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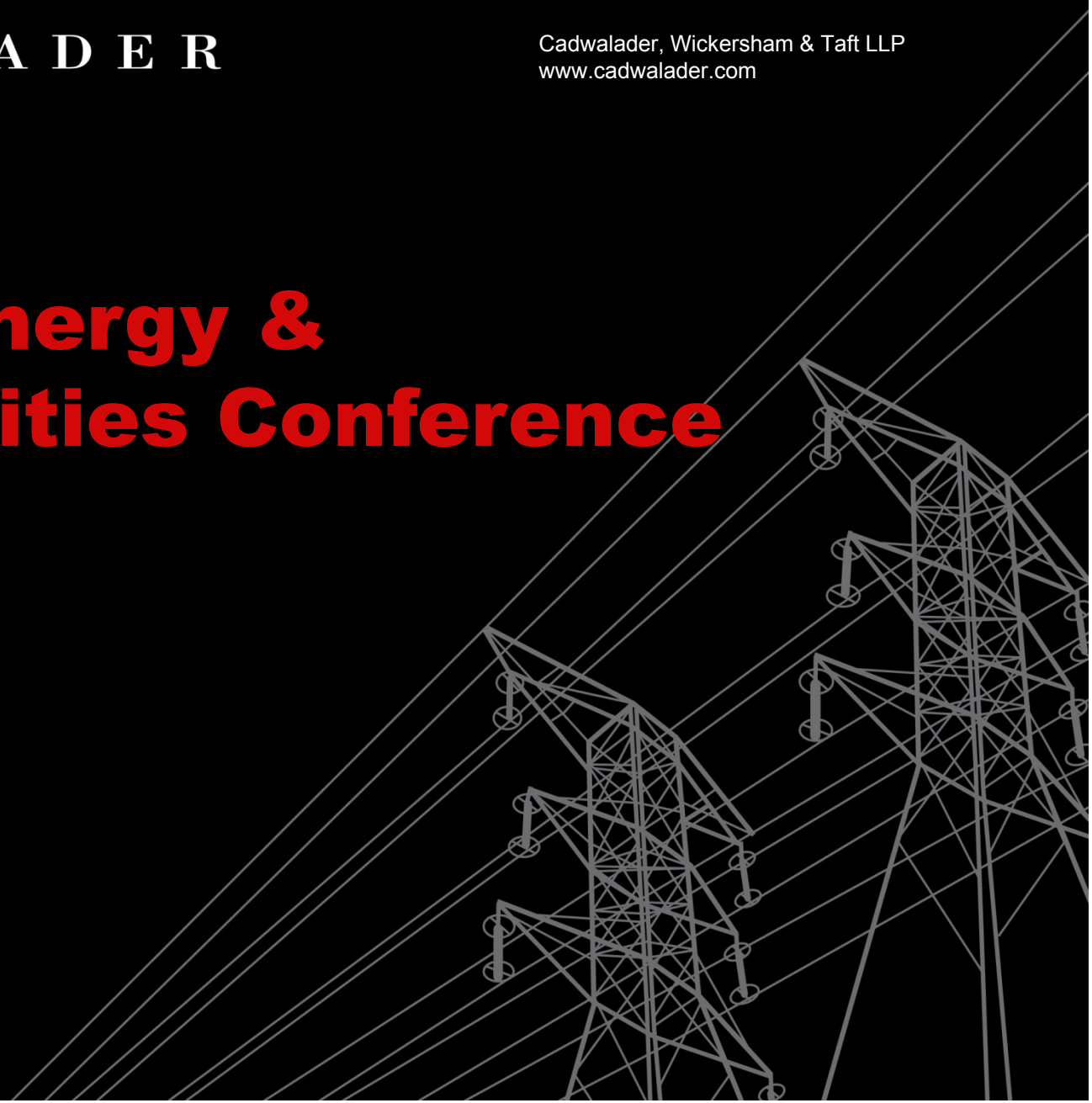
Spring Energy & Commodities Conference

