

THE DUTY OF DILIGENT SUPERVISION: TO WHOM AND WHAT DOES IT APPLY AND WHAT DOES IT REQUIRE?

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The Commodity Futures Trading Commission (“CFTC” or “Commission”) has placed increased focus on the duty of registrants diligently to supervise the “handling” of customer accounts and their “business as a Commission registrant” by their “partners, officers, employees and agents.” Some of the CFTC’s recent settlements and complaints seem to be expanding the scope of registrants’ supervisory liability beyond the originally intended scope of the Commission’s long-standing supervision rule. This trend highlights the need for futures commission merchants (“FCMs”), swap dealers and other CFTC registrants to understand the scope of their supervisory obligations and to implement and enforce a robust supervisory system appropriate to their businesses.

In this article, we evaluate the text of

the CFTC’s diligent supervision rules, Commission guidance, and enforcement actions to help registrants develop an understanding of to whom, to what activities and when the duty of supervision applies. We also offer suggestions about how to design, implement and enforce a supervisory system.

In order to comply with the CFTC’s diligent supervision requirements, CFTC registrants should consider and answer the following questions about their supervisory system:

- What activities fall within the scope of “handling” commodity interest accounts and a company’s “business as a Commission registrant”?
- Who is within the scope of a registrant’s “partners, officers, employees and agents (or persons occupying a similar status or performing a similar function)” involved in the “handling” of commodity interest accounts and a company’s “business as a Commission registrant”?
- Does the company’s system of supervision appropriately define and address the who, what and when of the company’s business as a CFTC registrant?
- Do the company’s supervisory policies and procedures include controls that are reasonably designed to en-



sure that supervisors perform their supervisory obligations?

- Does the company periodically review and update its system of supervision?

I. Failure to Supervise Charges in Recent CFTC Settlements

In 2017, the CFTC issued a number of orders accepting offers of settlement from Commission registrants that included findings of violations of the CFTC's diligent supervision requirement. For example, the CFTC accepted offers of settlement from Merrill Lynch, Pierce, Fenner & Smith Incorporated ("**Merrill Lynch**"), Cargill, Inc. ("**Cargill**") and INTL FCStone Financial, Inc. ("**FCStone Financial**") and FCStone Merchant Services, LLC ("**FCStone Merchant**") (collectively, "**INTL FCStone**"), that imposed civil penalties totaling nearly \$13 million for supervisory and other violations. This string of settlements indicates that the CFTC's new administration intends to make diligent supervision by Commission registrants a high priority.

A. The Merrill Lynch / BANA Settlements

On September 22, 2017, the CFTC issued an Order accepting a settlement offer of Merrill Lynch, a CFTC-registered FCM and a member of the CME Group exchanges, in which it imposed a civil penalty of \$2.5 million for violations of the CFTC's principal supervisory rule, Regulation 166.3.¹ In the Order, the CFTC found that Merrill Lynch failed diligently to supervise its employees and agents in connection with responding to a CME Group investigation and by failing to have in place adequate procedures to ensure that records of block trades executed by its affiliate, Bank of America, NA ("**BANA**"),

were prepared accurately and maintained in accordance with the CFTC's recordkeeping requirements.²

The CFTC's findings relating to the supervision of Merrill Lynch's response to the CME investigation raise a number of interesting and troublesome questions. In order to get a full understanding of the facts related to the CFTC's supervision findings, the CFTC's Order should be read together with the facts agreed to by BANA in its separate settlement with the U.S. Attorney's Office for the Western District of North Carolina.³

The CME was investigating whether traders on BANA's swaps desk (the "**Swaps Desk**") had traded ahead of customer block trade orders at various times between 2008 and 2010. According to the CFTC, during interviews by CME Market Regulation Staff, the traders made misleading statements about when their trades occurred and whether those trades were related to the customer block trades. After the interviews, external counsel for Merrill Lynch "sent a letter to CME Market Regulation Staff . . . [which] stated, among other things, that the traders 'did not have advance knowledge of a block trade such as to enable them to engage in any trading prior to the execution of the block.' " This representation proved to be inaccurate and Merrill Lynch eventually retracted the letter.⁴

The CFTC's Order explains that "Merrill Lynch's compliance department and legal department were responsible for responding to CME Market Regulation Staff's inquiries regarding block trades executed by the Swaps Desk." In order to collect information responsive to the CME's requests, "Merrill Lynch's compliance

and legal staff relied on the business operations support group (the “**Support Group**”) at BANA.” That group was supervised by the same BANA business unit that supervised the traders, not by “the compliance or legal department of either BANA or Merrill Lynch.” At some point during the investigation, the Support Group prepared an analysis of BANA’s futures trading which “showed that on a number of occasions certain Swaps Desk traders traded substantial volumes of futures contracts on Globex in the five minute window before the recorded execution time of a block trade in that same futures contract.” For reasons not explained in the CFTC’s Order, the Support Group did not share its trading analysis with Merrill Lynch’s compliance and legal staff.

According to the Order, Merrill Lynch’s compliance and legal staff relied exclusively on the Support Group to communicate with the traders during the investigation. Compliance and legal staff never interviewed the traders, and did not conduct their own internal investigation. The CFTC found that “Merrill Lynch’s reliance on the Support Group and failure to stay adequately informed regarding that group’s work during the CME Investigation contributed to Merrill Lynch’s failure to detect trading ahead of block trades by certain traders on the Swaps Desk before certain traders misled CME Market Regulation Staff during their interviews.” Accordingly, the CFTC concluded that “Merrill Lynch violated Regulation 166.3 because it failed to supervise diligently Merrill Lynch’s response to the CME Investigation.” It also found that Merrill Lynch failed diligently to supervise its compliance with the CFTC’s recordkeeping requirements.

