drums along the potomac

Not so fast, smart guy. This seems to be the current attitude about the CFTC's recent release of its long-awaited position limits regime. At first pass a few weeks ago when the draft was released, there was much rejoicing. We heard, "it's not so bad," or "this is workable," or "it could have been much worse." This week, if you ask the same question about the draft position limits rules, you may hear something entirely different. From exchanges to E&Ps, the new verdict is: This rule means more work, more paperwork, more reporting, more compliance costs, more expensive hedging and as always, "it's more complicated." It's always more complicated. One frustrated source we spoke to suggested that the staff rule writers at the agency simply have no experience in these markets, and thus lack the understanding or "subtleties." For some examples, look at the way Henry Hub gas contracts are now treated – much like any other gas contract. So, last time we checked, HH is more than a gas contract; it's the core contract for the entire sector. It's linked to essentially every basis contract, regardless of locale. It may one day be a global mark. It's certainly not just another gas contract. Check that one. Penultimate options – everybody needs to take another look at how these little darlings are treated. Should they be treated like everything else in the position limit tally? More than one person we spoke to thought this was just plain nutty. The CFTC site and *Federal Register* posting of the draft rule is here: *http://www.cftc.gov/LawRegulation/FederalRegister/ ProposedRules/2016-12964*. All 558 individual comments and related filings (since Dec. 30, 2014) can be found here: *http://comments.cftc.gov/PublicComments/ CommentList.aspx?id=1708*. Note to self: The closing date for the current comment period for Proposed Rule 81 FR 38458 is on July 13, 2016. *That's next week, folks. For a copy of Delta Strategy Group's 16-page summary of the rule, go to http://deltastrategygroup.com/wp-content/uploads/2016/05/DSG-Summary-Position-Limits-Supplemental-Proposal.pdf.*

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Adjusted for inflation? The CFTC amended the rule governing the maximum amount of civil monetary penalties that can be assessed for violations of the Commodity Exchange Act (CEA) and CFTC rules. The amendment adjusts the maximum amount for inflation. The penalties for the most common violations, which currently are assessed at $140,000 per violation, now will be raised to $152,243. Penalties for manipulation will be raised from $1 million to $1.098 million. The interim final rule will become effective on Aug. 1, 2016. Cadwalader's Bob Zwirb noted that under the CEA, "the calculation of penalties involves more art than science. If the statute limits the CFTC to X dollars for each violation, but it wants to impose X + Y dollars on a respondent, then the CFTC usually, though not always, can assess the higher amount simply by finding more violations," he says. "That is, by saying that each day represents a new violation and then multiplying the prescribed maximum amount by the number of newly discovered violations. Alternatively, even if a respondent commits only a small number of violations, but those violations generate enormous amounts of illegal monetary gains, then the CFTC can choose to base the penalty on the gains under the statute and treble that amount in order to calculate a larger penalty."

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We can do that too you know … Late last week (after our deadline) the FERC also issued an interim final rule amending the civil monetary penalties within its jurisdiction to adjust for inflation. FERC adjusted its penalties pursuant to its statutory obligation under the Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015 (the "2015 Adjustment Act"). The Act requires each federal agency to adjust for inflation each civil monetary penalty within the agency's jurisdiction by July 1, 2016, and to continue to update each penalty annually every Jan. 15. The commission explained that the interim final rule is not subject to notice and comment rulemaking because the adjustments are statutorily required and not subject to the agency's discretion. Pursuant to the methodology prescribed by the 2015 Adjustment Act, the commission, increased maximum civil monetary penalties for manipulation violations under the Federal Power Act, Natural Gas Act and Natural Gas Policy Act from $1 million to $1,193,970 per violation, per day. It also increased the other civil monetary penalties over which it has jurisdiction, including for certain Interstate Commerce Act violations that had not been updated since 1910 and other Federal Power Act violations. The commission summarized all the adjustments in a table incorporated into the interim final rule, which we separately attached to this summary. Finally, FERC also noted in the interim final rule, that the 2015 Adjustment Act directed that agencies, including the commission, shall use the civil monetary penalty applicable at the time of assessment of a civil penalty, regardless of the date that the violation occurred.

