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COMMODITIES

WilmerHale Attorneys Detail 2016 CFTC Enforcement Actions and Potential Priorities Under Trump Administration

By Vincent Pitaro

Fund managers that trade futures, swaps and other derivatives may be subject to both CFTC and SEC supervision. A recent web briefing by regulatory and enforcement attorneys from WilmerHale provided a comprehensive review of significant enforcement and regulatory actions by the CFTC in 2016, considered pending CFTC legislation and regulation and offered insight into what CFTC operations and priorities may look like under the Trump administration. The briefing, entitled "CFTC 2016 Year-in-Review and a Look Forward," featured WilmerHale partners Paul M. Architzel, Dan M. Berkovitz and Anjan Sahni, along with special counsel Gail C. Bernstein. This article highlights the panelists' key insights.

For additional insight from WilmerHale attorneys, see "*FCPA Concerns for Private Fund Managers (Part One of Two)*" (May 28, 2015); "*FCPA Risks Applicable to Private Fund Managers (Part Two of Two)*" (Jun. 11, 2015); and "*Best Legal and Accounting Practices for Hedge Fund Valuation, Fees and Expenses*" (Jul. 18, 2013).

Notable 2016 Enforcement Efforts

Spoofing

Spoofing has been on the regulatory radar for a long time, said Berkovitz. Section 4c of the Commodities Exchange Act (CE Act) (7 U.S.C. § 6c(a)(5)(C)), added by the Dodd-Frank Act, defines spoofing as "bidding or offering with the intent to cancel the bid or offer before execution."

A trader engaged in spoofing usually places multiple orders on one side of the market to create the impression that there is interest in a particular contract. The trader then enters orders on the other side of the market and cancels the original orders.

Berkovitz outlined three notable spoofing actions in 2016:

- Igor Oystacher and 3Red Trading, LLC: The defendants were cited for spoofing and manipulation in violation of Section 6c and Regulation 180.1 under the CE Act. They must pay a $2.5 million penalty, are subject to independent trade monitoring for three years and must employ certain trading compliance tools for eighteen months. The U.S. District Court for the Northern District of Illinois (NDIL) rejected the defendants' constitutional challenge to the law; however, the NDIL also rejected the CFTC's request for an injunction to prevent the defendants from trading during the suit.
- Navinder Singh Sarao: Also in the NDIL, this November 2016 consent order concerned thousands of bids and offers over a five-year period by the defendant to buy or sell certain Standard & Poor's (S&P) futures contracts on which he did not intend to close. The CFTC cited numerous incriminating emails from Sarao acknowledging that he was engaged in spoofing. The CFTC said his trading was a contributing factor in the 2010 "flash crash" in E-mini S&P contracts. In a separate criminal action, he pleaded guilty to one criminal count of wire fraud and one of spoofing, resulting in a civil fine of $25.7 million and disgorgement of $12.9 million.
- Michael Coscia: In a 2013 settlement of the CFTC's civil charges, Coscia agreed to pay a $1.4 million penalty and a like amount in disgorgement. He was sentenced to three years in prison and two years of supervised probation for spoofing and commodities fraud. See "Rules Against 'Spoofing' and Other Disruptive Trading in Futures, Swaps and Options" (Nov. 6, 2014).

The actions against Sarao and Coscia illustrate how, because the intent element is similar, it is possible to have civil and criminal liability for spoofing. Coscia has appealed to the U.S. Court of Appeals for the Seventh Circuit, claiming the spoofing law is unconstitutionally vague.

Illegal Contracts

Section 742 of the Dodd-Frank Act prohibits the sale of any commodity on leverage or margin to a person that is not an eligible contract participant unless the commodity is actually delivered within 28 days, Berkovitz explained. The CFTC has typically enforced this prohibition against precious metals dealers who were speculating, rather than actually dealing, in metals.

Last year, the CFTC brought suit pursuant to Section 742 against BFXNA (Bitfinex), an online bitcoin and crypto-currency exchange. Bitcoin purchasers could get financing from other exchange participants, with the exchange holding the keys to the wallets containing the coins until payment in full was made. The CFTC claimed that there had not been "actual delivery" while the exchange held the keys to the coins, and Bitfinex agreed to pay a $75,000 civil penalty. After that settlement, the CFTC received a request for guidance on what constitutes "actual delivery" of bitcoins and blockchain transactions.