Although the Merrill Lynch settlement showcases pitfalls to avoid when responding to an in-

quiry from a regulator, the CFTC’s finding that failure to supervise a registrant’s response to an exchange investigation is a violation of CFTC Rule 166.3 appears to be beyond the scope of the rule.⁵ One question raised by the Merrill Lynch settlement is the degree to which internal and external counsel and compliance teams can rely upon information provided to them by traders and others within the company. Oftentimes, inquiries from the government and SROs that appear to be routine are handled by the compliance team. Even with these types of inquiries, the compliance team should check the validity of information provided by traders against firm records before submitting a response.

When dealing with other than a routine inquiry and in order to preserve their credibility and trust with investigators, internal and external counsel should conduct reasonable diligence before passing along information provided by others. The amount of diligence should be proportionate to the seriousness of the inquiry. It is important, for example, to review relevant documents and the sequence of events in order to confirm that they are consistent with what traders may tell you in an interview before passing along information provided by traders to regulators. It also is important to include appropriate caveats in communications with investigators if, for example, you are continuing to collect or review relevant information. Otherwise you run the risk, as occurred in the Merrill Lynch/BANA matter, of having to withdraw or correct what later prove to be inaccurate representations.⁶ Absent exigent circumstances, most experienced investigators are willing to provide registrants and their counsel with a reasonable amount of time to respond to inquiries because they prefer to receive complete and accurate information.

B. The Cargill Settlement

On November 6, 2017, the CFTC announced a settlement with Cargill, Inc. in which it imposed a \$10 million civil monetary penalty against Cargill, a provisionally registered swap dealer, for providing counterparties with, and reporting, inaccurate mid-market swap marks, providing third-party marketers with inaccurate hedging statements, and failure to supervise violations.⁷ Interestingly, the Commission found that Cargill had violated Regulation 166.3, the supervision rule for CFTC registrants, but made no finding of a violation of Regulation 23.602, the supervision rule that specifically requires a swap dealer diligently to supervise “all activities relating to its business.”

The Commission found that Cargill failed to:

- have in place an adequate supervisory system;
- perform its supervisory duties diligently as to the mid-market mark and related disclosures;
- have in place a supervisory system to ensure that incorrect valuation data was not sent to the swap data repository (“SDR”);
- have in place an adequate supervisory system within its Cargill Risk Management business (“CRM”) and provided third-party marketers with inaccurate hedging statements;
- perform its supervisory duties diligently as to communications about swaps with third-party marketers, in that violations of CRM’s internal communications policies repeatedly occurred and communications with

counterparties were inaccurate regarding the percent accounts were hedged; and

- develop systems or procedures to prevent the violations or correct the conduct.

These findings would appear also to have provided a predicate for a finding of a violation of Regulation 23.602.

C. INTL FCStone Settlement

On November 14, 2017, the CFTC announced a settlement that imposed a \$280,000 civil monetary penalty against FCStone Financial, a registered FCM and FCStone Merchant, FCStone Financial’s physical marketing affiliate. The settlement found that FCStone Merchant executed non-*bona fide* exchange of futures for related position (“**EFRP**”) transactions because FCStone Merchant and its counterparty exchanged Canadian Dollar futures for physical canola seed, which are not sufficiently correlated.⁸ In addition to FCStone Merchant’s execution of non-*bona fide* EFRPs, the CFTC found that FCStone Financial’s supervisory system was inadequate because FCStone Financial failed to ensure that:

- FCStone Merchant’s EFRPs had the necessary corresponding and related cash or OTC derivatives position required for EFRPs;
- FCStone Merchant’s EFRPs were documented properly; and
- its employees involved in the execution, handling, and processing of EFRPs understood the nature of an EFRP and the requirements for executing, handling, and processing valid EFRPs.

In addition to the civil monetary penalty, both

FCStone Financial and FCStone Merchant agreed to develop more robust controls to detect non-*bona fide* EFRPs, enhance compliance manuals and procedures, develop new documentation and documentation processes for EFRPs, and conduct training for relevant employees.

The CFTC's finding that FCStone Financial's failure to supervise the trading activity of its affiliate is a violation of CFTC Regulation 166.3, as opposed to the finding related to its supervision of its own employees, appears to be beyond the scope of the rule. The duty to supervise, as discussed in detail below, applies to each registrant's handling of customer accounts and other aspects of the registrant's business. CFTC Regulation 166.3 does not impose an obligation on an FCM to supervise the business activity of its customer. In effect, the CFTC used its supervision rule to impose secondary liability on an FCM for the violations of its customer-affiliate. Furthermore, the settlement against FCStone Financial is inconsistent with the CME Group's amended EFRP Market Regulation Advisory Notice ("MRAN"), which clarified that FCMs are not obligated to surveil the *bona fides* of their customer EFRP activity.⁹ Rather, FCMs are only obligated to notify the exchange if the FCM has actual or constructive knowledge that an EFRP is not *bona fide*.

