

Derivatives Enforcement Outlook: 2016

February 4, 2016

Futures and Derivatives

Last year, the Commodity Futures Trading Commission (CFTC) notched a record \$3.144 billion in penalties, making frequent use of its new powers under the Dodd-Frank Act, often for the first time. We anticipate that the CFTC—along with other derivatives regulators and criminal authorities—will continue in the same vein this year, with a likely focus on insider trading, spoofing, reporting violations, and external business conduct violations. In this alert, we review the key derivatives enforcement activity from 2015, to provide insight into how the CFTC will interpret and apply its expanded enforcement authority in the year ahead. Firms would be well advised to review the adequacy of their compliance programs and systems in these priority areas, to minimize the risk of enforcement action against themselves and their employees.

Insider Trading

Although historically the CFTC did not pursue insider trading cases, it announced in 2011 that its new general antifraud regulation would impose insider trading liability for trading “on the basis of material nonpublic information in breach of a pre-existing duty” or “on the basis of material nonpublic information that was obtained through fraud or deception.”¹ In December 2015, the CFTC brought its first-ever insider trading case. The CFTC alleged that a natural gas trader used nonpublic information about his employer’s trading practices to enter into profitable futures trades opposite the company’s transactions and to trade ahead of the company. In a settlement, the CFTC found that the trader breached a duty he owed to his employer and engaged in unlawful insider trading, and ordered the trader to pay restitution of nearly \$217,000 and a penalty of \$100,000.² While small by recent CFTC standards, we think this action is a harbinger of bigger CFTC insider trading cases to come.

Spoofing

Spoofing—“bidding or offering with the intent to cancel the bid or offer before execution”³—is intended to overload the quotation system of an exchange or trading platform, to delay another’s execution of trades, or to create an appearance of false market depth. The CFTC brought its first spoofing enforcement action in 2013,⁴ and has continued to be very active in this area.

¹ Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,403 (July 14, 2011).

² *In re Motazedj*, CFTC Docket No. 16-02 (Dec. 2, 2015).

³ CEA § 4c(a)(5)(C); 7 U.S.C. § 6c(a)(5)(C).

⁴ *In re Panther Energy Trading LLC*, CFTC Docket No. 13-26 (July 13, 2013).

Adding to the CFTC's efforts, in 2015 the Department of Justice claimed a major victory by securing a conviction in the first-ever criminal case brought under the Dodd-Frank Act's anti-spoofing provisions. The government accused Michael Coscia, owner of Panther Energy Trading, of earning over \$1.5 million from a high-frequency trading strategy in which he entered a large volume of orders that he intended to cancel before they could be filled.⁵ Coscia allegedly implemented the strategy to create a false impression of depth in the market, and to induce other market participants to trade based on that false impression. At trial, Coscia argued that his actions simply represented a clever trading strategy rather than fraud or deceptive manipulation.⁶ After only an hour of deliberations, the jury convicted Coscia on all counts.⁷ This verdict will likely embolden the government to bring other criminal spoofing cases. This prospect significantly raises the stakes for market participants, since spoofing convictions can result in prison sentences of up to 10 years and fines of up to \$1 million.⁸

Futures exchanges, too, have been active in implementing and enforcing their own anti-spoofing rules. In October 2015, CME Group Inc. fined a trader of soybean futures \$20,000 and suspended him from trading on any CME platform for 20 days based on charges that he created the appearance of a market imbalance by placing small orders, subsequently placing multiple larger-sized opposing orders, and canceling the large orders once the small order began trading.⁹ Also in October, CME fined a metals futures trader \$100,000 for alleged spoofing and permanently banned him from trading on any CME exchange.¹⁰

Reporting Violations

Reporting violations—a traditional CFTC focus—continued to be a priority in 2015. For example, the CFTC fined Deutsche Bank AG \$2.5 million for allegedly failing to properly report cancellations of swap transactions and to promptly report the errors once it discovered them. Deutsche Bank was also ordered to strengthen its internal controls and to report its progress towards compliance to the CFTC every six months.¹¹ The CFTC also imposed a \$3 million civil money penalty on ICE Futures U.S., Inc., a designated contract market that allegedly reported data to the CFTC that “contained thousands of errors and omissions” caused by technology upgrades and data migration projects. ICE was also required to take remedial steps, including

⁵ Indictment, United States v. Coscia, No. 14-cr-551 (N.D. Ill.), at ¶ 3, available at http://www.justice.gov/sites/default/files/usao-ndil/legacy/2015/06/11/pr1002_01a.pdf.

