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U.S. CFTC Enforcement: Key Compliance Takeaways from 2016

At a Glance:

In 2016, the U.S. Commodity Futures Trading Commission brought several significant enforcement actions involving computerized robo-advisors, recordkeeping and reporting requirements, insider trading, spoofing, market manipulation, and employee liability. Many of these cases included novel theories and new interpretations of existing laws and regulations. This client briefing looks back on the Commission's 2016 enforcement agenda, and highlights key compliance takeaways for market participants going into the new year. In light of these trends, it is important that market participants review their compliance programs and understand the facts and circumstances that the Commission may consider in assessing penalties.

Introduction:

In fiscal year 2016, the U.S. Commodity Futures Trading Commission ("**CFTC**") issued more than $1.2 billion in fines for violations of the Commodity Exchange Act, as amended ("**CEA**"), and CFTC regulations.[1] Although this is slightly less than the total fines issued over the last fiscal year, the CFTC's Division of Enforcement brought several unique cases this year, opening the door to a vast terrain of diverse enforcement territory in 2017. Even though these cases stem from traditional CFTC enforcement authority, many include novel theories or new interpretations of the law, involving computerized robo-advisors, suitability, employee liability, insider trading, and violations of new reporting requirements. Additionally, the National Futures Association ("**NFA**") collected roughly $700,000 in fines in fiscal year 2016 for violations of its regulatory requirements. This client

briefing looks back on the enforcement agenda of the CFTC and highlights key compliance takeaways from 2016. A Reed Smith analysis of enforcement actions brought by the UK Financial Conduct Authority in 2016 is available here.

I. Misappropriation of Insider Information

Until December 2015, commodities traders were unlikely to risk an enforcement action from the CFTC when trading commodities based on material nonpublic information.[2] But that changed with the CFTC's investigation of Arya Motazedi for trading in personal accounts using information obtained from his employer. Motazedi was ordered to pay a $100,000 fine and restitution to his employer, and he received a permanent ban from the industry.[3] In September 2016, the Division of Enforcement brought its second enforcement action for insider trading, this time against Jon Ruggles, who similarly breached a duty of confidence to his employer by trading in a personal account in his wife's name using information about the energy markets obtained in the course and scope of his employment.[4] The CFTC ordered Ruggles to pay a $3.5 million civil monetary penalty and $1.75 million in disgorgement.

Material nonpublic information obtained from an employer is the property of the employer, who has the right to exclusive use of that information. Employees have a relationship of trust and confidence with their employer and therefore owe a duty to their employer to act in its best interests, keep such information confidential, and not misappropriate such information – in other words, a violation of the CFTC's insider trading rules is similar to a violation of the SEC's insider trading prohibition based on a misappropriation theory. Companies that trade commodities should implement an insider trading risk management policy that restricts and/or monitors employees' personal commodities trading to prevent the unauthorized use of nonpublic company information. Additionally, they should consider implementing a cybersecurity program to guard against the theft of proprietary information.

On December 6, 2016, the Supreme Court, in a unanimous opinion, provided long-awaited additional guidance with respect to insider trading cases in its ruling in *Salman v. United States*.[5] Adhering to its 1983 decision in *Dirks v. SEC*[6], the court held that a tippee is liable for trading on inside information when the tipper "personally will benefit directly, or indirectly, from his disclosure." The Supreme Court in *Salman* agreed with the Ninth Circuit's interpretation of *Dirks*, holding that the tipper "personally benefitted from making a gift of confidential information to a trading relative." In such a situation, the Court found a tipper benefits personally because his gift of trading information to a relative or friend is equivalent to if he traded on the information himself and gifted the proceeds. This ruling will likely serve to increase federal insider trading prosecutions (including those brought by the CFTC), specifically where the insider has not received a tangible monetary or

pecuniary benefit as a *quid pro quo* for sharing inside information with a friend or relative.

II. Reporting Violations

The CFTC continues to prioritize the enforcement of reporting violations. In fiscal year 2016, the CFTC issued more than double the number of enforcement orders for reporting violations than in the previous fiscal year.[7] A number of these violations involved new reporting requirements under Dodd-Frank.