April 6, 2016



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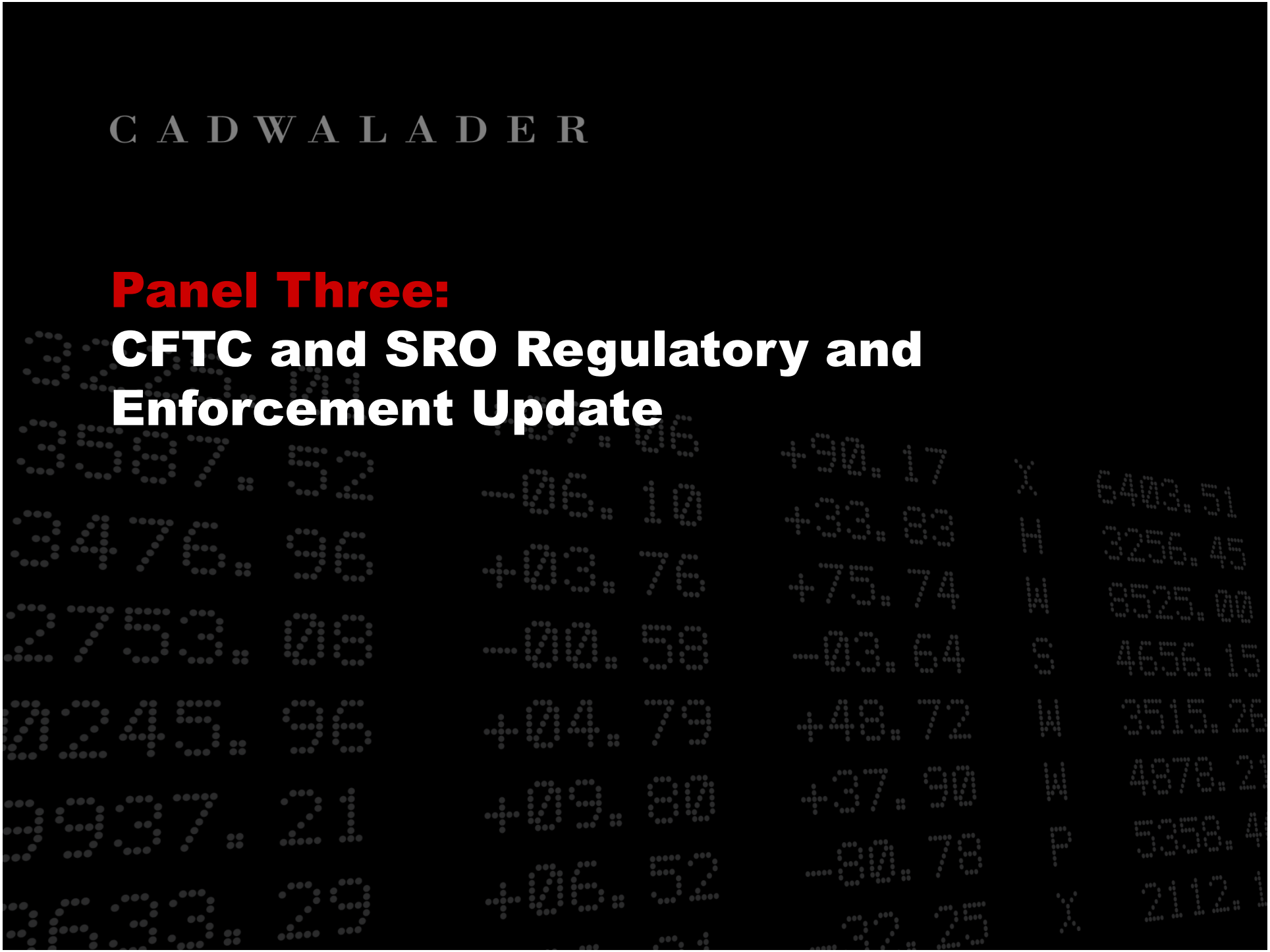
Panel Three:
CFTC and SRO Regulatory and Enforcement Update



