

ALERTS

CFTC 2019 Enforcement Report — Lessons for Private Fund Managers

December 4, 2019

The Commodity Futures Trading Commission's Enforcement Division released its second annual report on Nov. 25, 2019, disclosing higher penalties and more parallel criminal cases. The number of actions brought in 2019 (69) was slightly lower than in 2018 (83), but it is noteworthy that a supermajority of this enforcement activity took place following Chairman Heath Tarbert's assumption of office two-thirds of the way through the 2019 fiscal year.

Private fund managers that trade futures contracts, options or swaps (who are classified as "commodity pool operators" under the Commodity Exchange Act) should consider the implications of this report within the CFTC's active supervision initiatives over them and the markets in which they trade. (For example, the CFTC announced that it will begin examining hedge fund managers and other CPOs in 2020.[1])

Market Misconduct and Fraud

While the data in the 2019 Enforcement Report covers a wide variety of alleged violations, the two main focuses of the 2019 Enforcement Report are market misconduct and fraud, areas in which the CFTC has brought numerous actions against private fund managers.

Fraud. In keeping with its focus on the protection of investors, the CFTC continues to focus on fraud, stating:

Since its inception, the Commission has focused on protecting customers in its markets from fraud and other abuse. That focus remained a priority

during FY 2019. The Division aggressively prosecuted fraud in some of the historical areas of focus [but also] continued to track down fraudsters as they entered new markets — and sometimes entirely new asset classes, like digital assets[.]

The Enforcement Division underscored this by highlighting a case brought against the principal of a fund manager for soliciting, and then misappropriating, invested funds. While that case involved particularly egregious conduct (the principal was also charged criminally), it is not isolated. The CFTC also employed the anti-fraud section of the CEA to bring charges against registered CPOs and their employees for mismarking futures, physical commodity positions and swaps, and highlighted those cases in its annual report as well. In one mismarking case, brought in tandem with an SEC action for the same conduct, the CFTC charged a hedge fund portfolio manager with inflating interest rate swap valuations to show better trading profits. The portfolio manager was fined and given a three-year CFTC registration and trading ban.[2]

Market Misconduct. The 2019 Enforcement Report referenced a CFTC core belief that the futures markets exist primarily to allow producers of goods to “hedge the risk that this year’s output might not be as good as the last, which protects them and consumers against price increases” and to “allow companies and individuals to allocate capital more efficiently, which contributes to the growth of the broader American economy.”

Spoofing and other “disruptive” trading patterns, according to the CFTC, undermine the integrity of the markets and, in prosecuting these cases, the CFTC serves its “dual priorities” of protecting market integrity and market participants. As in prior years, the CFTC was especially focused on spoofing, which accounted for 23% of its enforcement actions. Most notable among these actions was a \$67-million fine for spoofing assessed against a trading firm earlier this month. Traders at the firm had sent thousands of non-bona fide orders to Globex opposite their actual orders in an attempt to move the price of the instruments they were trading.[3]

Market misconduct cases may present the greatest source of risk for private fund managers; this area also can be one of the most difficult for compliance officers to police, for several reasons. In general, it is simply harder to identify and isolate improper trading activity in an environment of contract “rolls,” complex hedges involving different categories of instruments, and a relatively fractured global market structure. Most

third-party trade surveillance systems, for example, were developed to address equities trading, and futures trading surveillance tools are less accessible. In addition, the surveillance of swaps activity can be especially challenging. Compliance officers at private fund managers should utilize their annual review as an opportunity to assess the adequacy of their relevant surveillance tools and skills and seek to implement improvements where necessary.

Emphasis on Compliance Programs

The CFTC emphasized the importance of adequate compliance programs as being central to its enforcement investigations. Specifically, the 2019 Enforcement Report indicated that the adequacy of an entity's compliance program will significantly impact how the CFTC views the severity of any misconduct, the penalty imposed and the need for undertakings.

The 2019 Enforcement Report footnotes two different cases where the CFTC found that compliance failures “directly resulted in the underlying substantive misconduct,” and two additional cases where it brought “failure to supervise” charges in addition to charging the underlying activity. An effective compliance program, according to the CFTC, must be able to both detect and deter misconduct.

For private fund managers, this only extends a theme heard in actions, guidance, and rulemaking at several other regulators and SROs. The message here is clear: a fund manager trading in the commodity interests markets needs to invest in its compliance infrastructure and provide adequate support to skilled compliance professionals. The message for supervisors and chief compliance officers is equally clear: documented, effective supervision measures are crucial to warding off personal liability or the prospect of being named in a failure to supervise case.

Digital Assets

The 2019 Enforcement Report emphasized the CFTC's commitment to aggressively prosecuting misconduct involving digital assets. The CFTC has, since 2015, taken the position that Bitcoin and other virtual currencies are properly defined as commodities within the meaning of the Commodities Exchange Act.[4]

The 2019 Enforcement Report discussed several actions involving digital currencies and highlighted favorable rulings in significant, litigated enforcement actions, “affirming the Commission’s authority to prosecute fraud and manipulation involving digital assets that satisfy the statutory definition of a commodity.” In these litigated actions, the CFTC argued that, because cryptocurrency futures can be traded on markets the CFTC regulates, the underlying asset is a commodity for the purposes of the CEA’s anti-fraud statute.[5]

For the moment, the CFTC has focused its digital asset enforcement activity on fraud cases. It remains to be seen whether the CFTC will extend its enforcement activities to wash trading, spoofing or other market integrity cases involving digital assets, although there is no impediment to such an extension.

