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Enforcement

Electronic Trading Leading To Data Deluge for CFTC Enforcement

High-frequency and electronic trading are driving up the time and cost involved in conducting CFTC investigations as the agency pleads with Congress for more money to bolster its enforcement staff.

The Commodity Futures Trading Commission is struggling to keep pace with a rapidly changing industry, even though its overall budget has increased by nearly half and its caseload has fallen by 30 percent in the last several years. Funding is still substantially short of what the agency says it needs to meet new regulatory and enforcement challenges stemming from its increased authority under the Dodd-Frank Act and the deluge of trading data it generates.

Triage. The agency is ''constantly in a situation of triage where we have to allocate available resources to the greatest need. This situation largely means that things get delayed and delayed,'' CFTC spokesman Steven Adamske told Bloomberg BNA. Some enforcement investigators are thousands of hours behind, ''and they never catch up,'' Adamske said.

In fiscal 2016, for example, the agency asked for $322 million in funding but received only $250 million, of which approximately $53 million was dedicated to enforcement (47 SRLR 296, 2/9/15). The commission currently is operating under a continuing resolution, as Congress still hasn't settled on a final figure for fiscal 2017.

The CFTC told Congress in its fiscal 2017 budget request that it doesn't have the resources to fulfill its enforcement mission and anticipates more time-intensive and complex investigations in the future.

Great Sophistication. ''We are in an age of electronic, and mostly automated, trading, which requires an entirely new level of sophistication,'' CFTC Chairman Timothy Massad told a House Appropriations subcommittee earlier this year (48 SRLR 330, 2/15/16).

One of the CFTC's prime enforcement priorities—spoofing—exemplifies what the agency faces as it takes on newer forms of manipulation and disruptive trading practices.

Spoofing, which is made possible by high-speed trading and was defined for the first time under Dodd-Frank, refers to when a trader makes multiple bids or offers with the intent to cancel the orders before execution.

Investigating spoofing requires sifting through potentially millions of bid or offer order ''messages,'' looking for patterns and intent to manipulate markets.

Technical Analysis. ''There's a lot of people to talk to, a lot of things to look at in order to prove intent. It involves a lot of time doing very technical analysis,'' Brian Walsh, a former CFTC enforcement lawyer now at Murphy & McGonigle, Washington, told Bloomberg BNA.

Investigators spent more than two years reassembling the CME Group order book after London trader Navinder Singh Sarao allegedly used spoofing to manipulate ''E-Mini'' futures contracts, contributing to the May 2010 ''flash crash,'' according to CFTC Enforcement director Aitan Goelman (47 SRLR 867, 4/27/15).

Manpower Intensive. Goelman told Bloomberg BNA that the commission sued Sarao about a week before the five-year statute of limitations was set to expire—an indication of how much time it takes to bring such cases.

A case arising from the collapse of Peregrine Financial Group consumed approximately 4,800 staff hours over two years. Investigations of other forms of sophisticated, data-driven misconduct are also manpower intensive.

The agency's probe into LIBOR—the London Inter-Bank Offered Rate—consumed 12 staffers full time and took four years to investigate before a single case could be brought, a CFTC spokesman said (44 SRLR 1318, 7/2/12).

Expensive Report. The CFTC also relies on outside experts, as in a spoofing case against Igor Oystacher and his Chicago firm, 3Red Trading LLC. The CFTC hired Hendrik Bessembinder, an Arizona State University finance professor, who spent more than 1,000 hours examining data and trading patterns for preliminary hearings in the case earlier in 2016, Goelman said.

''We had this guy spend a lot of time, write a very detailed report of hundreds of pages, and then do a rebuttal report'' to the defendants' expert witness, Goelman said. ''This stuff is unbelievably expensive. These are people with doctorates, so you're paying them a significant amount of money,'' he said.

Because of the CFTC's relatively small size, a few simultaneous investigations into manipulation or disruptive practices can overwhelm the enforcement unit. The $250 million the CFTC received in FY 2016 was dwarfed by the Securities and Exchange Commission's $1.6 billion; it has approximately 160 enforcement staffers, compared to approximately 1,300 for the SEC.

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Limited Bandwidth. ''We're small enough that a couple or three of these matters—especially when you get into scorched-earth litigation—can use up all of our available bandwidth, and we wouldn't be able to do anything else,'' Goelman said.

Nor can the CFTC afford the advanced computer technology that allows other government agencies, including the Justice Department and SEC, to dredge data, Goelman said.

The Enforcement Division ''does the best it can with the resources it has,'' Allison Baker Shealy, an attorney with Shulman Rogers Gandal Pordy & Ecker, P.A., Potomac, Md., and a former senior CFTC trial attorney, told Bloomberg BNA.

Spoofing typically involves a computer code, programmed to make and then withdraw millions of bids and offers every second. ''You've got to get to the guts of the computer software to see what the programming is,'' Daniel Nathan, a partner at Morvillo LLP, Washington, said; that takes special expertise.

Analysts also have to determine whether a program was created with the intention to do something disruptive or manipulative, Nathan, a former CFTC deputy enforcement director, said.

The agency needs staff to sort through the data, Zachary Brez, a partner at Ropes & Gray LLP, New York, who specializes in financial product enforcement defense, said. ''It's a lot of work that relates to the need for an increased budget,'' said Brez, author of a practitioner guide on futures enforcement.

Goelman said that while the CFTC gets better with each case it investigates, there's a limit to the economies of scale it can achieve. ''These are not cases that are going to fall into a particular cookie-cutter definition,'' Goelman said. ''Every case is different, and that's an additional complicating factor.''

The Sarao case was ''2010 complexity,'' Goelman said. ''Now we're dealing with 2016 complexity. It just gets that much harder.'' Goelman said traders are starting to spoof in different patterns now complicating matters. ''They evolve, we evolve to try to catch them, and then they evolve further.''

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