



Journal of Investment Compliance

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Article information:

To cite this document:

Peter Malyshev, Jennifer Achilles, Jill Ottenberg, Jessica Stumacher, (2018) "CFTC enforcement trends in 2017 and considerations for 2018", Journal of Investment Compliance, <https://doi.org/10.1108/JOIC-04-2018-0021>

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<https://doi.org/10.1108/JOIC-04-2018-0021>

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CFTC enforcement trends in 2017 and considerations for 2018

Peter Malyshev, Jennifer Achilles, Jill Ottenberg and Jessica Stumacher

Abstract

Purpose – This paper aims to discuss the types of cases that were brought by the Commodity Futures Trading Commission (CFTC) in 2017 and what to expect in 2018.

Design/methodology/approach – This paper discusses the overall statistics regarding enforcement actions brought by the CFTC, as well as the amount of restitution, disgorgement and penalties collected in 2017. These statistics are contrasted with the same statistics from 2016. This paper also discusses the types of enforcement actions brought by the CFTC in 2017 and identifies and analyzes trends. The analysis also includes a discussion of what to expect in 2018.

Findings – This paper concludes that 2017 was a year filled with personnel changes and vacancies at the CFTC, which resulted in no major policymaking cases being brought by the CFTC. This paper also finds that the CFTC is focused on actively monitoring the markets, and will continue to pursue actions involving reporting violations, fraud, manipulation, cryptocurrencies, and disruptive trade practices while rewarding parties for self-reporting and cooperation.

Originality/value – This paper contains valuable information from experienced lawyers regarding personnel changes at the CFTC, recent trends in CFTC enforcement activity and what to expect in 2018.

Keywords Cooperation, Disclosure, Enforcement, Market manipulation, Self-reporting, US Commodity Futures Trading Commission (CFTC)

Paper type Technical paper

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2017: A new administration ushers in new leadership at the CFTC

As a new administration arrived in Washington in January 2017, the US Commodity Futures Trading Commission (CFTC) embarked upon an uncertain year filled with personnel changes and vacancies that led to a notable decrease in enforcement actions during 2017. The CFTC brought 49 enforcement-related actions in the fiscal year ending September 30, 2017 (FY 2017). By comparison, the CFTC filed 68 enforcement actions in fiscal year 2016. Furthermore, restitution, disgorgement and penalties collected by the CFTC decreased significantly as well, from \$1.29bn in 2016 to \$413m in FY 2017.

The decline in enforcement actions and penalties is due in part to leadership vacancies and changes. The CFTC itself has been operating with only three commissioners versus a full panel of five. Commissioner J. Christopher Giancarlo, who ascended to the position of Acting Chairman in January 2017, was nominated by President Trump in March 2017 to serve in that role on a permanent basis. He was confirmed by the Senate in August 2017, alongside newly appointed commissioners Brian Quintenz and Rostin Behnam. There remain, however, two commissioner vacancies – one Republican and one Democrat. The year 2017 also saw new leadership in the CFTC's Division of Enforcement. Chairman Giancarlo nominated James McDonald, a former federal prosecutor from the Southern District of New York, to be the Director of Enforcement in March 2017.

Operating with new leadership and significant vacancies in FY 2017, the CFTC did not take on any policy-changing enforcement actions. However, a review of the Commissioners' and

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Director McDonald's public statements, a look at the enforcement actions that the CFTC brought in FY 2017 and evidence of increased enforcement actions so far in FY 2018, are helpful in determining the likely goals and priorities of the newly constituted CFTC going forward.

CFTC enforcement priorities: self-reporting and cooperation

Under the leadership of the new Enforcement Director McDonald, the CFTC has placed a clear priority on self-reporting and cooperation. In September 2017, the Enforcement Division of the CFTC released an Updated Advisory on Self-Reporting and Full Cooperation (the "Updated Advisory")^[1] to supplement the cooperation advisories that it released earlier in the year. McDonald presented remarks and fielded questions on the Updated Advisory on the day of its release.^[2] He made clear that companies and individuals that self-report misconduct and cooperate throughout the investigation process will receive a substantial reduction in the civil monetary penalties that otherwise would be applicable. McDonald noted in his remarks that a company that self-reports and cooperates can expect to receive "in the neighborhood" of 50 to 75 per cent reduction in potential penalties. If a company fails to self-report, however, the company is likely to face vigorous and aggressive prosecution.

While it is too early to determine the impact that the Updated Advisory will have on the amount of penalties imposed by the CFTC, the downward trend in the amount of fines imposed in FY 2017 may be attributed in part to market participants receiving reduced penalties because of significant cooperation credit. This trend is likely to continue, especially given the explicit policy shift articulated in the Updated Advisory. Market participants should carefully consider the merits of self-reporting misconduct and cooperating with the CFTC throughout the investigation process.