Panelists

- Moderator: Anthony Mansfield, Cadwalader
- Trabue Bland, President, ICE Futures US
- Monique Rowtham-Kennedy, Americas, Head of Compliance, BTG Pactual Commodities (US) LLC
- Adam Topping, Special Counsel, Cadwalader

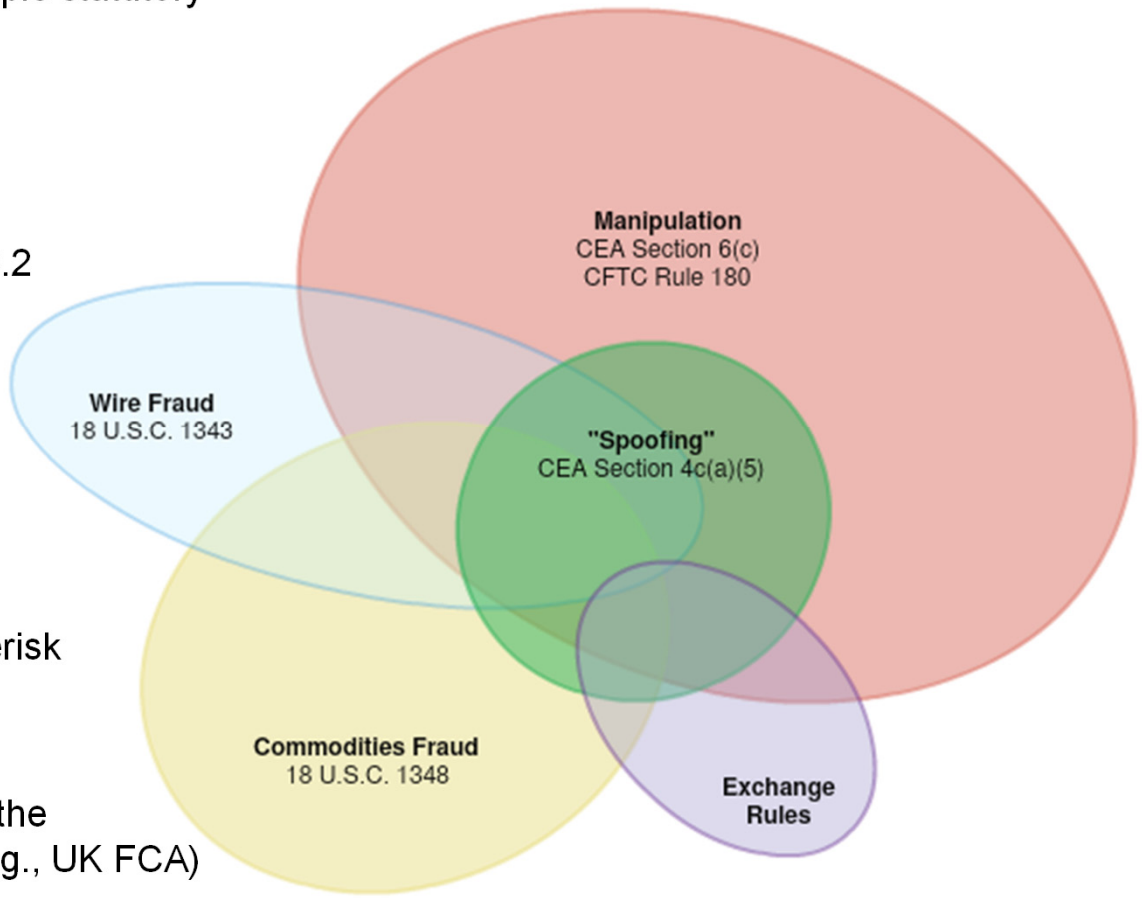
Spoofing Today

Spoofing can be pursued by the CFTC, DOJ and the Exchanges under multiple statutory and regulatory provisions:

- **CEA Section 6(c)***
- **CEA Section 4c(a)(5)***
- CFTC Rules 180.1 and 180.2
- **Wire fraud***
- **Commodities fraud***
- CME Rule 575
- ICE Rule 4.02

Provisions marked with an asterisk can be **criminally** prosecuted by the DOJ

Foreign regulators also have the authority to pursue spoofing (e.g., UK FCA)



Post-Dodd-Frank new Anti-Manipulation Rule Under the CEA (effective Aug. 15, 2011)

Rule 180.1 states that is 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** … employ, or attempt to employ, any manipulative device, scheme, or artifice to defraud…."

