

# CFTC 2016 Year-in-Review and a Look Forward

February 2, 2017

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# Agenda

## ➤ **CFTC Enforcement Developments**

- Spoofing
- Illegal Retail Commodity/Cryptocurrency Contracts
- Recordkeeping/Failure to Supervise
- Manipulation
- Insider Trading

## ➤ **CFTC Regulatory Developments**

- Proposed Rule: Recordkeeping
- Proposed Rule: Reg AT
- Final Rules: Cybersecurity

## ➤ **Looking Forward: 2017**

- Acting Chairman Giancarlo's Agenda
- CFTC Reauthorization



# CFTC ENFORCEMENT DEVELOPMENTS



## CFTC Enforcement Developments

- Spoofing
- Illegal Retail Commodity/Cryptocurrency Contracts
- Recordkeeping/Failure to Supervise
- Manipulation
- Insider Trading



# Spoofing

- Section 4c of the CEA
  - It is unlawful for “any person to engage in any trading, practice or conduct on or subject to the rules of a registered entity that . . . is, of the character of, or is commonly known to the trade as, ‘spoofing’ (bidding or offering with the intent to cancel the bid or offer before execution).”
- CFTC 2013 Guidance
  - “[A] spoofing violation will not occur when the person’s intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade.”



## Spooing

- *CFTC v. Oystacher*, No. 15-cv-09196 (N.D. Ill. Dec. 20, 2016)
  - According to the consent order, the Defendants “intentionally and repeatedly” participated in a spoofing scheme that involved a series of futures contracts including E-Mini S&P 500, Copper, Crude Oil, Natural Gas, and VIX futures contracts on four exchanges.
  - Allegedly, the Defendants placed orders for futures that they did not intend to fill. This strategy permitted them to purchase or sell futures contracts that would not have been available to them without the spoofing misconduct.
  - Settlement required defendants to pay \$2.5 million penalty.





## Spooing

- *CFTC v. Sarao*, No. 15-cv-3398 (N.D. Ill. Nov. 14, 2016)
  - Defendant was charged with spoofing E-mini S&P 500 near month futures contract that trades on the CME.
  - Consent order finds that Defendants used the dynamic layering program for a cumulative time of over 4 hours and 25 minutes on the day of the Flash Crash. The program placed orders that were modified over 81,000 times that day, with only 81 lots resulting in execution.
  - Sarao also plead guilty in the U.S. District Court for the Northern District of Illinois to one count of spoofing and one count of wire fraud in a related criminal action.
  - Consent order requires Sarao to pay a civil penalty of \$25.74 million and disgorgement of \$12.87 million.



## Spooing

- *US v. Coscia*, No. 16-3017 (U.S. Court of Appeals for the 7<sup>th</sup> Circuit)
  - In July, Defendant was sentenced to three years in prison and two years of supervised release for spoofing and commodities fraud.
  - In 2013, Coscia and his trading firm had entered into a settlement order with CFTC, providing for a \$1.4 million civil penalty and the disgorgement of \$1.4 million in profits for spoofing violations.
  - Appeal, including statutory challenge, is pending.



## Illegal Off-Exchange Contracts

- *In re BFXNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016)
  - Bitfinex operated an online platform for exchanging and trading cryptocurrencies, mainly bitcoins. Bitfinex did not “actually deliver” purchased bitcoins, instead holding them in bitcoin deposit wallets that it owned and controlled.
  - CFTC ordered Bitfinex to pay a \$75,000 penalty for engaging in illegal off-exchange commodity transactions and for failing to register as a FCM.
- Petition for rulemaking submitted to CFTC to clarify meaning of “actual delivery” in context of cryptocurrency.

## Recordkeeping/Failure to Supervise

- In 2016, CFTC brought two actions – one in federal court, and one administrative settlement – for failure to timely and accurately report swap transactions.
- CFTC continued to bring actions for failures to supervise
  - Swap reporting (Parts 43 and 45)
  - Exchange fee rebates
  - FCM risk management practices (Regs. 1.11 and 1.73)



## Anti-Manipulation

- **CFTC Regulation 180.1.** Prohibition on the employment, or attempted employment, of manipulative and deceptive devices.
  - (a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:
    - (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud . . .
- Regulation 180.1 is patterned after SEC Rule 10b-5.
  - CFTC “will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of [Exchange Act] Rule 10b-5.”



# Anti-Manipulation

- **CFTC Regulation 180.2.** Prohibition on price manipulation.

It shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.

- CFTC “will be guided by the traditional four-part test for manipulation that has developed in case law arising under 6(c) and 9(a)(2).”
  1. The ability to influence market prices;
  2. Specific intent to influence market prices;
  3. That artificial prices existed; and
  4. Caused the artificial price.



## Anti-Manipulation

- *CFTC v. Wilson & DRW Investments*, No. 13-cv-7884 (S.D.N.Y. Sept. 30, 2016)
- Debate about the first element in attempted manipulation:
  - Test For Attempted Manipulation
    - An intent to [affect the market price]/[create an artificial price];
    - some overt act in furtherance of that intent.
  - “[T]he CFTC asks this Court to adopt a new legal standard for intent in attempted manipulation cases that departs in a significant respect from decades of settled law. **The CFTC argues it need only prove ‘an intent to affect price’ and not that the price was intended to be artificial.**”
    - CME, CMC, FIA, ICE and MFA Amici Curiae
  - “Under any standard, **trading with the specific intent to unilaterally affect and define prices . . . is manipulative intent.**”
    - CFTC Response in Opposition to Brief of Amici Curiae



# Anti-Manipulation

- On September 30, 2016, Judge Analisa Torres of the S.D.N.Y. issued an order resolving competing motions for summary judgment for DRW. The order provides important guidance regarding the requisite intent to establish a manipulation or attempted manipulation claim under the CEA.
- Ultimately, the court agreed with DRW and the *amici*, stating plainly that:
  - *“CFTC’s interpretation is incorrect. The CFTC must prove that Defendants had the specific intent to affect market prices that “did not reflect the legitimate forces of supply and demand.” This means, that there is “no manipulation without intent to cause artificial prices.”*
  - In a footnote, the court further asserted that the CFTC *“base[d] its position on shorthand language suggesting that the intent standard is merely the intent to affect prices. But it is well settled that the intent to create an artificial price is the correct standard.”*
- This decision is a setback for the CFTC, which has been aggressively pushing to expand its anti-manipulation authority. While the distinction between the intent to “affect market prices” and the intent to “create an artificial price” may not have much practical effect in the most egregious cases, it may make it more difficult to establish manipulation claims in more complicated matters.





## Insider Trading

- *In re Jon P. Ruggles*, CFTC Docket No. 16-34 (Sept. 29, 2016)
  - Ruggles was responsible for developing his employer's fuel-hedging strategies and for executing futures and options trades on NYMEX.
  - In violation of his duties to his employer, Ruggles traded in the same NYMEX products in personal accounts in his wife's name, which he controlled.
  - CFTC ordered Ruggles to pay a \$1.75 million penalty and to disgorge more than \$3.5 million in ill-gotten profits, and banned him from trading and registration.



# CFTC REGULATORY DEVELOPMENTS



## CFTC Regulatory Developments

- Proposed Rule: Recordkeeping
- Proposed Rule: Regulation AT
- Final Rules: Cybersecurity



## Proposed Rule: Recordkeeping

- On Jan. 12, 2017, the CFTC unanimously proposed to amend Rule 1.31 (Books and Records, Keeping and Inspection).
  - Recordkeeping, 82 Fed. Reg. 6356 (Jan. 19, 2017)
- The proposed amendments are the most significant changes since the electronic recordkeeping provisions were added in 1999.
- Rule 1.31 applies to:
  - All registered entities (DCMs, SEFs, SDRs, DCOs)
  - Registrants (FCMs, SDs, IBs, RFEDs, FBs, FTs, CPOs, CTAs)



## Proposed Rule: Recordkeeping

- As currently in force, Rule 1.31:
  - Specifies certain acceptable technologies for the storage of electronic records in a “non-rewriteable, non-erasable” format—i.e., “WORM” format.
  - Requires that electronic records be kept in their “native format.”
  - Requires each electronic recordkeeper to use a third-party technical consultant to be able to locate and provide access to CFTC and DOJ representatives upon request.



## Proposed Rule: Recordkeeping

- Proposed amendments to Rule 1.31 would:
  - Eliminate the “WORM” requirement in favor of a general performance standard.
  - Would require recordkeepers to maintain electronic records in a manner that ensures “authenticity and reliability,” including security, signature, chain of custody and data necessary to ensure the authenticity of the information in the electronic record.
  - Eliminate the “native file format” requirement.
  - Eliminate the requirement for third-party technical consultant.
- The proposed amendments may have a significant effect on the cost and ease of compliance with CFTC recordkeeping requirements.