First, the CFTC is increasingly bringing enforcement actions for violating the large trader reporting requirements for physical commodity swap positions. Following its first two such enforcement actions in 2015, this year the Division of Enforcement fined two large banks $560,000 and $400,000, respectively, for violating the Swaps Large Trader Reporting Rule.[8]

Second, the Division of Enforcement brought a novel enforcement action against a non-U.S. swap dealer for multiple swap reporting violations, related supervision failures, and violation of a prior CFTC order issued also in connection with reporting violations.[9] This swap dealer's swap data reporting system experienced a systems outage that interfered with its swap data reporting for five days. According to the CFTC, it investigated the matter and discovered a pattern of reporting problems that began prior to the systems outage involving the integrity of certain data fields, including erroneous reporting of legal entity identifiers ("**LEI**"). The CFTC argued that the reporting problems resulted from this entity's failure to implement an adequate Business Continuity and Disaster Recovery Plan, and other supervisory systems.

Third, the Division of Enforcement issued a $450,000 fine against another non-U.S. swap dealer in December 2016 for allegedly failing to timely or properly report certain non-deliverable forwards, FX swaps, and FX forwards to a swap data repository ("**SDR**").[10] In that case, the swap dealer maintained that a software update to its FX trading platform caused the platform to incorrectly code this swap dealer as the reporting counterparty for certain transactions. As a result, neither the swap dealer nor its counterparty reported the swaps. This entity subsequently reported a number of the transactions several months later. The Division of Enforcement acknowledged this swap dealer's remedial efforts. Although the CFTC continues to work out technical issues involving the reporting of swap data to SDRs, it is critical that parties to swaps ensure that all required data is reported. When engaging in both domestic and cross-border transactions, it is important that the parties to the swap determine which party has the reporting obligations and report the swap data in the proper form and manner.

Finally, market participants must be cognizant of reporting requirements associated with their positions in futures and options. This year, the Division of

Enforcement fined several U.S. and non-U.S. commodity traders more than $1.5 million for failing to submit accurate monthly Form 204 Reports regarding the composition of their fixed-price cash commodity purchases and sales. Similarly, the CFTC fined two other non-U.S. commodity traders more than $630,000 for failing to file Form 304 Reports regarding cotton call purchases and sales.[12]

III. Recordkeeping

The Division of Enforcement sanctioned a handful of market participants in 2016 for failing to maintain books and records in the proper form and manner pursuant to the CEA and the CFTC's regulations. In September, the CFTC fined a non-U.S. bank $500,000 for failing to create, maintain, and promptly produce required confirmations for Exchange for Related Position transactions.[13] That same month, the CFTC filed a complaint against another entity for, among other things, failing to keep and produce for inspection the trading instructions it electronically received for customers who subscribed to third-party trading systems.[14]

Market participants must generate and keep records in accordance with the CEA and the CFTC's regulations, and should respond promptly to CFTC requests for the production of such records. Recordkeeping systems should routinely be tested to ensure that records are being generated and stored in the correct format. Furthermore, in the event information previously provided is no longer accurate, the filer must file an amended report in order to keep reportable information current and accurate.

IV. Futures Commission Merchant Risk Management

This year marked the first time the CFTC brought an enforcement action involving Rules 1.11 (Risk Management Program for FCMs) and 1.73 (Clearing FCM Risk Management). The agency imposed a $1.5 million fine jointly against a U.S. futures commission merchant ("**FCM**"); its CEO; and its former CCO for alleged supervision and risk management failures, and for making inaccurate statements to the CFTC.[15] According to the CFTC, the FCM did not promptly or thoroughly investigate the customer's trading after being notified that the customer was engaging in manipulative trading practices. The CFTC also found that, although the FCM had written risk management policies and procedures pursuant to CFTC Rule 1.11, it failed to follow them, including those pertaining to customer pre-trade limits. The CFTC found the CCO to be responsible for the company's failure to follow the policies.