- Manipulation by fraud
- Lower intent standard
- Untested

Post-Dodd Frank Deceptive Trading Practices Provision (effective July 16, 2011)

The CEA was amended to include Section 4c(a)(5)(C) which says that it is "unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of any registered entity that … is, is of the character of, or is commonly known to the trade as "spoofing."

- Rule says that "spoofing" is **bidding or offering with the intent to cancel the bid or offer before execution**
- Note that it must be intentional conduct
- Must be on a registered entity (e.g. exchange)

ICE Rule 4.02 (effective Jan. 2015)

- "In connection with the placement of any order or execution of any transaction, it shall be a violation of the Rules for any Person to . . . enter an order . . . or cause an order . . . to be entered, with . . . the intent to cancel the order before execution, or modify the order to avoid execution."

CME Exchange Rule 575 (effective Sept. 15, 2014)

- "No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution."

Criminal Securities & Commodities Fraud Statute (effective May 20, 2009)

18 U.S.C. § 1348 makes it unlawful to "defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery" and to "obtain by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any commodity for future delivery, or any option on a commodity for future delivery."

- Punishable by up to 25 years in prison
- Fine of up to $250,000 for individuals
- Fine of up to $500,000 for corporations
- With pecuniary loss to another the defendant may be fined up to twice the gross gain or twice the gross loss

How Regulators Interpret Spoofing: What They Say Is Spoofing!

- Intent to cancel a bid or offer before execution
- Submitting or cancelling bids or offers to overload the quotation system of a registered entity
- Submitting or cancelling bids or offers to delay another person's execution of trades
- Submitting or cancelling multiple bids or offers to create an appearance of false market depth

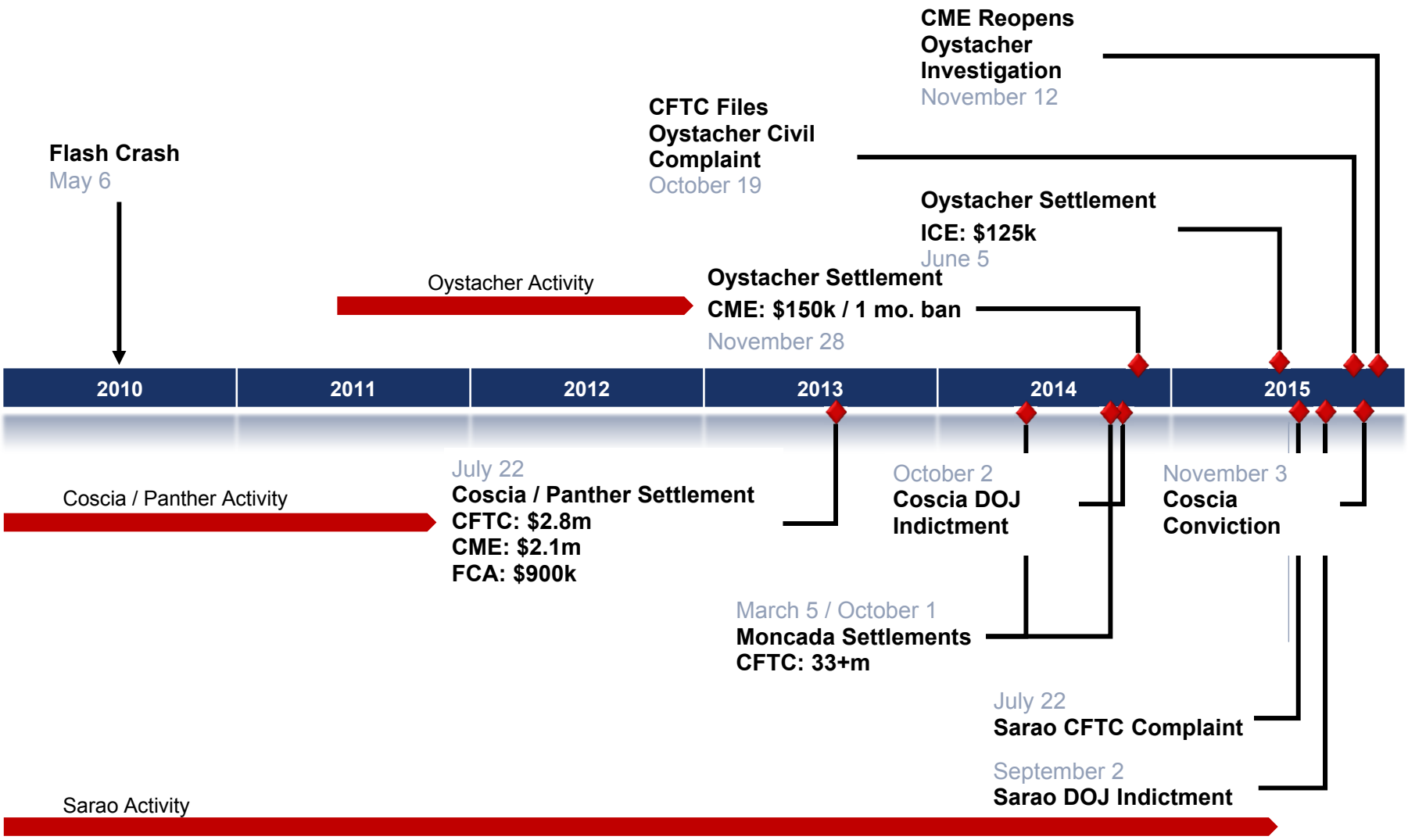
How Regulators Interpret Spoofing: Examples of Activity That Falls Outside of Spoofing Definition