Recordkeeping and Supervision

The CFTC's recent actions make clear that any grace period during implementation of Dodd-Frank rulemaking is over, cautioned Berkovitz.

For example, last year the CFTC brought two major cases for violations of the Part 43 and Part 45 swap reporting rules. One action against Deutsche Bank – which also includes charges of failure to supervise – is pending in the U.S. District Court for the Southern District of New York (SDNY). The other proceeding involved Société Générale and settled for $450,000.

The CFTC also brought a failure to supervise action against a futures commission merchant for violating the risk management rules in Regulations 1.11 and 1.73.

Insider Trading and Manipulation

There are two main sets of rules that address insider trading and manipulation, said Sahni.

"New" Rules: Insider Trading

The first set includes CFTC Rule 180.1, which is patterned on SEC Rule 10b-5, and Section 6(c)(1) of the CE Act (7 U.S.C. §9(1)), which the CFTC intended use as a "broad catchall provision reaching fraud in all its forms." The CFTC has tried to apply Rule 180.1 in situations that did not involve fraud, arguing that Section 6(c)(1) refers to use of a "manipulative or deceptive device" in the disjunctive. The NDIL has rejected the CFTC position and ruled that Section 6(c)(1) and Rule 180.1 only reach "fraudulent manipulation" (i.e., deception, misrepresentation and other actual fraud).

These rules combined to give the CFTC authority, for the first time, to bring insider trading actions. See "*CFTC Resolves Its First Insider Trading Case*" (Jan. 7, 2016). In its action against Jon P. Ruggles, the CFTC alleged that he used material, non-public information about his trading in fuel futures and options on behalf of his employer, Delta Airlines, to trade for himself through his wife's account on at least 71 days in 2012. Ruggles executed personal trades against trades he placed for Delta, ensuring advantageous prices and eliminating market risk. He reached a settlement to pay a $1.75 million fine and to disgorge $3.5 million in illicit trading profits.

"Old" Rules: Anti-Manipulation

The "old" rules according to Sahni – CE Act Sections 6(c)(3) and 9(a)(2) and Rule 180.2 – make it unlawful to attempt to manipulate any swap or commodity. The traditional four-part test under those provisions considers whether:

1. the trader has the ability to influence prices;
2. the trader has specific intent to influence prices;
3. an artificial price existed; and
4. the trader's conduct actually caused the artificial price.

The CFTC action against Wilson & DRW Investments (DRW) in the SDNY is an aggressive attempt to expand its anti-manipulation authority under these "old" provisions, Sahni said. It alleged that DRW used fictitious bids – 2,900 over an eight-month period, none of which was hit with an offer – in an effort to manipulate the settlement price of interest rate futures contracts. DRW acknowledged trying to affect the market price but argued that its bids were meant to correct a fundamental mispricing in the market – not to create an "artificial" price.

Prior to the CFTC action, the NFA and other oversight bodies had concluded that DRW's conduct had not been manipulative. Nevertheless, the CFTC took the position that the mere intent to affect market price – rather than an intent to create an artificial price – violated these rules. The court rejected this position and held that the CFTC had to prove specific intent to create an artificial price – one that does not genuinely reflect "legitimate forces of supply and demand." The case went to bench-trial in December 2016, and a decision is pending in the matter.

Acceptance of the CFTC's position in DRW could have had serious implications for market participants, Sahni noted. Many legitimate trading practices are aimed at moving market prices; it can be difficult to distinguish between traders who are conscious of their impact on market prices and those who intentionally seek to affect prices. Thus, the court's decision is a significant safeguard against the potential unfair characterization of certain trading activities as "manipulative."

2016 Rulemaking

Electronic Records

The CFTC proposed the first significant changes to Regulation 1.31 since its adoption in 1999, concerning maintenance of electronic records. Currently, registrants must:

1. maintain any electronic records in "non-rewriteable, non-erasable" (also known as WORM, or "write once, read many") format;
2. keep those records in their "native" format; and
3. use a third-party consultant that can provide access to electronic files to the CFTC and DOJ.

See "*Further CFTC Harmonization of Rules for Hedge Funds: A Welcome and Continuing Trend*" (Sep. 18, 2014).

The CFTC proposes to eliminate those three requirements and give registrants more flexibility in storing electronic records, provided they ensure the "authenticity and reliability" of the records. This would enable firms to update and streamline their systems. It is not clear whether the SEC, which also requires storage in WORM format, will follow the CFTC's lead.