V. Commodity Trading Advisor Fraud

The CFTC broadly construes the concept of commodity-trading advising to now encompass computerized robo-advisor trading software platforms. In 2016, the agency brought several enforcement actions against companies offering computerized trading software that assists traders in their decision-making. The

CFTC filed a complaint against a company operating an online trading platform (and its owner), alleging the fraudulent solicitation of customers to use software that guided customers in their commodity trading decisions by instructing them when to buy or sell, what products to buy or sell, and at what price.[16] The CFTC also filed a complaint against another company and its owners for fraudulently marketing a commodity futures trading software platform.[17] The complaint alleges that the defendants failed to comply with the CFTC's requirements pertaining to Commodity Trading Advisors ("**CTAs**"), and made material misrepresentations when marketing the software.

Firms that offer automated trading software or in any form provide advice in connection with commodity trading should consider registering as CTAs, and must follow the CFTC's regulations for such registrants, including the requirement to distribute a hypothetical disclaimer to potential customers. Similar authorities exist for introducing brokers under the CFTC's and NFA's regulations, and the CFTC has been increasingly taking a broad look at activities that may qualify as introductory brokerage services in connection with trading in commodity interests.

VI. Protection of Customer Funds

The protection of customer funds held by commodity pools and FCMs remains a critical objective of the CFTC. This past year, the agency brought numerous cases against market participants for failing to segregate or protect customer funds pursuant to the CFTC's regulations. In December, the CFTC obtained a $21.8 million default judgment against two investment funds and their owner for fraudulently soliciting pool participants and misappropriating their funds.[18] In another case, a federal court in North Carolina ordered an investment fund and its owner to pay more than $15 million in fines for misappropriating and comingling commodity pool participants' funds.[19]

VII. Disruptive Trading Practices

The CFTC continues to test the waters regarding its new anti-disruptive trading practices authority in a handful of high-profile enforcement matters. In 2016, the CFTC resolved three federal district court lawsuits involving "spoofing," a practice whereby a trader places large orders without an intention to fill them for the purpose of moving prices in a favorable direction to the trader. These enforcement actions provide valuable guidance on the outer boundaries of permissible behavior.

In October 2015, the agency filed a civil complaint in federal district court charging a proprietary trading firm and its owner with spoofing and employing a manipulative and deceptive device while trading crude oil and natural gas futures on four different exchanges.[20] The Division of Enforcement alleged that the scheme "created the appearance of false market depth that [the company

and its owner] exploited to benefit their own interests, while harming other market participants." On December 21, 2016, the individual defendant, without admitting or denying wrongdoing, agreed to pay $2.5 million to settle the claims. He also consented to having his trading monitored by an independent party for three years.

In April 2016, the CFTC issued a Consent Order imposing a permanent injunction against two individual traders, prohibiting them from engaging in spoofing in violation of the CEA. The Order arose out of a CFTC complaint filed in May 2015, alleging that defendants engaged in unlawful spoofing in the gold and silver futures markets by placing bids and offers on the Commodity Exchange, with the intent to cancel them before execution. The Consent Order requires the defendants to pay $1.38 million and $1.31 million civil monetary penalties.

In November 2016, a federal district court in Chicago entered a Consent Order against a London trader, ordering him to pay a whopping $25,743,174.52 in civil monetary penalties and $12,871,587.26 in disgorgement.[22] The settlement arises out of an enforcement action against the trader and his company, charging them with unlawfully manipulating, attempting to manipulate, spoofing, and using a manipulative device with regard to the E-mini S&P 500 near month futures contract. In the Consent Order, the defendant admits to the CFTC's allegations that he placed tens of thousands of bids and offers that he intended to cancel before execution.

VIII. Market Manipulation

The CFTC brought several enforcement actions for manipulation and attempted manipulation in 2016. The scope of the CFTC's anti-manipulation authority continues to be tested in federal court. Notably, on October 4, 2016, a federal court in Manhattan ruled that the CFTC must show that a trader intended to create an "artificial" price in order to prove attempted market manipulation.[23] The Division of Enforcement sued an investment firm and its chief executive in November 2013, charging the defendants with "banging the close" (i.e., illegally placing buy or sell orders toward the end of the trading day in an effort to impact the daily closing price and gain a benefit in a related market). The defendants argued that the trading was an attempt to correct mispricing in an interest rate contract, and that the trading "moved market prices towards, rather than away from, their intrinsic values." The judge's ruling in this case increases the CFTC's burden and may help future defendants facing similar charges.