- Orders, modifications, or cancellations will not be classified as “spoofing” if they are submitted as part of a legitimate, good-faith attempt to consummate a trade (i.e. trader changing her mind; legit stop loss orders) (CFTC guidance 2013)
- Accidental or negligent trading, practices, or conduct (i.e. system malfunction; trader does fat finger mistake) (CFTC Guidance 2013)
- Reckless trading (has to be “intentional”)(CFTC Guidance 2013)
- Bona fide transactions that are then modified or cancelled due to “perceived change in circumstances” (CME MRAN/ICE Rule 4.02 FAQ)

Factors Considered by Regulator / Potential Indicia of Spoofing /

- A pattern of order entry and cancellation prior to execution
  - participants historical pattern of activity
  - participants order entry and cancellation activity
- Low fill rate (small percentage of orders actually executed compared to market norms)
- Size of the orders relative to market conditions at the time of order entry
- Duration for which order exposed to market
- Layered or lopsided orders (e.g., iceberg offer vs. large, visible bids that are cancelled)
- Flashed orders that appear designed to “wake up” the market

Spoofing Enforcement Trends and Targets



Takeaways

- Extent of the problem
  - Addressing conduct that occurred in the past
  - Addressing ongoing conduct
- Monitoring for potential spoofing activity
- Implications of aggressive enforcement in this area
  - Chilling effect of criminal prosecution
  - Ambiguity regarding definition of spoofing
  - Inconsistent approach to enforcement between CFTC and SROs
- Failure to Supervise
  - Focus on traders
  - Potential focus on supervisors

US Perspective: Insider Trading Under the Pre-Dodd-Frank CEA

- Conventional wisdom: With limited exceptions, insider trading is a permissible and integral practice in commodities and derivatives markets.
- Historically, certain types of insider trading were prohibited under the pre-Dodd-Frank CEA, for example:
  - CEA § 4c(3) – Prohibits federal employees from trading futures or swaps for personal gain based on price-sensitive non-public information acquired as a result of their position
  - CEA § 9(c)(1), (d)(1) – Prohibits CFTC commissioners, employees, and agents from trading futures, swaps, or commodities based on non-public information, or sharing such information with the intent to assist another person in trading
  - CEA § 9(e)(1) – Prohibits employees, members of the governing board or a committee of a registered entity (*e.g.*, futures exchanges, SDRs) or a registered futures association from willfully and knowingly trading futures or swaps or disclosing improperly any material non-public information obtained through special access related to the performance of such duties

