

Recent Enforcement Orders Remind FCMs: Train Your Brokers on Post- Execution Allocation Rules.

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INTRODUCTION

On May 29, 2018, the CFTC and NFA¹, respectively, issued enforcement decisions against Chicago-based X-Change Financial Access, LLC (“XFA”) that should serve as a cautionary tale for Futures Commission Merchants, and other registrants, about the importance of training, updating supervisory procedures, and appropriately maintaining records.

The orders addressed conduct by XFA, which was registered as an FCM until 2016. According to the regulators, XFA failed to supervise its staff through inadequate policies and training in several areas. XFA’s deficiencies led to it processing customers’ orders in violation of the Commodity Exchange Act.

Though XFA had some prior regulatory woes, it found itself in the CFTC’s and NFA’s crosshairs this time due, in part, to the actions of its client: Newport Private Capital, then a CTA and CPO, (“Newport”) and its principal, Jonathan Hansen (“Hansen”).

¹ Full copies of the public regulatory actions referenced above can be accessed at: Copies of those actions are available at:

In re X-Change Financial Access, LLC, No. 18-13, CFTC Order (May 29, 2018) <https://www.cftc.gov/sites/default/files/2018-05/enfX-changefinancialaccessllcorder052918.pdf>;

In re X-Change Financial Access, LLC, No. 18-BCC-004, NFA Decision, (May 29, 2018) <https://www.nfa.futures.org/basicnet/CaseDocument.aspx?seqnum=4556>;

In re Newport Private Capital, LLC, No. 13-MRA-006, NFA MRA Notice (Sept. 4, 2013) <https://www.nfa.futures.org/basicnet/CaseDocument.aspx?seqnum=3698>;

In re Newport Private Capital, LLC, No. 13-MRA-006, NFA Notice (Jan. 16, 2014) <https://www.nfa.futures.org/basicnet/CaseDocument.aspx?seqnum=3849>;

In re Newport Private Capital, LLC, No. 13-MRA-006, NFA Decision (Dec. 26, 2013) <https://www.nfa.futures.org/basicnet/CaseDocument.aspx?seqnum=3832>;

VIOLATIVE ALLOCATIONS:

Newport and Hansen carried several accounts at XFA. The CFTC and NFA indicate that Newport and Hansen gave XFA's floor broker bundled orders and later provided instructions on how to allocate those orders.

According to the regulators, Newport and Hansen's allocation instructions violated Regulation 1.35(b)(5) in at least four ways: First, Newport and Hansen did not convey allocation instructions "as soon as practicable" after entering the order; rather, they conveyed allocation instructions hours after placing the order, often at the end of the trading day. Second, Newport and Hansen did not have any set, objective method for allocating orders amongst accounts. Third, instead of allocating orders fairly, as required, Newport and Hansen allocated the most profitable orders to accounts in which Hansen, or his associates, held a proprietary interest—and allocated unprofitable trades to Hansen's customers' accounts. Fourth, though the orders were entered as "bundled orders," sometimes Hansen allocated an entire order to a single account, which violates requirements applicable to non-bundled orders.

VIOLATING TRADING BAN:

In addition, Newport and Hansen were subjects of a NFA Member Responsibility Action ("MRA") in 2013, due to issues unrelated to XFA, and were banned from trading in 2014—except for liquidation orders. In violation of the MRA, Hansen placed orders through XFA for the benefit of an account in his wife's name. Though the regulators alleged that XFA's broker knew that Hansen was really placing the trades, XFA did not report violation of the MRA. XFA allocated trades to the wife's account but failed to add the wife's account to the give-up agreement—a further violation of allocation rules.

FCM'S FAILURES:

The CFTC and NFA made specific findings regarding XFA's failure to detect or prohibit Hansen's violative conduct through XFA's broker, as well as a failure to maintain and produce records. These included:

1. XFA failed to train its staff on allocation rules and the requirements for post-execution allocations.
2. XFA did not have any written policies and procedures dealing with post-execution allocation rules.
3. XFA had insufficient policies and procedures designed to ensure compliance with regulatory enforcement orders (for failing to detect and prevent Hansen's circumvention of the MRA through his wife's account).
4. XFA failed to preserve timestamps on Instant-Messaging orders received from Newport and Hansen.

From these failings, the CFTC and NFA concluded that XFA failed in its duty to supervise its employees, and its obligations to keep accurate and complete records required under the CEA and NFA Compliance Rules.

XFA incurred fines of \$150,000 to the CFTC and \$100,000 to the NFA. In their respective decisions, both regulators noted that XFA had withdrawn as a FCM in 2016. The CFTC further noted that XFA's policies and procedures had been revised since the referenced failings. It is unclear from the public record what role, if any, XFA's remedial actions played in reducing XFA's monetary penalties.

TAKEAWAYS FOR OTHER FCMs:

FCMs would be prudent to review their own training and internal policies on allocation rules, and particularly post-execution allocation rules, in the wake of these orders.

Attorneys in Lawrence Kamin's Financial Services group routinely counsel clients on their obligations under CFTC and NFA rules as firms or individuals. [Learn more at www.lksu.com](http://www.lksu.com).

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