The CFTC also fined two large banks a total of $545 million for attempted manipulation and false reporting relating to interest rate benchmarks. On May 25, 2016, the agency settled charges with one of the banks for attempted manipulation and false reporting in connection with LIBOR, TIBOR, and ISDAFIX benchmarks.[24] With respect to LIBOR and TIBOR, the CFTC charged the bank

with false reporting to benefit derivatives trading positions priced based on the two benchmarks. The agency also alleged that traders attempted to manipulate the benchmarks by contacting other panel banks to adjust their submissions to benefit the bank's trading positions. With respect to ISDAFIX, the CFTC alleged that the bank "submitted a rate or spread higher or lower than the reference rates and spreads disseminated to the panel banks on certain days that the bank had a derivatives position settling or resettling against the USD ISDAFIX benchmark. . . ." The CFTC fined the bank $425 million for the alleged violations.

On December 21, 2016, in its third enforcement action relating to the ISDAFIX interest rate benchmark, the Division of Enforcement settled charges against a large investment bank in connection with the alleged attempt of the bank's New York traders to manipulate the benchmark and make false reports.[25] The CFTC alleged that the bank heavily traded swaps at 11:00 a.m. when the broker sent a snapshot to the panel banks charged with submitting rate quotes. The CFTC maintained that the bank intentionally pushed the benchmark higher or lower to benefit the positions of its interest rate products trading group. The bank agreed to pay a $120 million civil monetary penalty and implement remedial steps to improve its internal controls.

IX. Conclusion

The CFTC's enforcement agenda in 2016 highlights a number of significant topics and trends that market participants should note, as follows:

First, the CFTC has demonstrated a new concern about insider trading and the misappropriation of material nonpublic information, issuing significant penalties in its second such enforcement action this year.

Second, the CFTC brought its first enforcement action involving risk management for FCMs and their CCOs. Market participants must be cognizant that the CFTC is actively enforcing failure to investigate and failure to follow written procedures, even where such procedures are in compliance with the CFTC's rules. It is essential that FCMS have clear written risk management policies and procedures in place, and that CCOs ensure all personnel follow these policies.

Third, reporting remains low-hanging fruit for enforcement. In addition to Series '04 and Large Trading Reporting violations, the CFTC has begun to bring actions pursuant to new Dodd-Frank reporting requirements. As such, reporting parties should determine their reporting obligations prior to engaging in futures or swaps transactions, and ensure that all reports are timely, complete, and accurate. As highlighted in a significant enforcement matter last year, reporting parties should take care to ensure the accuracy of LEIs in their reports to SDRs, including in the cross-border context where privacy laws and other considerations may come into play. Care should be taken to ensure that each LEI is not lapsed, retired, or cancelled. LEI renewals may be enforced in the future.

Fourth, with respect to the CFTC's treatment of new technology, vendors that develop and market commodity trading software should be aware that commodity trading software platforms may be treated by the CFTC as commodity trading advisors.

Fifth, the CFTC continues to investigate market participants for engaging in spoofing. Automated trading systems should not be designed to enter orders without the intent to execute them, and must be carefully monitored.

Finally, the Southern District of New York made it much more difficult for the CFTC to prosecute market manipulation, mandating that the agency show a defendant's intent to create an artificial price. The question remains whether other jurisdictions will follow suit.

Given the CFTC's aggressive pursuit of a wide variety of enforcement violations in 2016, clients should be sure to contact Reed Smith as soon as possible if they discover a compliance shortcoming within their company, receive a subpoena or inquiry from the CFTC, or learn of allegations that may lead to an investigation.

See CFTC Releases Annual Enforcement Results for Fiscal Year 2016, Nov. 21, 2016, available at http://www.cftc.gov/PressRoom/PressReleases/pr7488-16.

The CEA included provisions applicable to government employees, as well as exchange employees trading on material non-public information. Under the Dodd-Frank Act of 2010, the CFTC promulgated section 180.1, which contains provisions similar to SEC's 10-b(5) authority, provided, however, it still clarifies that a commodity trader does not have an affirmative duty to disclose material non-public information that has been legitimately obtained.

