) (B) of the Commodity Exchange Act, and notwithstanding Rule 432.W., the act, omission, or failure of any official, agent, or other person acting for any party within the scope of his employment or office shall be deemed the act, omission or failure of the party, as well as of the official, agent or other person who committed the act.

"This is not another example of a lawless interpretation by regulators as we have seen in recent days with the CFTC's interpretation of intent for attempted manipulation and the Obama's administration's defense of the CFPB," Zwirb tells *The Risk Desk*. "As the Seventh Circuit Court of Appeals said in Rosenthal & Co. v. CFTC, 802 F.2d 963, 966 (7th Cir. 1986) (stating that § 2(a) (1) (B) imposes strict liability on principals): "strict liability is no a stranger to the principal-agent relationship."

The following are some relevant excerpts from the opinion. "Section 2(a) (1), which dates back to 1921, enacts a variant of the common law principle of *respondent superior*. The common law principle makes an employer strictly liable – that is to say, regardless of the presence or absence of fault on the employer's part – for torts committed by his employees in the furtherance of his business; in legalese, it "imputes" the employee's negligence to his employer, thus making the employer's own lack of fault immaterial. *(See Prosser and Keeton on the Law of Torts § 70 (5th ed. 1984)*. Section 2(a) (1) departs from the common law in two respects. It is in effect a quasi-criminal statute as well as a tort statute, for it can make the principal liable for not only the payment of damages to the victim of the tort (the statutory tort of commodities fraud), but also the payment of a fine to the government. And it applies to torts committed by agents who are not necessarily employees. The resemblance to the tort doctrine is so close, however, and the language of the statute so clear – it expressly imputes the agent's wrongdoing to the principal – that we have no doubt that section 2(a) (1) imposes strict liability on the principal (Rosenthal), provided, of course, as the statute also states expressly, that the agent's misconduct was within the scope or (equivalently but more precisely) in furtherance of the agency," Zwirb says.

So, principals are strictly liable for their agents' acts – even if the agents are not employees – if the principals authorize or ratify the acts or even just create an appearance that the acts are authorized. Think about that, in the context of our extremely complex and interconnected electronic markets. And consider again the vagueness of several elements of the CFTC's disruptive trading practices rule, and spoofing and intent. "And this is so even though in a case of ratification or apparent authority the principal does not himself direct the act and may indeed know nothing about it when it occurs, as Rosenthal (we may assume) knew nothing of Pinckney's fraud. Ratification is not the theory of section 2(a)(1), but we mention it to show that strict liability is no stranger to the principal-agent relationship even outside the narrow domain of the employment relationship," Zwirb says. "Strict liability is no stranger to the criminal law either, and anyway, technically at least, section 2(a) (1) is not a source of criminal liability – though, functionally speaking, a fine is a fine. Although there is no preenactment legislative history of section 2(a)(1) and no extended judicial discussions, it has long been assumed, and for the reasons stated we agree, that the statute was intended to impose strict liability, under a theory of respondent superior, for acts within its reach. See, e.g., CFTC v. Premex, Inc., 655 F.2d 779, 784 n. 10 (7th Cir. 1981); H.R. Conf.Rep. No. 964, 97th Cong., 2d Sess. 48 (1982), U.S. Code Cong. Admin.News 1982, pp. 3871, 4066. At Cadwalader in DC, Bob Zwirb can be reached at *robert.zwirb@cwt.com*.

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CFTC Punts on De Minimus, Again

So, about that point we made earlier on the Massad CFTC making the tough decisions in short order. We still stand by the idea, but not insofar as it relates to the de minimus threshold that has captivated the lot of us for many years. But other capital rules, Reg AT and position limits? Absolutely. This week the chairman actually made good on suggestions he offered in remarks at the OTC Derivatives Summit North America last month; he indicated he would recommend delaying the drop in the swap dealer de minimis threshold, but he didn't say by how long. The threshold, which is currently $8 billion in notional swap dealing activity for a single year, was scheduled to drop to $3 billion as of Dec. 31, 2017. Lots of folks have been breaking pencils over that one. So yesterday the commission approved an order to push back the deadline a full year for certain market participants to apply for provisional registration as a swap dealer, to Dec. 31, 2018. This is excellent news for many banks, as well as for dozens of big utilities and E&P companies with large nonfinancial commodity marketing operations. (Collective exhale.) Massad said the one-year delay will allow the agency to more thoroughly analyze market liquidity and to more fully assess how current capital and margin rules are working for a wider swath of market participants. Like, energy companies, for example.