## Proposed Rule: Regulation AT

- On Nov. 3, 2016, the CFTC proposed revisions to proposed Regulation Automated Trading (Reg AT).
  - Reg AT, 81 Fed. Reg. 85334 (Nov. 25, 2016)
  - Reg AT, 80 Fed. Reg. 78824 (Dec. 17, 2015)
- If adopted, Reg AT would impose risk controls and other requirements on:
  - AT Persons
    - CFTC registrants engaged in “Algorithmic Trading” and
    - Proprietary traders who have direct access to DCMs and are engaged in Algorithmic Trading
  - Clearing member FCMs whose customers are AT Persons
  - DCMs executing orders from AT Persons



## Proposed Rule: Regulation AT

- The Supplemental Proposal includes six significant changes to the proposed regulatory framework for automated trading:
  1. Revised pre-trade risk control requirements;
  2. Minimum volume threshold for an “AT Person”;
  3. Broader definition of “Direct Electronic Access”;
  4. Clarification regarding the retention of source code;
  5. Alternative compliance pathway via certification for parties using third-party algorithmic trading systems;
  6. Elimination of the annual reporting requirements for AT Persons and clearing member FCMs and review requirements for DCMs in favor of an annual certification process.





## Proposed Rule: Regulation AT

- The provisions relating to Commission access to algorithmic source code, even as modified, remain quite controversial.
  - Commissioner Giancarlo, now Acting Chairman, strongly opposed the revised provision and has expressed serious concerns regarding due process, confidentiality, and security of such commercially-sensitive data.
- The CFTC extended the comment period from Jan. 24, 2017 to May 1, 2017.
- It is highly likely that Reg AT will be further revised before final consideration by the Commission.



## Final Rules: Cybersecurity

- In September 2016, the CFTC adopted amendments to its system safeguards rules for DCMs, SEFs, SDRs, and DCOs.
  - System Safeguards Testing Requirements, 81 Fed. Reg. 64272 (Sept. 19, 2016); System Safeguards Testing Requirements for DCOs, 81 Fed. Reg. 64322 (Sept. 19, 2016)



# Final Rules: Cybersecurity

- Final vs. proposed rules
  - Narrower scope of testing and assessment requirement
    - Strict liability replaced with reasonable standard-generally accepted best practices; no safe harbors
  - Expanded categories of risk analysis and oversight for exchanges
    - Adds enterprise risk management for exchanges
  - Broader books and records obligations
    - Includes parent company where the oversight program of parent is shared with a registered entity
  - Narrower scope of requirement to remediate vulnerabilities and deficiencies
    - Substitutes reasonable standard
  - Unlike exchanges and SDRs, no reduced requirements for DCOs



# LOOKING FORWARD: 2017



## Looking Forward: 2017

- Currently only three CFTC commissioners.
  - Sunshine Act requirements – with only three commissioners, any two constitute a meeting quorum.
  - Apparent difficulty reaching unanimity on final rulemakings. Two recent votes have been split decisions – but not the same commissioner dissenting.
- President Trump will have the opportunity to fill the chair's position and three Commission vacancies.
- Commissioner Giancarlo, who was chosen to serve as Acting Chairman, has been reported as a leading choice for Chairman.

## Acting Chairman Giancarlo's Agenda

- On January 18, 2017, Acting Chairman Giancarlo delivered a speech outlining his “Making Market Reform Work for America” agenda, in which he outlined 5 key elements of that plan:
  1. Providing Customer Choice in Trade Execution
  2. Fixing Swaps Data Reporting
  3. Achieving Cross-Border Harmonization
  4. Encouraging FinTech Innovation
  5. Cultivating a Regulatory Culture of Forward Thinking
- Acting Chairman Giancarlo's comments presage a significant shift in the priorities and goals of the Commission during the Trump Administration.



## CFTC Reauthorization

- On January 12, 2017, the House passed the Commodity End-User Relief Act (H.R. 238), a bill reauthorizing the CFTC.
  - Freezes the Commission's budget at its current level, \$250 million, from FY2017 to FY2021.
  - Substantially similar to the CFTC reauthorization legislation passed in the last congressional session.
- Contains a number of provisions aimed at CFTC processes
- It is likely that a final reauthorization bill will roll back a number of Dodd-Frank Act provisions, however, a full reversal of the core provisions of the Act appears to be unlikely.



# Questions?

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