Insider Trading and the Misappropriation Theory Under the Post-Dodd Frank CEA

- **CEA § 6(c)** – The fraud-based anti-manipulation provision (modeled on SEC Rule 10b-5)
- **CFTC Rule 180.1** – The CFTC noted that a misappropriation claim could be brought when someone trades on material non-public information that was **lawfully obtained, but used in a way that breaches a pre-existing duty**
- A duty established by law or rule, or agreement is readily understood
- However, until recently, the CFTC has been publicly silent as to what **"understandings, or other sources"** establish a duty not to trade commodities or derivatives when in possession of inside information

CFTC Settlement - Arya Motazedi – December 8, 2015

Allegation: From September to December of 2013, Arya Motazedi engaged in **insider trading** in violation of CFTC Rule 180.1 by executing transactions in his personal accounts **ahead of – and to the detriment of – similar transaction in his employer's account**

Penalty: $216,956 restitution
$100,000 penalty to the CFTC; plus $100,000 penalty to NYMEX
Permanent trading ban

Significance: First, the order expressly references the securities laws **"relationship of trust and confidence"** construct, which is not limited to fiduciary relationships

Second, it applies a **recklessness** standard to misappropriation claims

Third, the settlement order likely was meant to put market participants on notice of the CFTC's intention to pursue misappropriation claims based on this more expansive view of pre-existing legal duties

"Understandings and Other Sources"

- Drawing from SEC precedent, the CFTC has suggested that certain relationships give rise to a duty of confidentiality:
  - The relationship must be one of **"trust and confidence"**
  - The relationship must be **mutual**
- However, the duty of confidentiality does **not** need to be:
  - Based on a **fiduciary** or business relationship
  - Part of a **continuous** chain of relationships or dealings
  - Explicit (*e.g.*, a written confidentiality agreement)

Relationship of "Trust and Confidence"

What types of relationships create an expectation of "trust and confidence"?

- Does the recipient agree to keep the information confidential?
- Do the source and recipient have a **history, pattern, or practice** of sharing confidences such that the recipient knew or reasonably should have known the source expected confidentiality?
- For example:
  - **Attorneys and clients**: *U.S. v. O'Hagan*
  - **Business partners**: *SEC v. Peters* (duty of trust developed based on discussions between long-time friends and business associates regarding a proposed joint venture)
  - But compare: arms-length negotiations do not constitute a relationship of trust and confidence
  - **Employer-employee**: *U.S. v. Newman* (broker violated a duty to his employer and clients by misappropriating confidential information and concealing when under a duty to disclose)

Elements of a Misappropriation Claim under Rule 180.1

Elements of a misappropriation claim:

- A person **deceives** another when he or she:

  1. Misappropriates
  2. Material
  3. Non-public information for trading purposes, in
  4. Breach of a duty owed to the source of the information (*i.e.*, relationship of "trust and confidence")

CFTC Definition of Misappropriation

- **What constitutes "misappropriation"?**
  - Non-public information is considered the "property" of the person who lawfully possesses it
  - Therefore, non-public information is misappropriated when an individual trades (or attempts to trade) while either **"using"** or in **"knowing possession"** of the information:
    - Without disclosing the intent to trade to the person to whom the duty is owed
  - The CFTC has indicated that it intends to take the position that disclosing one's intention to trade on non-public information prior to actual trading satisfies the duty of confidentiality

Breach of Pre-Existing Legal Duty

- **When is a pre-existing legal duty, including a relationship of trust and confidence breached?**
  - Insider trading only occurs where a trader acts with requisite scienter by knowingly or recklessly disregarding the fact that:
    - The information was non-public, and
    - There was a pre-existing legal duty such as a relationship of trust and confidence between the trader and the source that precludes the trader from using the information for his or her benefit

  Note: Under the misappropriation theory the trader **obtains** the information lawfully; the breach occurs when it is **used** in an impermissible manner.