For coverage of actions by FINRA against twelve broker-dealers for failure to store records in WORM format, see "*Failure to Store Electronic Records in Proper Format May Result in Regulatory Enforcement Action*" (Jan. 12, 2017).

Automated Trading

The CFTC proposed Regulation Automated Trading (Regulation AT) in 2015, said Bernstein, to allow it to monitor trading and avoid market disruptions. Regulation AT accomplishes this by imposing risk controls on "AT Persons," which are defined as CFTC registrants and certain other market participants who engage in algorithmic trading.

In 2016, the CFTC proposed several revisions to proposed Regulation AT, including:

- revised pre-trade risk control requirements;
- a volume threshold test for "AT Persons";
- a broader definition of "direct electronic access" to a "designated contract market";
- an alternative compliance framework for firms that use third-party algorithmic trading systems; and
- a simplified annual certification process.

In the face of significant concerns about easy CFTC access to key proprietary information, the 2016 revision makes it more difficult for the CFTC to access source codes by requiring the agency to obtain a subpoena or a "special call" in advance. Further proposed revisions to Regulation AT are likely, she said. See our two-part series on managing automated trading strategies: "*Examining and Documenting Strategies*" (Jan. 7, 2016); and "*Monitoring and Reviewing Strategies*" (Jan. 14, 2016).

Cybersecurity

The CFTC adopted a final cybersecurity rule in 2016 to amend the "system safeguards" rules that apply to infrastructures subject to CFTC regulation, Bernstein explained. The NFA also issued cybersecurity rules for registrants that took effect in March 2016. See "*Practical Steps That Commodity-Focused Hedge Fund Managers Can Take to Combat Cybersecurity Threats*" (Mar. 10, 2016); and "*Hedge Fund Managers Face Imminent NFA Cybersecurity Deadline*" (Feb. 25, 2016).

The CFTC amendments are not prescriptive but specify five types of tests considered essential for a sound program. The amendments also set a minimum frequency for some tests and require some testing by independent contractors. The final rule has narrower requirements for testing and remediation, replacing strict liability with a "generally accepted best practices standard." However, it imposes broader recordkeeping obligations and broader risk analysis for exchanges.

Other Rulemaking

According to Bernstein, the CFTC undertook several other rulemaking initiatives described below during 2016.

- granted registration to more than 20 swap execution facilities (SEFs);
- adopted final margin requirements for uncleared swaps [See our two-part series on the CFTC's final swap rules: "*Increased Margin Requirements*" (Feb. 18, 2016); and "*Increased Trading Costs*" (Feb. 25, 2016).];
- proposed rules regarding cross-border application of certain swaps rules [See "CFTC Proposes Rule to Clarify Registration Obligations of Foreign CPOs and CTAs" (Sep. 1, 2016).];
- proposed minimum capital requirements for swap dealers and major swap participants;
- extended the swap dealer de minimis registration exemption to the end of 2018;
- extended mandatory clearing to additional types of interest rate swaps;
- issued a final rule on aggregation of futures and options positions on nine agricultural commodities; and
- re-proposed rules for limits on speculative positions.

What to Expect in 2017

CFTC Composition

"The past is not always prologue," surmised Architzel, based on his belief that the coming year will be quite different than 2016 for the CFTC. Whenever the CFTC has a quorum, it is required to hold a public meeting. However, because the CFTC now has only three commissioners, they have to hold a public meeting if two of them want to discuss something. Consequently, the commissioners are now communicating through their staffs, which is cumbersome and inefficient.

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President Trump will name a new Chair – Acting Chair J. Christopher Giancarlo is seen as the leading choice – and fill three vacancies on the CFTC. One current member may leave before replacements are chosen, which would leave only two members who would be forced to act unanimously. Historically, CFTC decisions have not been highly partisan, but that may change if only two commissioners remain.

Market Reforms

In a recent speech, Acting Chair Giancarlo cited five target areas for market reforms, signaling a significant shift in CFTC priorities:

- providing customer choice in trade execution;
- fixing swaps data reporting;
- achieving cross-border harmonization;
- encouraging financial technology (FinTech) innovation; and
- cultivating a regulatory culture of forward thinking.

The first three are "backward-looking," Architzel explained, and address changes brought about by the Dodd-Frank Act. Acting Chair Giancarlo is concerned about global fragmentation of liquidity and seeks to restore a global market for SEFs and swap trading.