II. Who Has a Duty to Supervise Under the CFTC's Supervisory Rules?

A. Regulation 166.3

The key to designing, implementing and enforcing a system of diligent supervision is understanding what is required by the text of Regulation 166.3, who is charged with the duty to

supervise and what constitutes diligent supervision in the context of a registrant's business.

i. To Whom Does the Duty to Supervise Apply?

CFTC Regulation 166.3 provides that:

[e]ach Commission registrant, except an associated person who has no supervisory duties, must ***diligently supervise the handling*** by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) ***of all commodity interest accounts*** carried, operated, advised or introduced by the registrant ***and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business*** as a Commission registrant. (Emphasis added).

On its face, Regulation 166.3 requires diligent supervision by a "registrant" of the "handling" of "commodity interest accounts" and all other activities "relating to its business" as a registrant. The duty to supervise has always been thought to apply to persons in the business unit of a registrant who handle commodity interest accounts, not to persons performing other functions, such as the operations, risk management, legal, and compliance functions.¹⁰ The exception from the obligation diligently to supervise for "an associated person who has no supervisory duties" supports the logical interpretation that this regulation is intended to apply only to persons who supervise the handling of accounts and closely related "business" activities.

When the CFTC issued Regulation 166.3 in 1978, it said that "[t]he basic purpose of the rule is to protect customers by ensuring that *their dealings with the employees of Commission registrants* will be reviewed by other officials in the firm."¹¹ Thus, Regulation 166.3 applies to the

dealings between employees of a registrant and the registrant's customers.¹² Notably, when the Commission adopted Regulation 166.3, it did not refer to the dealings between a registrant and an exchange, or between a registrant and a regulator, as being within the scope of a registrant's duty to supervise.

After determining that Regulation 166.3 applies to those aspects of a company's "business" as a registrant that interacts with customers, the next step in identifying the activities to which a supervisory obligation applies is to define the scope of a company's business as a CFTC registrant. The plain text of the CEA and the Commission's regulations which define the activities that require registration as an FCM, swap dealer, commodity trading advisor ("CTA"), or commodity pool operator ("CPO") is the logical starting place for determining the scope of a registrant's business that interfaces with the handling of customer accounts. Each registrant definition in the CEA is discussed below.

1. The Business of FCMs

The CEA's definition of FCM identifies the following as activities related to the "handling" of a customer account:

- Soliciting and accepting orders for the purchase or sale of a commodity interest; and
- In connection with any of these activities accepts, any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.¹³

The scope of an FCM's business as a Commission registrant should be defined by reference to these core functions.

The CFTC's regulations impose a number of obligations on FCMs that relate to an FCM's core functions of soliciting and accepting orders, accepting margin, and other activities related to its business as an FCM. FCM obligations related to the handling of commodity interest accounts include, for example:

- The obligation to maintain the confidentiality of customer information;¹⁴
- The obligation to provide risk disclosure statements;¹⁵
- The prohibition against guaranteeing customers against loss;¹⁶
- The requirement to obtain customer consent for bulk transfers of positions;¹⁷
- The requirement to adopt and implement conflicts of interest procedures;¹⁸
- The prohibition against restrictions on customer clearing arrangements;¹⁹
- The requirement to establish and implement risk-based limits;²⁰ and
- The obligations applicable to accepting orders for clearing.²¹

These obligations are within the scope of activities related to handling of accounts and an FCM's business as a Commission registrant and therefore must be diligently supervised.

2. The Business of Swap Dealers

The CEA definition of a swap dealer identifies

the following as activities related to the business of a swap dealer “performed by its partners, members, officers, employees, and agents”:²²

- Holding itself out as a dealer in swaps;
- Making a market in swaps;
- Regularly entering into swaps with counterparties as an ordinary course of business for its own account; or
- Engaging in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.²³

The CFTC’s regulations impose a number of obligations on swap dealers that relate to the core functions of acting as a swap dealer. These obligations are within the scope of a swap dealer’s business activities and therefore must be diligently supervised. A swap dealer’s obligations related to its business as a swap dealer include, for example:

- Complying with business conduct standards with counterparties;²⁴
- Complying with internal business conduct standards;
- Collecting and posting margin for uncleared swaps;²⁵ and
- Segregating collateral for uncleared swaps.²⁶

3. The Business of CTAs

The CEA defines a CTA as a person who, for compensation or profit, engages in the following activities:²⁷

- Advising others, either directly or through

publications, writings, or electronic media, as to the value of, or the advisability of trading in, commodity interests; or

- Issuing analyses or reports concerning commodity interests as part of a regular business.

The CFTC’s regulations impose a number of obligations on a CTA that relate to its core business as a CTA. Examples of these regulatory obligations include:

- Not accepting funds, securities or other property to purchase, margin, guarantee or secure a customer trading commodity interests;²⁸
- Maintaining records of trading activity and details concerning customers;²⁹
- Complying with disclosure and reporting obligations to customers,³⁰ and
- Complying with advertising restrictions.³¹

All of these business activities are within the scope of a CTA’s diligent supervision obligation.