Takeaways from Swap Dealer Rules

- **Registered swap dealers are subject to business conduct standards that:**

  1. **Prohibit** the use or disclosure of confidential counterparty information in a way that would tend to be materially adverse to the counterparty; and

  2. **Require** policies and procedures to protect material confidential counterparty information

  3. **Allow** the use or disclosure of confidential counterparty information:

     - where authorized in writing by the counterparty
     - for the effective execution of any swap for the counterparty
     - to hedge or mitigate exposure created by such swap

EU Developments in Insider Trading

- Physical commodity markets historically exempt from insider trading rules. Financial markets only in scope in a relatively limited capacity, i.e., commodity derivatives traded on a regulated market
- Key Regulations changing this
  - REMIT (2011)
  - MAR (2015)
- Expanded range of products covered:
  - REMIT: "wholesale energy products" covers power and gas markets
  - MAR: broader definition of "commodity derivatives" under MiFID II

EU Developments in Insider Trading *(cont'd)*

- New markets covered
  - REMIT: any organised market place and OTC
  - MAR: any regulated market, MTF, OTF; OTC transactions that depend or have an effect on those traded on trading venues
- New definitions of Inside Information, e.g under MAR:
  - In relation to commodity derivatives, information of a precise nature, which has not been made public, relating, directly or indirectly to one or more such derivatives or relating directly to the related spot commodity contract, and which, if it were made public, would be likely to have a significant effect on the prices of such derivatives or related spot commodity contracts.

EU Developments in Insider Dealing *(cont'd)*

- **New definitions *(cont'd)***
  - The information must be of a type that is reasonably expected, or required, to be disclosed on the relevant commodity derivatives markets or spot markets in accordance with legal or regulatory provisions at EU or national level, market rules, contract, practice or custom (Article 7(1)(b), MAR).
- **REMIT Standard:**
  - Similar to MAR, but includes some specific types of information, including information published by TSO, capacity information, planned and unplanned outages and "other information that a reasonable market participant would be likely to use as part of the basis of its decision to enter into a transaction relating to, or to issue an order to trade in, a wholesale energy product."

EU Developments in Insider Dealing *(cont'd)*

- New Insider Dealing offenses under REMIT and MAR:
  - trading or attempting to trade on the basis of inside information (own account or third party)
  - cancelling or amending an order
  - recommending or inducing
  - unlawfully disclosing (i.e. not in accordance with normal exercise of employment or duties)
- Disclosure Obligation:
  - MAR - ESMA preparing a consultation paper on guidelines relating to the information expected or required to be published in relation to commodity derivatives.
  - REMIT – market participants required to publicly disclose inside information in respect of its own business or facilities.

What Trading Relationships May be Implicated by CFTC Rule 180.1?

- Swap dealer (managing to *de minimis*) / customer?
- Voice broker / customer?
- Aggregator, originator / customer?
- Pipeline operator / customer?
- Storage operator / customer?
- Cooperative / members?
- Asset management agreements, energy management agreements?
- Supply agreements?
- Other?

What Activities May be Implicated?

- Front-running (OTC derivatives, physical commodities)?
- Pre-hedging anticipated transactions (not limited to block trades)?
- Trading to trigger resting orders (*e.g.*, barrier options)?
- Voice broker that feeds market orders to one particular customer?
- Other?

Implications for Commodities Traders

- Consider whether to make proprietary trades based on non-public information received from counterparties or other market participants
  - Distinguish between trading on your non-public information, and trading on non-public information obtained from another source
- For non-registrants, consider whether to adopt written policies and procedures described in CFTC Rule 23.410(c)
  - Address how to handle material non-public information – *e.g.*, outages, congestion, changes to supply/demand
- For all market participants, consider conducting a compliance review to assess the adequacy of existing policies and procedures, and to identify trading relationships that may trigger heightened scrutiny
  - Review confidentiality obligations with counterparties and brokers