Enforcement trends in 2017 and considerations for 2018

In 2017, the CFTC seemed to be backing away – at least temporarily – from pursuing enforcement actions based on a theory of insider trading that the CFTC initiated in 2016. Instead, the CFTC continued to focus on a low-hanging fruit and the more traditional theories of liability that have been the basis of historical enforcement actions. Continuing this trend into FY 2018, the CFTC has already filed 15 cases related to market manipulation.

Some of the representative actions brought by the CFTC in fiscal year 2017 are discussed below, as well as what we can expect from the CFTC in 2018.

Disclosures

The CFTC followed the SEC's lead in bringing enforcement actions related to the disclosure requirements that were introduced in Part 23 of the Dodd-Frank Act. In November 2017, the CFTC ordered a provisionally registered swap dealer to pay \$10m for underreporting up to 90 per cent of the mark-up that was included in market marks on complex swaps, resulting in artificially increased revenue^[3]. The fine also covered the swap dealer's alleged failure to supervise employees, as well as the company's inaccurate reporting on the hedging percentage of some of the commodities (with some being more than 100 per cent hedged, and some less than 0 per cent hedged).

This case illustrates that disclosures by swap dealers must be specific and comprehensive to avoid scrutiny by the CFTC. Also, this enforcement action shows that the CFTC's interpretation of the available enforcement authorities is evolving and the Enforcement Division will likely continue to focus on more technical rule violations in 2018 to encourage compliance.

Market manipulation

The CFTC flexed its muscle in 2017 with respect to pursuing market manipulation. In November 2017, the CFTC imposed sanctions of \$4m against an international energy company headquartered in Norway. The CFTC found that the company attempted to manipulate the Argus Far East Index (FEI), a key benchmark for propane, to benefit its physical and financial positions – including its NYMEX-cleared over-the-counter swaps which settled to the Argus FEI. The company's efforts to move the price of the FEI were found in internal company email communications, which the CFTC found satisfied the intent requirement for market manipulation. With 15 manipulation-related cases already filed so far in FY 2018, market participants should expect that the CFTC will continue to focus its enforcement efforts in this area for the foreseeable future.

Fraud and trading violations

Spooing

The CFTC continued to pursue market participants for trading violations, in particular spoofing (placing bids or offers with the intent to cancel the bid or offer before execution). Spoofing is unlawful under the Dodd–Frank Act, and it has been an area of enforcement interest for the CFTC over the past few years. In October 2017, the CFTC fined a proprietary trading firm headquartered in Dubai \$300,000 for engaging in spoofing in the copper futures contract traded on the Commodities Exchange, Inc. (COMEX) between March and August 2016[4]. A trader was alleged to have placed large orders (e.g. more than 100 contracts) while having a smaller resting order (i.e., less than 10) on the opposite side of the book. The trader would then cancel the large order when the trader's small order was filled. In this case, the company did not face an additional fine for failure to supervise because the company dismissed the trader immediately after discovering the misconduct.

Front-running

In October, 2017 a jury found a foreign exchange (FX) trader at a large bank guilty of fraud for trading ahead of a \$3.5bn client order[5]. Although this case was brought by the Department of Justice as a criminal matter, and not by the CFTC, this case raised a number of important issues for FX traders, including the importance of knowing the types and magnitude of pre-hedging transactions that will not be deemed front-running violations. This case puts FX traders on notice that trading ahead of a client order, even for hedging purposes, may qualify as front-running and result in criminal liability. Although these cases are typically prosecuted criminally, the CFTC could pursue a civil enforcement action on similar facts seeking injunctive relief and penalties.

Cryptocurrency fraud

In 2017, the CFTC showed its intent to pursue persons engaged in fraud or manipulation in connection with digital assets under its general anti-manipulation and anti-fraud authority, irrespective of whether the scheme involves futures or swaps. In September 2017, the CFTC announced the filing of a federal civil enforcement action in the Southern District of New York against a New York corporation and its principal[6]. The defendants were charged with fraud, misappropriation and issuing false account statements in connection with soliciting investments in Bitcoin. This is a significant action by the CFTC, as there were no "commodity interests" directly involved in the alleged unlawful activity.

In recent Congressional testimony, Chairman Giancarlo stated that the CFTC intends to address the complex challenges that cryptocurrencies present to regulators by focusing on interagency cooperation (specifically with the SEC, State banking regulators, the IRS and FinCEN); strong enforcement spearheaded by the CFTC's internal virtual currency enforcement task force; and

heightened review of virtual currency product self-certifications^[7]. The CFTC's scrutiny of cryptocurrency transactions was validated on March 6, 2018, when a federal court in New York held that cryptocurrencies could be regulated by the CFTC as commodities^[8]. This will be an area to watch going forward into 2018.

Retail FX and precious metals

The CFTC continues to prioritize precious metals and retail FX fraud cases. In September 2017, the CFTC filed a civil enforcement action in the US District Court for the Northern District of Illinois against three affiliated companies, as well as the companies' principals^[9]. The CFTC charged defendants with defrauding thousands of retail customers out of hundreds of millions of dollars while executing thousands of illegal, off-exchange leveraged commodity transactions on precious metals. The complaint also alleged that the defendants were required to register as Futures Commission Merchants ("FCM") but failed to do so in violation of the CEA.