4. The Business of CPOs

The CEA defines a CPO as a person who solicits or receives funds or property for the purpose of trading in commodity interests.³² The CFTC’s regulations impose a number of obligations on a CPO that relate to its core functions as a CPO and are within the scope of the CFTC’s diligent supervision requirements. Examples of these regulatory obligations include:

- Only receiving funds, securities or other property from customers in the pool’s name;³³

- Segregating property of any pool that the CPO operates with the property of any other person;³⁴
- Maintaining records of trading activity and details concerning customers;³⁵
- Complying with disclosure and reporting obligations to customers;³⁶ and
- Complying with advertising restrictions.³⁷

All of these business activities are within the scope of a CPO's diligent supervision obligation.

ii. What Constitutes Diligent Supervision Under CFTC Regulation 166.3?

When the duty of supervision applies, Regulation 166.3 requires that the supervision must be “diligent.” According to the CFTC, diligent supervision includes an adequate supervisory system that is administered “diligently.”³⁸ To meet this standard, a registrant's supervisory system should be written and incorporate procedures for the detection and deterrence of possible wrongdoing.³⁹ The CFTC has stated that “[e]vidence of violations that ‘should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly,’ is probative of a failure to supervise.”⁴⁰

The “diligent” administration and enforcement of a system of supervision requires earnest and careful effort in the context of a registrant's business as a Commission registrant. It does not require perfect supervision—a goal that is not attainable. As the Commission acknowledged in *Lobb v. J.T. McKerr & Co.*, the performance of a wrongful act by an employee in the course of his

or her employment “does not necessarily mean that the employee was improperly supervised.”⁴¹

To gain an understanding of the amount of effort required “diligently” to supervise a registrant's commodity interest account business, it is useful to consider how “diligent” is commonly understood. Merriam-Webster, for example, defines diligent as “characterized by steady, earnest, and energetic effort.” Oxford defines diligent as “[h]aving or showing care and conscientiousness in one's work or duties.” Other similar definitions refer to acting in a careful and thorough manner. All of these definitions require performing supervision carefully, steadily and thoroughly; again, none requires perfection.

In 1978, the CFTC declined to adopt a proposal with proscriptive requirements for diligent supervision by registrants.⁴² Perhaps realizing that proscriptive requirements cannot be tailored to a registrant's specific business, the Commission adopted several, but not all, of its proposed proscriptive supervision requirements as “guidelines” for diligent supervision primarily by an FCM. The guidelines strongly recommend:⁴³

- Prior written approval by a supervisor of the opening of each commodity account;
- Prior written approval by a supervisor of the delegation by any customer of discretionary authority to an associated person under the supervisor's supervision;
- Written approval by the designated supervisor of each commodity trade effected pursuant to discretionary authority in an account under his supervision;
- Frequent examination by the designated supervisor of the commodity accounts un-

der his supervision to detect and prevent any violation of the CEA or rules thereunder, or of any bylaw, rule, regulation, or resolution of each contract market and registered futures association of which an FCM is a member; and

- Prompt review of all customer complaints, whether written or oral, concerning the handling of commodity accounts.

B. Swap Dealer Diligent Supervision under CFTC Regulation 23.602

In addition to CFTC Regulation 166.3, swap dealers are subject to diligent supervision requirements that apply specifically to swap dealers pursuant to CFTC Regulation 23.602.

i. To Whom Does the Swap Dealer Duty to Supervise Apply?

CFTC Regulation 23.602(a) provides that a swap dealer must:

establish and maintain a system to supervise, and shall diligently supervise, *all activities relating to the business performed* by its partners, members, officers, employees, and agents [. . .]. Such system shall be reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and Commission regulations. (Emphasis added).

The first sentence of CFTC Regulation 23.602 regarding the duty to supervise “all activity relating to the business performed” by its employees is consistent with CFTC’s supervision requirements for registrants under CFTC Regulation 166.3. The Commission noted the similarity between CFTC Regulation 23.602 and CFTC Regulation 166.3, and its intent to rely on existing supervision-related precedent, in a 2015 settle-

ment order when it explained that “[t]he operative language of Regulation 23.602(a) is similar to the language of the Commission’s longstanding supervision regulation, Regulation 166.3, and its case law is therefore instructive.”⁴⁴

The second sentence of CFTC Regulation 23.602 potentially places a broader scope of supervisory responsibilities on swap dealers compared to the supervisory responsibilities of other registrants. Regulation 23.602 requires supervision “to achieve compliance with [the CEA and CFTC regulations].” Unlike CFTC Regulation 166.3, it is unclear whether this requirement is tied expressly to a swap dealer’s business as a CFTC registrant, *i.e.*, its swap dealing activity with customers. As a result, Regulation 23.602 may extend the diligent supervision obligation to the functions of individuals and/or systems that are, for example, responsible for compliance with CFTC requirements applicable to swap dealers that are not directly related to interactions with customers (*e.g.*, reporting requirements).⁴⁵

ii. What Constitutes Diligent Supervision under CFTC Regulation 23.602?

Although CFTC Regulation 23.602 is fairly new and the CFTC has only settled enforcement actions involving this provision a few times since it was adopted in 2012, the CFTC noted that the scope of diligent supervision is analogous to CFTC Regulation 166.3. As a result, consistent with CFTC Regulation 166.3, diligent supervision under CFTC Regulation 23.602 includes having a written system of supervision that includes controls to prevent wrongdoing along with the diligent administration and enforcement of the system of supervision.

