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Global Regulatory Enforcement Alert

If you have questions or would like additional information on the material covered in this Alert, please contact one of the authors:

Efrem M. Grail
Partner, Pittsburgh
+1 412 288 4586
egrail@reedsmith.com

Elizabeth S. Fenton
Partner, Philadelphia
+1 215 851 8867
efenton@reedsmith.com

Andrew P. Cross
Partner, Pittsburgh
+1 412 288 2614
across@reedsmith.com

...or the Reed Smith lawyer with whom you regularly work.

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Market Manipulation – Traders Beware: What Does the CFTC's Triple Threat of MF Global, Dodd-Frank and Enforcement Pressure Mean for Traders?

The fallout from the financial crisis was the enactment of the Dodd-Frank Act, a tsunami of mandated regulatory initiatives, and heightened pressure on all regulators to bring enforcement actions. As part of the Dodd-Frank's "re-regulatory" mandate, the Commodity Futures Trading Commission implemented final regulations, including its new Rule 180.1 (July 21, 2011). Then, only a few short months later, MF Global collapsed, putting additional pressure on the CFTC, which has rarely been in the news as much as it has been these past few months. Against this backdrop, traders everywhere are groping to understand what the new market manipulation rules and heightened enforcement activity really mean in today's derivatives' market, especially in thinly traded, illiquid markets where there is an imperfect correlation to corresponding cash markets.

Old Law, Some New Twists

The Commodity Exchange Act (the "Act" or "CEA") prohibits both market manipulation and attempted market manipulation in the commodities markets. 7 U.S.C. § 13(a)(2). Under the Act, the CFTC may impose, among other things, criminal sanctions, civil monetary penalties and cease-and-desist orders when "any person . . . has manipulated or attempted to manipulate the market price of any commodity . . . for future delivery on or subject to the rules of any registered entity . . . or otherwise is violating or has violated any of the provisions of [the] Act . . . ." 7 U.S.C. §§ 9a, 13(a)(2) and 13b.

Market manipulation, although a central focus for the CFTC's enforcement actions, has been historically difficult to prove. Attempted manipulation has been even harder for the Commission to prove. To show attempted manipulation, the CFTC must prove (1) an intent to affect the market price of a commodity; and (2) an overt act in furtherance of that intent.
In today's hyper sensitive regulatory environment, just one otherwise innocent email explaining a trading strategy may in hindsight give the CFTC evidence of intent, making an otherwise legal trade look like an overt act.

This new regulatory landscape under Dodd-Frank provides the Commission with even greater latitude to act. New CFTC Rule 180.1, which implements section 6(c)(1) of the CEA (and which was part of Dodd-Frank), states that it is unlawful for any person, directly or indirectly, i***n connection with*** any cash or derivatives market transaction, to ***intentionally or recklessly***

1. Use or employ (or attempt to use or employ) any manipulative device, scheme or artifice to defraud
2. Make (or attempt to make) any untrue or misleading statement of a material fact or to omit a material fact necessary to make statements not untrue or misleading
3. Engage in (or attempt to engage in) any act operating as a fraud on any person
4. Deliver (or attempt to deliver) any false or inaccurate or misleading report

The CEA's new section 4c(a)(5)[1] also prohibits the following "disruptive practices," including:

- "Violating" bids or offers (*per se* offense; no intent required)
- Bidding or offering with the specific intent to cancel bid or offer before execution (i.e., "spoofing")
- Trading in a manner that demonstrates intentional or reckless disregard for "orderly execution of transactions during close"
- Any practice determined by CFTC to be disruptive of "fair and equitable trading"

The CFTC's enforcement arsenal thus looks very different – and more daunting – with the enactment of Dodd-Frank and rules the Commission enacted thereunder. It has also given the CFTC

more discretion, to which courts are likely to defer.

The Impact on Enforcement—Looking Back, Looking Forward

According to the CFTC, manipulative intent can often be shown only circumstantially, often from what it considers an uneconomic trading strategy, leading to price artificiality. *See, e.g., Commodity Futures Trading Comm'n v. Hunter*, No. 07-6682, slip op. at 2-3 (S.D.N.Y. Jan. 31, 2012); *In re Indiana Farm Bureau Coop. Assoc*., 1982 WL 30249 at *6 (C.F.T.C. Dec. 17, 1982). Most importantly, in *DiPlacido v. Commodity Futures Trading Comm'n,* 364 Fed. Appx. 657 (2d Cir. 2009), the Second Circuit approved without significant consideration the CFTC's position by finding that manipulation may occur in a thinly traded, illiquid market by a party that does not control market share. The Second Circuit determined that manipulation can occur when a party "violates" trades – that is, makes higher bids (or accepts lower ones) than existing offers at a given time, and thus pays more than necessary for its settled trades, which the CFTC contended had an artificial impact on the commodity's price. In *DiPlacido,* the Commission also had evidence of taped conversations signaling DiPlacido's improper intent as well. *In re DiPlacido,* Comm. Fut. L. Rep. (CCH) ¶ 30,970, 2008 WL 4831204 at *26 (CFTC Nov. 5, 2008). In another recent case, *Commodity Futures Trading Comm'n v. Optiver US, LLC*, Civil Action No. 08-06560 (S.D.N.Y.) (stayed pending settlement discussions), the CFTC focused on a trail of preserved communications that used words like "hammer," "influence," "move," "whack" and "bully" to describe what they intended to do to futures prices. Clearly, the CFTC considers uneconomic trading to be, at the very least, a strong indicator of manipulative intent, and it will look to contemporaneous communications as proof of intent.

Such "uneconomic trading activity" also satisfies the overt act requirement, which need not be unlawful or fraudulent on its own to establish manipulation. *CFTC v. Amaranth Advisors, LLC,* 554 F. Supp. 2d 523, 534 (S.D.N.Y. 2008). Under this legal framework, the CFTC may deem any trading activity that could lead to price artificiality as suspicious and possibly manipulative.

In light of these considerations, it is imperative that companies take proactive steps to prevent potential CEA violations, especially because the CFTC also discounts the fact that new, electronic trading platforms have the potential to be far more transparent than pit trading. See section 4(c)(a)(5) of the Act (codifying these restrictions).

The CFTC's new enforcement tools are powerful. The Commission has great discretion to levy high civil fines, impose trading bans and even refer cases for criminal prosecution. In today's regulatory environment, the Commission faces intense political pressure to bring aggressive enforcement actions.

What's a Commodity Trader To Do?

A company involved in trading commodities and related derivatives must protect itself against potential CEA exposure by (1) conducting due diligence on company policies regarding trading practices, (2) auditing the trading conduct, and (3) acting on what it learns. In addition to having the right policies, it is imperative that a company educate its employees and agents about acceptable trading practices, and ensure that the policies are implemented and that compliance is monitored. Periodic training and a commitment from top management to a culture of compliance are a must.

Our attorneys have experience developing and implementing such policies and practices, and they welcome the opportunity to share their experience on these important measures with you.

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Reed Smith also has extensive experience defending against CFTC investigations and related civil actions, as well as in conducting preemptive internal investigations. Contact the authors of this article or the Reed Smith attorney with whom you regularly work for advice.

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1. Section 4c(a)(5) does not apply to bilaterally negotiated OTC derivatives.

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