Parallel Criminal Proceedings

The annual report touts the CFTC’s increasing cooperation with criminal authorities, citing a new high-water mark of 16 cases brought with parallel criminal proceedings. The 2019 Enforcement Report labeled this “a trend we expect to continue.” Similarly, Director of Enforcement James McDonald, in a July 25, 2019 speech, specifically stressed inter-agency cooperation as an initiative in which the CFTC had “made great strides.” According to Director McDonald, the CFTC’s specialized expertise in complex markets and market data allows it to identify misconduct that would otherwise not be readily apparent to the Department of Justice and other criminal authorities. Director McDonald also noted the CFTC’s cooperative efforts with other regulators, including the U.S. Securities and Exchange Commission.

“Bad Actor” Disqualifications

The CFTC’s increasing involvement with the SEC already has raised questions about where the two agencies’ regulatory mandates intersect. For example, a recent spoofing settlement revealed internal disagreement at the CFTC about the extent to which the CFTC can, or should, opine on whether its enforcement actions should trigger a “bad actor” disqualification from certain private placements under SEC Rule 506.[6] In separately published opinions, two commissioners took issue with the CFTC’s recommendation to the SEC that the company should not be disqualified.[7] As the CFTC continues stepping up enforcement

for manipulation, or other activities that fall within the “bad actor” definitions in Rule 506, these issues are likely to recur.

Cooperation and Self-Reporting

The 2019 Enforcement Report also touted the CFTC’s “robust” cooperation and self-reporting program, crediting the involvement of cooperating witnesses or corporations in some of its most significant matters. Recent CFTC press releases accompanying settlements, like those of the SEC and DOJ, have emphasized that lower civil penalties were imposed because of significant cooperation afforded to CFTC staff. Similarly, the 2019 Enforcement Report noted the CFTC’s practice of bifurcating liability and penalties for cooperating witnesses, and assessing reduced penalties after cooperation is substantially complete, a mirror of the criminal cooperation paradigm.

Cooperation and self-reporting have been emphasized by the CFTC since 2017. As with the SEC and DOJ, to obtain cooperation credit from the CFTC, companies are expected to:

1. Voluntarily report wrongdoing before the start of any investigation, promptly after becoming aware of it;
2. Fully cooperate in investigations, including identifying individuals involved in the wrongdoing; and
3. Timely and appropriately remediate the issue, including enhancing compliance and internal controls.

The 2019 Enforcement Report echoes these sentiments and adds the corollary that enhanced penalties will be sought for those obstructing or undermining investigations.

Takeaways

The leadership of the new chair, and the tone of the 2019 Enforcement Report, make clear that the CFTC is embracing its regulatory and enforcement mandate and managers should pay heed to the warning contained in the CFTC’s press release: “enforcement activity at the Commission shows no sign of slowing down as we enter the new Fiscal Year.” In choosing to characterize its activity in 2019 as part of a trend upward, the CFTC signaled its intent to continue to regulate the futures

markets in a robust way. The Enforcement Division appears to be modeling its program on the enforcement programs we have seen from other regulators, including formal cooperation programs and parallel proceedings with criminal authorities.

While this is not news to private fund managers, it is worth repeating that the CFTC's enforcement scope is not limited to "plain vanilla" agricultural futures contracts. The CFTC has jurisdiction over a myriad of financial futures, licenses many of the key financial exchanges and now oversees swap execution facilities ("SEFs"). As the CFTC gets more familiar with digital assets, the extension of its enforcement reach should be expected to continue.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] See, e.g., "CFTC 2020 Examination Initiative — Guidance for Private Fund Managers," *SRZ Alert*, Nov. 8, 2019, available here.

[2] See Rel. No. 7979-19, CFTC Orders Former Hedge Fund Portfolio Manager to Pay More than \$700,000 in Monetary Sanctions for Fraudulently Mismarking Swaps, July 18, 2019, available here.

[3] The individual traders were also charged by the CFTC in 2018, and criminally prosecuted as well. See, e.g., Order In the Matter of Kamaldeep Ghandi, CFTC Doc. No. 19-01, Oct. 11, 2018, available here.

[4] See In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29, available here; See also A CFTC Primer on Virtual Currencies, Oct. 17, 2017, available here.

[5] See, e.g., *CFTC v. McDonnell*, CFTC Release 7702-18, March 6, 2018; *CFTC v. My Big Coin Pay, Inc.* CFTC Rel. No. 7820-18, Oct. 3, 2018.

[6] SEC Rule 506 allows entities to raise almost unlimited capital through "Reg D" private placements, but disqualifies felons and other "bad actors" from participating in such offerings.

[7] See Statement of Commissioner Rostin Benham Regarding Tower Research Capital LLC, Nov. 7, 2019, available here; Dissenting Statement

of Commissioner Dan M. Berkovitz, In re Tower Research Capital LLC:
Waiver of SEC “Bad Actor” Disqualifications, Nov. 7, 2019, available here.

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