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Don't tell Bernie. The drafting committee for the Democratic Party's 2016 platform has rejected a number of proposals that seek to ban fracturing across the US, however, it also supports a hefty carbon tax as an incentive for lowering emissions. The platform also pushes the renewable energy agenda (50 percent by

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2050) and formally directs the DOJ to investigate oil and gas producers that "have reportedly misled shareholders and the public on the scientific reality of climate change." Hmm. We'll see how it all turns out – this year *Energy Metro Desk* will be on the ground covering the Democratic Convention in Philly; it should be enlightening, this platform process, post-Bernie.

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No fat-finger safe harbor. Gary DeWaal of Katten Muchin Rosenman LLP noted a recent exchange hand-slap for an unintentional power futures trade. He suggests that the exchange, NASDAQ Oslo, "appears to suggest that even negligent conduct might provide the basis for a finding of market manipulation, no matter that the conduct is concededly inadvertent." The gist: Last week the board of NASDAQ Oslo ASA published a letter of warning against J. Aron & Company for the placement of an unintentional sell instead of a buy order of an electricity futures contract by one of its traders in the exchange's order book. The board claimed that this error constituted market manipulation under its rules. According to the exchange, the trader's sell order, which it conceded was "inadvertently entered," had the impact of lowering the best asking price of the relevant futures contract. While this order was pending, said NASDAQ Oslo, the same trader apparently bought "a larger quantity" in the market outside the order book against a seller who had lowered his asking price based on the "new market valuation in the exchange order book." The trader, said NASDAQ Oslo, cancelled his unintentional sell order four seconds after placing it. NASDAQ Oslo relied on its rule prohibiting market manipulation, claiming that the trader's sell order "gave or was likely to give, false or misleading signals as to the supply for and price of a listed product" in issuing the warning letter to J. Aron. According to the exchange, "[w]hile no evidence of intention to mislead the market has been found and it is accepted that the trader did not act deliberately, it is not decisive for the application of this regulation whether misleading the market was done deliberately."

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Spoofing and Your Excellent Compliance Program.

We read an excellent piece on the GARP site this week by Cadwalader's Tony Mansfield and Jonathon Flynn on one of our favorite moving-target topics: spoofing and it's evolving definition and nature. We recommend you give this brief analysis a read and pass it around to your staff, the risk and compliance staff, the trade desk, your GC, your board, and so on. Lots more on the GARP site at www.garp.org. –the editor

Managing Commodities Risk: A Compliance Guide for the Next Wave of Spoofing Enforcement

By Anthony Mansfield and Jonathan Flynn

As we approach the sixth anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, "spoofing" – a type of disruptive trading that was specifically prohibited in the act – remains in the spotlight. Indeed, spoofing continues to generate headlines, most recently with the conviction of Michael Coscia (for alleged spoofing on the Chicago Mercantile Exchange) and the order requiring the extradition of a UK resident – Navinder Sarao – to face a combination of criminal and civil charges in the United States for alleged spoofing in the S&P 500 E-mini futures contract.

Spoofing is defined in the Commodity Exchange Act as "bidding or offering with the intent to cancel the bid or offer before execution." More broadly speaking, this type of trading is part of a new antidisruptive trading practices provision that makes it "unlawful for any person to engage in any trading, practice or conduct on or subject to the rules of a registered entity" that is "of the character of, or is commonly known to the trade as, 'spoofing.'" While spoofing is now part of the everyday vocabulary of traders and compliance professionals in the commodities and derivatives markets, that wasn't always the case. Six years ago, initial reactions to the spoofing provision focused on its ambiguity. On its face, spoofing seemed to capture a wide range of activities, including legitimate trading.

Interpretive guidance by the US Commodity Futures Trading Commission (CFTC) – along with proposed rules that were never finalized – arguably exacerbated the confusion by introducing examples of prohibited conduct that CFTC staff acknowledged could fall within or outside the statutory definition. Placing "multiple bids or offers to create an appearance of false market depth," based on highly subjective factors, is one example of such prohibited conduct.

Even with the CFTC's guidance, it was unclear how market participants could objectively determine whether such activity was legitimate, e.g., stop-loss orders used to mitigate risk, or merely an attempt "to create an appearance of false market depth." Many observers therefore argued that spoofing was impossibly vague and, as a practical matter, unenforceable.

But times have changed. There are now clear indications that spoofing cases will remain a priority for prosecutors and regulators in the United States and elsewhere. For companies and individuals trying to comply with the spoofing provisions, the focus is now shifting from interpretation of this new prohibition to implementation of effective compliance programs based on the prohibition as applied in practice.