III. Supervisory Duties Under NFA Rule 2-9

NFA Rule 2-9, which imposes supervisory obligations on NFA members, provides that “[e]ach Member shall diligently supervise its employees and agents *in the conduct of their commodity futures activities* for or on behalf of the Member. Each Associate who has supervisory duties shall diligently exercise such duties in the conduct of that Associate’s *commodity futures activities* on behalf of the Member.” *Id.* (emphasis added). The NFA describes Rule 2-9 as “broadly written to provide Members with flexibility in developing procedures tailored to meet their particular needs.”⁴⁶ According to the NFA, “commodity futures activities” include sales practices,⁴⁷ the activities of branch offices and guaranteed IBs,⁴⁸ the use of emails, web sites and online social networks to communicate with customers,⁴⁹ funds transfers,⁵⁰ the use of automated order-routing systems,⁵¹ ethics training,⁵² the promotion of third-party trading systems,⁵³ the use of electronic means to collect and maintain customer and counterparty information,⁵⁴ and other similar customer-focused activities.⁵⁵

IV. The Scope of the Duty to Supervise as Defined in CFTC Settlement Orders and Litigated Cases

The CFTC repeatedly has emphasized that, in order to comply with Regulation 166.3, a registrant must: (1) have in place an adequate supervisory system; and (2) perform its supervisory duties diligently.⁵⁶ An adequate supervisory system has two principal components: (i) systems

and controls designed to prevent and detect violations, and (ii) sufficient training of supervisors and APs.⁵⁷ The CFTC has asserted on many occasions that failure to supervise “is an *independent and primary* violation for which no underlying violation is necessary.”⁵⁸

In order to understand what constitutes an adequate supervisory system, and diligent supervision, it is useful to look at the types of omissions that the CFTC and the courts have found to amount to a failure diligently to supervise. These omissions also must be considered in the context of a company’s business as a registrant. Because the businesses of FCMs, swap dealers, CPOs, CTAs and other Commission registrants differ between and among themselves, what constitutes an adequate supervisory system for each of them necessarily differs.

A review of the decisions and settlements that include findings of a failure to supervise beyond the CFTC’s recent settlements with Merrill Lynch, Cargill and INTL FCStone discussed above, provides insight into the types of omissions that evidence either an inadequate supervisory system or a failure diligently to supervise a registrant’s commodity interest account-related business. The CFTC has found a failure to supervise under Regulation 166.3 due to, among other things, improper handling of customer accounts, inadequate systems and internal controls, failure to detect fraudulent activity, and inadequate training. The factual bases for the Commission’s failure to supervise findings is listed in the chart below:

Table 1: Summary of CFTC Manipulation Cases

Type of Failure to Supervise Violation	Specific Factual Circumstances
Improper Handling of Customer Accounts and Funds	Failure to— <ul style="list-style-type: none"> ● Follow account opening procedures⁵⁹ ● Record account numbers on orders⁶⁰ ● Supervise the handling of customer funds⁶¹ ● Monitor deposit and withdrawal activity from customer accounts⁶² ● Supervise the disbursement of funds from customer accounts⁶³ ● Follow procedures for transferring trades between related accounts⁶⁴ ● Supervise the opening and operation of related accounts⁶⁵ ● Monitor trading of a customer far in excess of limits that led to the bankruptcy of the FCM⁶⁶ ● Supervise employees transferring positions between accounts with different beneficial ownership⁶⁷ ● Supervise the segregation of customer funds⁶⁸ ● Prepare accurate trading records⁶⁹ ● Supervise the handling of risks related to give-up arrangements⁷⁰ ● Supervise slippage between customer orders and execution prices of dually registered FCM and retail foreign exchange dealer⁷¹ ● Supervise a trader who entered trades while account was in deficit⁷² ● Supervise the processing of exchange and clearing fees charged to customers⁷³
Inadequate Systems And Internal Controls	Failure to— <ul style="list-style-type: none"> ● Implement adequate internal controls concerning customer access to account statements made available via the internet⁷⁴ ● Adopt procedures to ensure appropriate transmission of price indications⁷⁵ ● Implement adequate procedures for handling wire transfers from customers⁷⁶ ● Have adequate credit and concentration risk policies and controls⁷⁷ ● Correct errors or omissions when reporting swap data to a swap data repository due to a design flaw in the swap data reporting system⁷⁸ ● Have an adequate system to supervise all activities related to compliance with the swap reporting requirements⁷⁹

Type of Failure to Supervise Violation	Specific Factual Circumstances
	<ul style="list-style-type: none"> ● Lack of oversight procedures to manage and control large concentrated positions by a CPO's / CTA's traders⁸⁰
Failure to Detect Fraudulent Activity	Failure to— <ul style="list-style-type: none"> ● Detect the fraudulent allocation of orders⁸¹ ● Detect the entry of matching buy and sell orders⁸² ● Respond to warning signs of a customer acting as an unregistered CPO⁸³ ● Respond to indications of questionable activity of a hedge fund manager⁸⁴ ● Supervise a trader who entered fictitious transactions into FCM's electronic systems⁸⁵
Inadequate Training	Failure to— <ul style="list-style-type: none"> ● Train supervisor how to properly supervise⁸⁶
Incomplete And Untruthful Communications With Regulators	Failure to— <ul style="list-style-type: none"> ● Ensure that communications with regulators were full, complete and truthful⁸⁷

Virtually all of these examples involve a failure diligently to supervise a core commodity interest account activity or directly related business activity of an FCM or other CFTC registrant. Only one involved a failure to ensure that communications with regulators were full, complete and truthful, and in that case, the communications were between the Chicago Board of Trade and the company.⁸⁸ As noted above, the CFTC's finding in the Merrill Lynch settlement order that "Merrill Lynch violated Regulation 166.3 because it failed to supervise diligently Merrill Lynch's response to the CME investigation" does not appear to be supported by the plain text of Regulation 166.3, the stated purpose of the rule, litigated precedent, or the overwhelming majority of prior settlement orders.⁸⁹ On the other hand, the CFTC's finding that "Merrill Lynch had inadequate procedures for preparing and maintaining records for block trades" appears, irrespective of whether it could be proven based upon a con-

tested evidentiary record, to be more grounded in the rule text, the purpose of the rule and prior precedent.