The CFTC has traditionally been seen as being receptive to innovation, Architzel noted, but has become less so in recent years – something that Acting Chair Giancarlo wants to change. To this end, he has suggested that the CFTC emulate the U.K. Financial Conduct Authority's "sandbox" program, which allows firms to test ideas in the marketplace before pursuing the full authorization process. That program also provides for no-action relief and rule waivers for "concepts which do not fit within current regulatory requirements."

Although it is too early to know what the CFTC will actually propose, Architzel expects that it will become easier to get favorable no-action relief. He also expects greater receptiveness to FinTech firms, blockchain technology and other innovations.

CFTC Reauthorization

The CFTC is a "sunset" agency that must be reauthorized by Congress periodically, Architzel explained. Its reauthorization has been caught up in the political struggles over the Dodd-Frank Act.

The House passed a bill reauthorizing the agency in January 2017 but froze its budget at its current level for the next five years – well below its requested level. This budget freeze may discourage "needless" investigations but may also hinder the CFTC's ability to issue useful rulemaking and no-action relief.

The bill also contains provisions that would affect certain CFTC processes:

- CFTC rulemaking would be subject to a more quantitative cost-benefit analysis, making it more difficult and time-consuming.
- Division directors would serve at the pleasure of the full CFTC, rather than the Chair, which could slow CFTC action.
- No-action letters would have to remain with the commissioners for a specified time determined by the commission, giving the commissioners a greater voice.
- Subpoenas in sweeps would have to be renewed periodically.
- All binding guidance would have to be published for notice and comment.

The overall effect of these provisions would be to slow down rulemaking and require greater consensus from the whole commission, Architzel said. The original goal of the notice and comment provision was to constrain the CFTC under the Obama administration, Berkovitz added, but it may now constrain Trump's commission instead.

The House bill also addresses certain issues under the Dodd-Frank Act, Architzel said:

- It codifies the Southwest Airlines no-action letter by permitting a delay in reporting certain bilateral swaps in illiquid markets.
- It provides recordkeeping relief for certain unregistered members of SEFs.
- It sets the de minimis threshold for swap dealer registration at $8 billion.
- It amends the definition of "bona fide hedging" to include risk management transactions.
- Foreign branches and affiliates doing business with non-U.S. entities would be permitted to comply with "comparable" foreign regulations. It includes procedures for determining comparability and provides that if the CFTC does not act on comparability within 18 months, the top eight jurisdictions will be deemed comparable.

None of these likely amendments to the Dodd-Frank regime will affect its "core" requirements regarding clearing and trade execution. The bill also provides that "volumetric options will be considered to be forwards." This is notable, explained Architzel, because it is unusual for Congress to get into this level of detail regarding CFTC regulation.

The House bill is before the Senate, which has not acted on it.

Enforcement Priorities

New administrations typically have new regulatory priorities, Berkovitz said, but there has never been a shift of the "basic enforcement agenda." Even so, the CFTC may choose to emphasize some types of cases over others. In his view, regulatory changes are likely to be more significant.

The low likelihood of a shift in enforcement priorities is due to the fact that Vincent A. McGonagle had been named acting director of CFTC Division of Enforcement. McGonagle's long history in the division suggests that there will be continuity in enforcement efforts.

For more on CFTC priorities, see "*Regulators From the SEC, CFTC and New York Attorney General's Office Reveal Top Hedge Fund Enforcement Priorities (Part Two of Four)*" (Dec. 18, 2014).

As mentioned, Acting Chair Giancarlo desires to make the CFTC more innovative, Architzel said. In the past, market participants hesitated to contact the Division of Market Oversight (DMO) for fear that it could lead to an enforcement referral. Giancarlo has named his long-time legal counsel, Amir Zaidi, to head the DMO. This is likely to move the DMO away from being an "adjunct of the enforcement division" and return it to its roots of supporting innovation and promoting the market.

The panelists also addressed the potential impact of President Trump's recent order that for every new regulation an agency imposes, that agency must eliminate two others. Architzel pondered what effect it will have if the CFTC proposes a new regulation that "eases" the regulatory process. It is unclear whether this would count as a new regulation requiring the elimination of two others, he continued, or whether it would be considered an eliminated regulation.

With only two commissioners, the CFTC could also face a deadlock in complying with this requirement. Further, there is some ambiguity as to whether President Trump's order applies to independent regulatory agencies, concluded Berkovitz.