The passage of time and progress of several prominent spoofing cases through various stages of litigation have provided a degree of perspective. In Coscia, the US Department of Justice (DOJ) distilled the statutory definition of spoofing down to a simpler formula: "bidding or offering with the intent to cancel the bid or offer before execution." This omitted the more general statutory language, i.e., the language referring to activity that "is of the character of, or is commonly known to the trade as, 'spoofing'", and the DOJ's working definition survived the defendant's vagueness arguments

Defendants and respondents, generally, continue to challenge the claim of spoofing under the CEA as unconstitutionally vague. (See, e.g., U.S. CFTC v. 3 Red Trading LLC et al., C.A. No. 15-cv - 09196 [N.D. Ill. 2016] [Docket No. 164].) However, contrary to speculation by many observers, the DOJ's approach in the Coscia case was successful with a jury. Despite the technical nature of the alleged violation, the jury convicted Coscia on all counts after just over an hour of delibera-

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tion.

Enforcement officials appear to be generally following the roadmap used in Coscia in other spoofing cases, including the CFTC's civil case against Igor Oystacher and his company – 3Red Trading – and the DOJ's criminal case against Navinder Sarao – the trader allegedly behind the 2010 "flash crash."

Based on the fact patterns that have come to light, regulators appear to be going after alleged conduct that, from their perspective, jumps off the page because the alleged spoofing involves large volume orders and repeated patterns of activity that appear to be timed to take advantage of market movements. Moreover, according to statements by senior government officials, there are enough of these types of cases to keep enforcement attorneys busy for the foreseeable future.

Spoofing has become an increasingly common cause of action for the CFTC and other financial regulators. This trend is likely to continue for several reasons:

Regulators believe that spoofing is a common practice and readily identifiable. In a recent conference focusing on enforcement trends in the financial markets, the head of the DOJ's Securities & Financial Fraud Unit expressed his view that spoofing is widespread in the commodities and derivatives markets.

The CFTC's director of enforcement has made similar statements, suggesting that spoofing is pervasive in the financial markets. Coupled with this expectation, regulators appear increasingly comfortable with where to look, what to look for and how to look for it.

Regulators are increasingly confident in their ability to prevail in spoofing cases. The Coscia conviction will likely embolden civil and criminal authorities to believe that they can withstand further legal challenge to the claim of spoofing and successfully delineate illegitimate from legitimate activity before a finder of fact.

Exchanges and regulators are enlisting companies to more actively police their employees. The Financial Industry Regulatory Authority (FINRA) recently made available to member firms supervision "report cards" that identified potential spoofing or layering in equities by (1) the firm; or (2) entities to which the firm provides market access. As FINRA made clear, the purpose in giving members access to its "sophisticated automated surveillance technology" is to augment the members' own surveillance and supervisory processes so that members can "take appropriate action to address the activity even before FINRA can complete a formal investigation."

FINRA is giving its members additional tools to combat allege spoofing, and it is reasonable to assume that the regulator expects its members to use those tools. Failure to do so could lead to charges of supervisory failures. What's more, it is possible that the National Futures Association and other exchanges will pursue a similar approach in the commodities and derivatives markets.

Whistleblowers are contributing to spoofing cases. Whistleblowers have, in fact, taken prominent roles in several recent spoofing cases, including the DOJ's case against Coscia and CFTC's case against 3Red. With whistleblower awards becoming larger and more common, it is reasonable to expect that competitors and even third-party market observers will report suspected spoofing to regulators.

Spoofing cases allow regulators to hold both individuals and companies liable. Because spoofing typically involves individual traders, spoofing cases allow regulators to hold individuals liable – an explicit priority of the DOJ. In addition to standard employer-employee liability, firms also may face charges of failure to supervise, particularly where regulators find their compliance controls and systems to be deficient.

Given the real risk that allegations of spoofing may lead to both civil and criminal penalties, traders and compliance departments should embrace an approach to spoofing that is both active and practical. The following steps offer a good start:

Accept that the legal claim of spoofing is real and serious, and is not going to fade away. Even though the concept of spoofing may continue to be ambiguous and vague, especially in certain circumstances, it will still be pursued by regulators. Traders and compliance departments should not rest their collective heads on vagueness as a defense.