V. What is an Appropriate Model of Diligent Supervision of a CFTC Registrant's Business?

The most important thing to keep in mind when designing, implementing and enforcing a system of diligent supervision is that no one structure works for the businesses of all CFTC registrants. The supervisory system must be adequate in light of the registrant's commodity interest account-related business, and it must be implemented and enforced earnestly and with reasonable care. The first step in designing a system of supervision for purposes of CFTC Regulations 166.3 or 23.602 is to identify the core aspects of a company's business as a CFTC registrant. The nature of a registrant's business will differ across the various registration

categories. In addition, the nature of a registrant's business may differ within a registration category. For example, not all FCMs provide the same services.

After identifying the core aspects of the registrant's business, the company should develop a plan of who should supervise specific activities and how they should supervise those activities. Although legal and compliance should help a designated supervisor to understand the scope of his/her supervisory responsibilities, the designated supervisors should be business persons, not individuals in legal or compliance functions. To evidence that the registrant has an adequate system of supervision, it should be documented in a policy and procedures that clearly delineate the scope of each supervisor's responsibilities. The supervisory system should also incorporate periodic training for supervisors. Furthermore, to demonstrate diligent supervision, the registrant should periodically review its system or plan of supervision to ensure that supervisors carry out their supervisory duties, and make modifications to the plan, if needed. To the extent that supervisors detect potential misconduct or compliance gaps, they should be remediated and escalated, as necessary, to ensure adequate supervision going forward.

NFA publishes a self-examination "checklist" for all registration categories that includes a section on supervision.⁹⁰ Examples from the NFA self-examination checklist under the category of supervision include:

- Adopt policies and procedures to handle customer complaints, along with designating a compliance officer to handle customer complaints or inquiries of a compliance nature;

- Establish an internal audit department;
- Establish policies and procedures regarding the hiring and supervision of APs who have been or whose past employers have been disciplined by NFA or the CFTC for fraud;
- Distribute changes in rules to appropriate personnel;
- Supervise sales solicitations by any or all of the following methods: direct listening, reviewing taped solicitations, silent phone monitoring and customer contact;
- Provide APs with training on the futures and options markets and sales solicitation training; and
- Require an officer or other supervisory personnel regularly to review trading in non-customer and proprietary trading accounts.

As is the case with CFTC Regulations 166.3 and 23.602(a), neither the express language of NFA Rule 2-9, NFA's supervisory interpretations, nor NFA's supervisory checklist addresses communications by registrants with regulators or exchanges.

VI. Conclusion

The benefits of diligent supervision greatly outweigh the costs. The CFTC has assessed civil penalties totaling more than \$45.3 million during the past year for supervisory violations.⁹¹ CFTC's registrants could review and enhance their current supervisory systems for a small percentage of that figure. Designing, implementing and enforcing an adequate system for supervising a company's activities related to its business as a registrant places a registrant in the best position

to avoid violations of the CEA, and the rules of the CFTC, the NFA and the exchanges. And, perhaps more importantly, diligent supervision helps to protect a registrant's reputation with its customers.

Furthermore, if a substantive violation occurs, a registrant that maintains and enforces an adequate supervisory system is better positioned to persuade a regulator to exercise its discretion not to charge the company with a violation based upon the misconduct of an employee that is not reasonably detectable.⁹² For the same reasons, the existence and enforcement of an adequate system of supervision should help to avoid a failure to supervise charge either just because a substantive violation occurred, or as a separate violation.

ENDNOTES:

¹*In re Merrill Lynch*, CFTC Docket No. 17-25 (Sept. 22, 2017).

²Order at 2.

³A copy of the BANA settlement with the USAO of the WDNC is available at <https://www.justice.gov/usao-wdnc/press-release/file/998141/download> (“**BANA Settlement**”).

⁴BANA Settlement, Statement of Facts, pg. 2.

⁵Even if a response to an exchange inquiry is beyond the scope of CFTC Regulation 166.3, it is critically important for a registrant's internal and external counsel to maintain their credibility with investigators. Obtaining the best result for a registrant, whether it is closure of the investigation, a settlement, or an agreement to disagree, requires the belief on the part of investigators that registrants, their business persons and their counsel are providing them with complete and accurate facts. Every registrant and practitioner should know that it is a civil and criminal viola-

tion of the CEA and a violation of exchange rules to “knowingly and willfully” provide an exchange or federal regulator with “false, fictitious or fraudulent information.” 17 C.F.R. § 11.6 (“Any person who knowingly and willfully makes false or fraudulent statements, whether under oath or otherwise, or who falsifies, conceals or covers up a material fact, or submits any false writing or document, knowing it to contain false, fictitious or fraudulent information, is subject to the criminal penalties set forth in 18 U.S.C. 1001.”). Separate and apart from the statutory provisions and rules requiring registrants and their counsel to provide investigators with accurate information, it is necessary to do so to maintain the trust of investigators. Once that trust is lost, it is very difficult to regain.