⁶ Kim Janssen, Alleged CME ‘Spoofer’ Testifies: ‘I Didn’t Move Any Market.’ Chi. Tribune, Oct. 29, 2015, <http://www.chicagotribune.com/business/ct-spoofing-trial-1030-biz-20151029-story.html>.

⁷ Kim Janssen, CME Trader Found Guilty in Landmark ‘Spoofing’ Case, Chi. Tribune, Nov. 3, 2015, <http://www.chicagotribune.com/business/ct-spoofing-trial-1104-biz-20151103-story.html>

⁸ CEA § 9(a)(2); 7 U.S.C. § 13(a)(2).

⁹ Matthew Garber Disciplinary Action, No. CBOT 12-8862-BC (Nov. 6, 2015), <http://www.cmegroup.com/tools-information/lookups/advisories/disciplinary/CBOT-12-8862-BC-MATTHEW-GARNER.html#pageNumber=1>.

¹⁰ Ninin Gupta Disciplinary Action, No. COMEX 13-9391-BC (Oct. 12, 2015), <http://www.cmegroup.com/tools-information/lookups/advisories/disciplinary/COMEX-13-9391-BC-NITIN-GUPTA.html#pageNumber=1>

¹¹ In re Deutsche Bank AG, CFTC Docket No. 15-40 (Sept. 30, 2015).

hiring a Chief Data Officer and maintaining a staff of at least three employees dedicated to the quality assurance of its regulatory reporting.¹²

Swap data reporting, while still in its regulatory infancy, will continue to mature over the next months, particularly as the CFTC strengthens the standards surrounding reporting.¹³ The result will be little to no tolerance for reporting errors or failures to promptly correct them.

External Business Conduct Violations

We also expect the CFTC to bring enforcement actions in 2016 based on violations of its external business conduct rules, which impose stringent obligations on swap dealers (SDs) and major swap participants (MSPs) in their dealings with swap counterparties. These rules contain many traps for the unwary. For example, SDs and MSPs are required to disclose “material information” about the swap to each counterparty, including “material risks” and “material characteristics of the swap.”¹⁴ Further, an SD, at a counterparty’s request, must provide a “scenario analysis” to allow the counterparty to assess its potential exposure in connection with the swap.¹⁵ SDs and MSPs face even more stringent obligations when dealing with governments, government agencies, employment plans, endowments, or other so-called Special Entities.¹⁶ For example, an SD or MSP must have a reasonable basis to believe the Special Entity has a qualified representative to advise it regarding the swap.¹⁷ Further, an SD acting as an advisor to a Special Entity must make a reasonable determination that a swap recommended by it is “in the best interests of the Special Entity.”¹⁸

SDs and MSPs should pay careful attention to these and other requirements imposed by the CFTC’s external business conduct rules. While the external business conduct obligations are typically covered in an SDs onboarding process, testing compliance with the SDs onboarding procedures can be a fact-intensive exercise, which will be even greater should a CFTC enforcement inquiry arise.

Covington is well-positioned to provide market participants with compliance advice related to all areas of CFTC regulation, including event-driven compliance issues. We also regularly defend clients in CFTC and other government investigations and prosecutions concerning derivatives transactions.

¹² *In re ICE Futures U.S., Inc.*, CFTC Docket No. 15-17 (Mar. 16, 2015) at 2.

¹³ See Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps, 80 Fed. Reg. 52,544 (proposed Aug. 31, 2015); see also CFTC Staff Issues Advisory Reminding Swap Dealers and Major Swap Participants of their Reporting Obligations as Required by Commission Regulations, CFTC Staff Advisory No. 15-66 (Dec. 17, 2015).

¹⁴ 17 C.F.R. § 23.431(a)

¹⁵ 17 C.F.R. § 23.431(b).

¹⁶ 17 C.F.R. § 23.401(c).

¹⁷ 17 C.F.R. § 23.450(b)(1).

¹⁸ 17 C.F.R. § 23.440(c)(2).

Futures and Derivatives

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Futures and Derivatives or White Collar Defense and Investigations practice group:

Stephen Humenik	+1 202 662 5803	shumenik@cov.com
David Kornblau	+1 212 841 1084	dkornblau@cov.com
Bruce Bennett	+1 212 841 1060	bbennett@cov.com
James Kwok	+1 212 841 1033	jkwok@cov.com
Jason Grimes	+1 202 662 5846	jgrimes@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.