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1. *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2016, Nov. 21, 2016, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7488-16.
2. The CEA included provisions applicable to government employees, as well as exchange employees trading on material non-public information. Under the Dodd-Frank Act of 2010, the CFTC promulgated section 180.1, which contains provisions similar to SEC's 10-b(5) authority, provided, however, it still clarifies that a commodity trader does not have an affirmative duty to disclose material non-public information that has been legitimately obtained.
3. *See In the Matter of Arya Motazedi*, Comm. Fut. L. Rep. (CCH) ¶33,599, (Dec. 2, 2015).
4. *See In the Matter of Jon P. Ruggles*, Comm. Fut. L. Rep. (CCH) ¶33,872, (Sep. 29, 2016).
5. No. 15-628 (U.S. Dec. 6, 2016)
6. *Dirks v. SEC*, 463 U.S. 646 (1983)
7. In fiscal year 2016, the CFTC issued nine enforcement orders for reporting violations, compared with four the previous fiscal year.
8. *See In the Matter of Barclays Bank PLC*, Comm. Fut. L. Rep. (CCH) ¶33,791, (Jul. 6, 2016); *In the Matter of Wells Fargo Bank, N.A.,* Comm. Fut. L. Rep. (CCH), ¶33,869, (Sep. 27, 2016).
9. *In the Matter of Deutsche Bank AG*, Comm. Fut. L. Rep. (CCH) ¶33,452, (Apr. 23, 2015)
10. *In the Matter of Société Générale SA*, CFTC Docket No. 17-01 (Dec. 7, 2016).

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11. *See In the Matter of CHS, Inc*., Comm. Fut. L. Rep. (CCH) ¶33,681, (Mar. 9, 2016); *In the Matter of Golden Agri International Pte Ltd*., Comm. Fut. L. Rep. (CCH) ¶33,794, (Jul. 11, 2016); *In the Matter of Alfred C. Toepfer International, Inc*., Comm. Fut. L. Rep. (CCH) ¶33,563, (Sept. 30, 2015).
12. *See In the Matter of Agrocorp International Pte Ltd*., Comm. Fut. L. Rep. (CCH) ¶33,804, (Jul. 11, 2016); *In the Matter of Libero Commodities, SA*, Comm. Fut. L. Rep. (CCH) ¶33,464, (May 11, 2015).
13. *See In the Matter of Barclays Bank PLC*, Comm. Fut. L. Rep. (CCH) ¶33,864, (Sept. 22, 2016).
14. *See CFTC v. eFloorTrade, LLC and John A. Moore*, Docket No. 16-cv-7544 (S.D.N.Y. 2016).
15. *See In The Matter of Advantage Futures, LLC*, Comm. Fut. L. Rep. (CCH) ¶33,862, (Sept. 21, 2016).
16. *See CFTC v. Jody Dupont and Open Range Trading LLC*, Civil Action No 8:16-cv-03258-TMC (D.S.C. 2016).
17. *See CFTC v. United Business Servicing LLC, et al*., Case No. 2:16-cv-07358 (C.D. Cal. 2016).
18. *See CFTC v. Alvin Guy Wilkerson, et al*., Civil Action No. 1:16-cv-6734 (N.D. Ill. 2016).
19. *See CFTC v. James A. Shepherd, et al*., Case No. 3:13-cv-00370 (W.D.N.C. 2013).
20. *See CFTC v. Oystacher*, Civil Action No. 1:15-cv-09196, (N.D. Ill. 2015).
21. *See CFTC v. Heet Khara and Nasim Salim*, Case No. 1:15-cv-03497 (S.D.N.Y. 2015).
22. *See CFTC v. Nav Sarao Futures Limited PLC, et al*., Case No. 1:15-cv-3398 (N.D. Ill. 2015).
23. *See CFTC v. Donald R. Wilson, et al*., Civil Action No. 13-cv-7884 (S.D.N.Y. 2013).
24. *See In The Matter of Citibank N.A*., CFTC Docket No. 16-16 (May 25, 2016); *In the Matter of Citibank, N.A., et al*., CFTC Docket No. 16-17(May 25, 2016).
25. *See In The Matter of The Goldman Sachs Group, et al*., CFTC Docket No. 17-03 (Dec. 21, 2016)