⁶*In re Merrill Lynch*, CFTC Docket No. 17-25 (Sept. 22, 2017).

⁷*In re Cargill, Inc.*, CFTC Docket No. 18-03, Nov. 6, 2017. Cargill consented to the entry of the Commission's Order without admitting or denying the Commission's findings or conclusions.

⁸The execution of non-*bona fide* EFRPs was in violation of CFTC Regulation 1.38.

⁹See Market Regulation Advisory Notice, CME Group RA1716-5 (Nov. 2, 2017) (A25).

¹⁰See the precedent discussed below. Similarly, the prudential regulators of financial institutions, including financial holding companies, expect management, not lawyers and compliance personnel, to supervise the business activities of those institutions and to make sure that they maintain a strong compliance program and system of internal controls. See, e.g., Federal Reserve Board Division of Supervision and Regulation, Commercial Bank Examination Manual, April 2013, Section 5010, and Federal Reserve Board Division of Supervision and Regulation, Bank Holding Company Supervision Manual, January 2015, Section 2124.07.4.2 (“Senior management . . . is responsible for communicating and reinforcing the compliance culture established by the board and for implementing measures to promote the culture. Senior management also should implement and enforce the compli-

ance policies and compliance risk-management standards that have been approved by the board.”).

¹⁴³Fed. Reg. 31886, 31889 (emphasis added).

¹²Note that an FCM is not required to supervise the commodity-related activities of an introducing broker that has introduced accounts to the FCM, or the commodity-related activities of anyone acting on behalf of such an introducing broker. 48 Fed. Reg. 35248, 35274 (1983).

¹³⁷U.S.C § 1a(28)(A); 17 C.F.R. 1.3(p).

¹⁴¹17 C.F.R. § 155.3.

¹⁵¹17 C.F.R. § 1.55.

¹⁶¹17 C.F.R. § 5.16.

¹⁷¹17 C.F.R. § 1.65.

¹⁸¹17 C.F.R. § 1.71(b).

¹⁹¹17 C.F.R. § 1.72.

²⁰¹17 C.F.R. § 1.73.

²¹*Id.*

²²*See* CEA Section 1a(49).

²³*Id.*

²⁴¹17 C.F.R. § 23.450.

²⁵¹17 C.F.R. § 23.158.

²⁶¹17 C.F.R. § 23.702.

²⁷*See* CEA Section 1a(12).

²⁸¹17 C.F.R. § 4.30.

²⁹¹17 C.F.R. § 4.33.

³⁰¹17 C.F.R. §§ 4.31; 4.34; 4.35.

³¹¹17 C.F.R. § 4.41.

³²*See* CEA Section 1a(11).

³³¹17 C.F.R. § 4.30.

³⁴¹17 C.F.R. § 4.20.

³⁵¹17 C.F.R. § 4.23.

³⁶¹17 C.F.R. § 4.24.

³⁷¹17 C.F.R. § 4.41.

³⁸*See In re Forex Capital Markets LLC*, [2012-2013 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 32,658 at 73166 (Oct. 3, 2011).

³⁹*See, e.g., In re Citigroup Global Markets Inc.*, CFTC Docket No. 17-06 (Jan. 19, 2017).

⁴⁰*See In re Cargill*, citing *In re Paragon Futures Ass’n*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,850 (CFTC Apr. 1, 1992).

⁴¹*Lobb v. J.T. McKerr & Co.*, Comm. Fut. L. Rep. (CCH) ¶ 24,568 at 12 n.24 (CFTC 1989).

⁴²*Adoption of Customer Protection Rules*, 43 Fed. Reg. 31886, 31889 (July 24, 1978).

⁴³Each of these guidelines relates directly to the handling by associated persons (“APs”) of a customer’s commodity interest account(s). None relates to the response of a registrant to questions raised by an exchange or other regulator.

⁴⁴*See In re INTL FCStone Markets, Inc.*, CFTC Docket No. 15-27 (Aug. 19, 2015).

⁴⁵*See, e.g., In re Citibank, N.A. and Citigroup Global Markets Limited*, CFTC Docket No. 17-26 (Sept. 25, 2017) (Due to a design flaw in swap data reporting systems, Respondents failed to correct errors or omissions when reporting swap data to a swap data repository); and *In re Deutsche Bank AG*, CFTC Docket No. 15-40 (Sept. 30, 2015) (Respondent “did not have an adequate system to supervise all activities related to compliance with the swaps reporting requirements”).

⁴⁶NFA Interpretive Notice 9070, Mar. 1, 2016.

⁴⁷NFA Interpretive Notice 9021, Sept. 19, 2016.

⁴⁸NFA Interpretive Notice 9019, July 24, 2000.

⁴⁹NFA Interpretive Notices 9037, Aug. 19, 1999 and 9063, Dec. 24, 2009.

⁵⁰NFA Interpretive Notice 9045, Aug. 27, 2013.

⁵¹NFA Interpretive Notice 9046, Dec. 12, 2006.

⁵²NFA Interpretive Notice 9051, July 1, 2003.

⁵³NFA Interpretive Notice 9055, Sept. 19, 2016.

⁵⁴NFA Interpretive Notice 9070, Mar. 1, 2016

(also applicable to CTAs, CPOs, IBs and SDs).