In another case, the CFTC addressed the novel issue of classifying diamonds as "commodities". In August 2017, the CFTC announced a Consent Order against three Florida companies and their employees, alleging that the defendants fraudulently solicited customers in connection with precious metals and diamonds transactions, misappropriated customer funds, concealed their fraud with false account statements and acted as an unregistered FCM^[10]. The order requires the defendants to pay \$5m in fines.

In February 2017, the CFTC settled a case against a registered FCM and retail foreign exchange dealer (RFED) and its two founding partners for \$7m^[11]. The CFTC found that the company engaged in false and misleading solicitations of its retail foreign exchange (Forex) customers by concealing its relationship with its most important market maker and by misrepresenting that its "No Dealing Desk" platform had no conflicts of interests with its customer. The company was found to have made false statements to the National Futures Association (NFA) about its relationship with the market maker, and was required to deregister as a futures commission merchant (FCM) and an RFED.

Reporting

The CFTC issued several orders imposing civil monetary penalties against market participants for failing to file accurate reports. These enforcement actions ran the gamut of the CFTC's reporting regulations, and included violations pertaining to series '04 reports (i.e. Forms 204 and 304), larger trader reports and swap data reporting. In one of these enforcement actions involving a large swap dealer, the CFTC imposed a \$350,000 fine for failing to submit Legal Entity Identifier (LEI) information in swap data reports and failing to diligently supervise by establishing electronic systems and procedures necessary to detect such reporting errors^[12].

Cross-border transactions

In an important case limiting the extraterritorial reach of the Commodity Exchange Act (CEA), a US federal court found in June 2017 that the anti-fraud provisions of the CEA are limited to activity that has a sufficient nexus to the USA. In the Brent Crude Oil Futures litigation, a New York district court dismissed multidistrict litigation complaints brought by derivatives traders and landowners alleging that a number of energy companies manipulated the price of North Sea Brent crude oil and Brent crude futures through spoofing^[13]. The court found that the allegations failed to sufficiently link the activity to any alleged economic harm suffered by the plaintiffs. While the alleged misconduct in this case occurred in Europe, the plaintiffs had claimed it had a "ripple" effect that reached the USA. The court found that the CEA claims could not be sustained because they are based on activity that occurred outside the USA. This case is significant as it shows that courts are

requiring that plaintiffs – including the CFTC – show a nexus with US interests to bring cases under the CEA.

Conclusion

In FY 2017, the Division of Enforcement brought several enforcement actions related to reporting violations and will likely continue to focus its resources on this area going forward. Moreover, the uptick in the number of market-manipulation actions filed so far in FY 2018 show that the CFTC will likely continue to dedicate resources to bringing more traditional cases related to fraud, manipulation and disruptive trading practices.

Notably, however, Director McDonald often references an adage from Chairman Giancarlo about hockey when explaining his posture on bringing enforcement actions. The very best hockey players are focused not on where the hockey puck is but on where it is going. The CFTC recently moved its market surveillance branch from within the Division of Market Oversight to within the Division of Enforcement. Moreover, the CFTC is working on reforming its swap data reporting rules to ensure that they are receiving useful data. The Division of Enforcement is also closely monitoring and pursuing enforcement actions involving initial coin offerings and trading in cryptocurrencies. This demonstrates that the CFTC is focused on being more proactive and not taking a back seat, despite a relatively sleepy FY 2017.

Notes

1. The Updated Advisory is available [here](#).
2. A transcript of McDonald's remarks is available [here](#).
3. See *In The Matter of Cargill, Inc.*, CFTC Docket No. 18-03 (November 6, 2017).
4. See *In The Matter of Arab Global Commodities DMCC*, CFTC Docket No. 18-01 (October 10, 2017).
5. The Department of Justice press release announcing the conviction of Mark Johnson is available [here](#).
6. The Complaint is available [here](#).
7. Chairman Giancarlo's Written Testimony before the US Senate Agriculture, Nutrition, and Forestry Committee is available [here](#).
8. *Commodity Futures Trading Comm'n v. McDonnell*, No. 18-CV-361, 2018 WL 1175156 (E.D.N.Y. Mar. 6, 2018).
9. The Complaint is available [here](#).
10. The Consent Order is available [here](#).
11. See *In the Matter of Forex Capital Markets, LLC, et al.* CFTC Docket No. 17-09 (February 6, 2017).
12. See *In the Matter of Citibank N.A and Citigroup Global Markets Limited*, CFTC Docket No. 17-26 (September 25, 2017).
13. See generally *In re N. Sea Brent Crude Oil Futures Litig.*, No. 13-md-02475 (ALC), 2017 WL 2535731 (S.D.N.Y. June 8, 2017).

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