Respond to the ambiguity by taking an unambiguous position on this issue. Develop written policies and procedures that establish a clear standard for traders to follow. Then, implement and support these policies and procedures with practical training and compliance support that ensures that the lines of communication between the trading floor and the compliance/legal department are open and used.

Go on the offensive to meet potential spoofing activity at its source. Consider targeted audits of trading data to identify spoofing retroactively – or implement a surveillance program to identify spoofing on a more proactive basis.

Taking these initial steps before an investigation begins provides companies with the opportunity to position themselves most effectively (and successfully) to respond to a regulatory investigation and potential enforcement action. Conversely, taking a wait-and-see approach to spoofing risks not only liability for spoofing but may lead to failure to supervise claims, should an enforcement action arise.

Anthony Mansfield is a partner at Cadwalader, a NYC-based law firm an a former senior official at the CFTC's enforcement office.

Jonathan Flynn is an associate at Cadwalader, focused on commodities, derivatives and related regulatory, compliance and litigation matters.

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File under, "Don't Hold Your Breath." Bills working their way through Congress. Last month we alerted you to a fine piece of legislative rancor that's destined to go, well, nowhere. Texas GOP Congressman Jeb Hensarling released a draft of something he calls The Financial CHOICE Act, which is aimed at largely rolling back all the complicated legal machinations and reporting drivel we all know and love about Dodd-Frank. You heard right – roll back and delete all the stuff you've dedicated your lives to be in compliance with these past seven or so years. Nobody thinks this piece of legislation will actually get off the ground, but many on the Hill view it as a likely and available source of talking points

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for election year politics. We note that the Donald has already pledged to yank Dodd-Frank up by the roots. Well, if Trump actually becomes the next president, this bill authored by Hensarling would likely be Trump's go-to Kill Dodd-Frank crib sheet. Incidentally, the CHOICE in the Financial Choice Act is all upper case for a reason – in proper DC fashion, the word is an acronym, standing for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs. Thank the gods, eh? A lot of the bill deals with clipping the wings of the CFPB, something the GOP faithful and many Democrats have been at odds with since the get-go. The draft bill (discussion draft) is in four sections. The preamble goes like this: "To create hope and opportunity for consumers, investors, and entrepreneurs by ending bailouts and Too Big to Fail, holding Washington and Wall Street accountable, eliminating red tape to increase access to capital and credit, and repealing the provisions of the Dodd-Frank act that make America less prosperous, less stable, and less free, and for other purposes … " There are a lot of Dodd-Frank details covered in these nearly 500 pages. Section 4 had some interesting stuff: "Demand accountability from financial regulators and devolve power away from Washington … Make all financial regulatory agencies subject to the REINS Act, bipartisan commissions and place them on the appropriations process so that Congress can exercise proper oversight … Impose an across-the-board requirement that all financial regulators conduct a detailed cost-benefit analysis of all proposed regulations … "Section 5 demands "accountability from Wall Street through enhanced penalties for fraud and deception … Impose enhanced penalties for financial fraud and self-dealing and promote greater transparency and accountability in the civil enforcement process … Allow the SEC to triple the monetary fines sought in both administrative and civil actions in certain cases where the penalties are tied to the defendant's illegal profits. Give the SEC new authority to impose sanctions equal to investor losses in cases involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" where the loss or risk of loss is significant, and increase the stakes for repeat offenders. Increase the maximum criminal fines for individuals and firms that engage in insider trading and other corrupt practices. All fines would be remitted to the Treasury for deficit reduction. Section 6, "Repeal sections and titles of Dodd-Frank, including the Volcker Rule, that limit capital formation." We see plenty of stuff in here that both Hillary and Donald can call their own. Give it a read, all 498 pages. Click here for the full text and an exec summary and other documents: *http://financialservices.house.gov/choice/*.

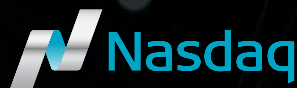
CHALLENGES

IN MONITORING ENERGY MARKETS

+ Regulatory obligations are increasingly stringent and enforcement more aggressive
+ Order Book surveillance is highly complex and requires significant resources
+ Cross-market analysis is compute-intensive and complicated by different data standards between the markets

TURN COMPLEXITY INTO CLARITY.

SMARTS Trade Surveillance for Energy



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