⁵⁵NFA Rule 2-9 only applies to futures activity. See NFA Interpretive Notice 9070, Mar. 1, 2016 (Compliance Rule 2-39 imposes supervisory obligations on retail foreign exchange dealers (RFEDs) for their forex activities and NFA Compliance Rule 2-49 imposes supervisory obligations on swap dealers (SD) and major swap participants (MSPs)).

⁵⁶See, e.g., *In re Citigroup Global Markets Inc.*, CFTC Docket No. 17-06 (Jan. 19, 2017).

⁵⁷*Id.*

⁵⁸See, e.g., *In the Matter of Collins*, 1997 WL 761927 (C.F.T.C. 1997); *In the Matter of GNP Commodities Inc.*, 1992 WL 201158, at *24 n.11 (Emphasis added). The italicized language is inconsistent with the CFTC's use of a failure to supervise finding in some cases in effect to impose secondary liability on CFTC registrants.

⁵⁹*In re Interstate Sec. Corp.*, Comm. Fut. L. Rep. (CCH) ¶ 25,295 (C.F.T.C. 1992).

⁶⁰*In re Refco, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 27,650 (C.F.T.C. 1999).

⁶¹*In the Matter of Triland USA, Inc.*, 2010 WL 3862763 (C.F.T.C. 2010).

⁶²*In the Matter of Robbins Futures, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 29,503 (C.F.T.C. 2003).

⁶³*In the Matter of Rosenthal Collins Group, LLC*, Comm. Fut. L. Rep. (CCH) ¶ 30,899 (C.F.T.C. 2008).

⁶⁴*In the Matter of MF Global Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 30,718 (C.F.T.C. 2007).

⁶⁵*In the Matter of Morgan Stanley Smith Barney, LLC*, 2014 WL 4658496 (C.F.T.C.).

⁶⁶*In re Wolcott & Lincoln Futures, LLC*, 2 Comm. Fut. L. Rep. (CCH) ¶ 27,729 (C.F.T.C. 1999).

⁶⁷*In the Matter of FCStone, LLC*, 2015 WL 2066891 (C.F.T.C.).

⁶⁸*In the Matter of Cadent Financial Services LLC*, 2009 WL 3195582 (C.F.T.C.).

⁶⁹*In the Matter of MF Global Inc.*, 2009 WL

5125367 (C.F.T.C.).

⁷⁰*In the Matter of Alaron Trading Corp.*, 2010 WL 3827406 (C.F.T.C.).

⁷¹*In the Matter of Forex Capital Markets LLC*, 2011 WL 4689390 (C.F.T.C.).

⁷²*In the Matter of FCStone, LLC*, Comm. Fut. L. Rep. (CCH) ¶ 32,142, 2013 WL 2368539 (C.F.T.C. 2012).

⁷³*In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2014 WL 4259211 (C.F.T.C.).

⁷⁴*In the Matter of MF Global Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 30,718 (C.F.T.C. 2007).

⁷⁵*In the Matter of MF Global Inc.*, 2009 WL 5125367 (C.F.T.C.).

⁷⁶*In the Matter of Robbins Futures, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 29,503 (C.F.T.C. 2003).

⁷⁷*In the Matter of FCStone, LLC*, Comm. Fut. L. Rep., 2013 WL 2368539 (C.F.T.C.).

⁷⁸*In re Citibank, N.A. and Citigroup Global Markets Limited*, CFTC Docket No. 17-26 (Sept. 25, 2017).

⁷⁹*In re Deutsche Bank AG*, CFTC Docket No. 15-40 (Sept. 30, 2015).

⁸⁰*In the Matter of EMF Financial Products, LLC*, 2009 WL 3863294 (C.F.T.C.).

⁸¹*In the Matter of Anderson*, Comm. Fut. L. Rep. (CCH) ¶ 29,498 (C.F.T.C. 2003).

⁸²*In the Matter of Enskilda Futures Ltd.*, Comm. Fut. L. Rep. (CCH) ¶ 32,062 (C.F.T.C. 2011).

⁸³*In the Matter of Robbins Futures, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 29,503 (C.F.T.C. 2003).

⁸⁴*In the Matter of MF Global Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 30,718 (C.F.T.C. 2007).

⁸⁵*In the Matter of Goldman Sachs & Co.*, 2012 WL 6101176 (C.F.T.C.).

⁸⁶*In the Matter of Rosenthal Collins Group, LLC*, 2014 WL 6068391 (C.F.T.C.).

⁸⁷*In the Matter of EMF Financial Products*,

LLC, 2009 WL 3863294 (C.F.T.C.).

⁸⁸*In the Matter of EMF Financial Products, LLC*, 2009 WL 3863294, at *1-2 (C.F.T.C.).

⁸⁹*In re Merrill Lynch, Pierce, Fenner & Smith Incorporated*, CFTC Docket No. 17-25, slip op. at 6 (Sept. 22, 2017).

⁹⁰Self-Examination Questionnaire, NFA (Mar. 2017) at <https://www.nfa.futures.org/mem>

[bers/self-exam-questionnaire.html](#).

⁹¹This figure is limited to CFTC orders imposing civil penalties that include failure to supervise violations issued from November 14, 2016 to November 14, 2017.

⁹²This is true notwithstanding the CEA's *respondeat superior* provision. CEA § 2(a)(1)(B).

