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WHITE PAPER

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Commodity Exchange Act: Key Decisions from 2018 and Enforcement Trends to Monitor in 2019

2018 was an interesting year for market participants subject to the Commodity Exchange Act (the “CEA”), with federal appellate courts issuing three noteworthy decisions involving claims under the CEA. The Commodity Futures Trading Commission (“CFTC”) also issued public statements in 2018 expressing new (or at least renewed) interest in insider trading and market manipulation.

This Jones Day *White Paper* reviews significant 2018 developments regarding CEA claims and identifies issues and trends to monitor in 2019.

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INTRODUCTION

2018 was an interesting year for market participants subject to the Commodity Exchange Act ("CEA"), with federal appellate courts issuing three noteworthy decisions involving claims under the CEA. The Commodity Futures Trading Commission ("CFTC") also issued public statements in 2018 expressing new (or at least renewed) interest in insider trading and market manipulation.

TRIO OF FEDERAL CIRCUIT COURT DECISIONS ALTER THE CEA LANDSCAPE IN 2018

The Territorial Reach of the CEA

In early 2018, the U.S. Court of Appeals for the Second Circuit issued a significant decision concerning claims under the CEA for commodities transactions with substantial foreign ties. In *Choi v. Tower Research Capital, LLC*, 890 F. 3d 60 (2d Cir. 2018), the Second Circuit was called upon to determine whether applying the CEA to allegedly manipulative futures transactions on a Korean derivatives and securities exchange would violate the general presumption against applying U.S. statutes extraterritorially. The plaintiffs alleged that the defendants, a high frequency trading firm and its founder, violated Section 6(c) of the CEA by engaging in hundreds of thousands of manipulative "spoofing" transactions on the "night market" of the Korea Exchange ("KRX"). This "night market" allowed market participants to place futures orders on the KRX system in Korea during overnight hours when the exchange was closed, have their orders electronically matched on the CME Globex trading platform in the United States, and then have their transactions settled and cleared on the KRX when it reopened for business the following morning.

The Second Circuit began its extraterritoriality analysis by summarizing the two-part test articulated by the U.S. Supreme Court in *Morrison v. National Australia Bank, Ltd.*, 561 U.S. 247 (2010), for determining the reach of the U.S. securities laws. In *Morrison*, the Court concluded that claims under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") could only be applied to: (i) "transactions in securities listed on domestic exchanges"; and (ii) "domestic transactions in other securities." The Second Circuit in *Choi* first noted that, in light of statutory differences between the Exchange Act and the CEA, the "domestic exchange" prong of *Morrison* might not apply to claims under the CEA. The Second Circuit then proceeded to analyze whether the alleged spoofing transactions on the KRX "night market" were properly considered "domestic transactions" under the second prong of *Morrison* and the "irrevocable liability" test previously established by the Second Circuit in *Absolute Activist Value Master Fund, Ltd. v. Ficeto*, 677 F. 3d 60 (2d Cir. 2012). In *Absolute Activist*, the Second Circuit held that a securities transaction is properly considered "domestic" if "the parties incurred irrevocable liability [for the transaction] within the United States."

In *Choi*, the Second Circuit concluded that the plaintiffs plausibly alleged that parties to futures transactions on the KRX "night market" incurred "irrevocable liability" for their transactions when their orders were matched on the CME Globex platform in the United States, rather than when they settled and cleared in Korea the following trading day. The Second Circuit, therefore, concluded that the plaintiffs' allegations were sufficient to plead the existence of "domestic transactions" under *Morrison* and denied the defendants' motion to dismiss.

The *Choi* decision was an unexpected victory for investors seeking to assert CEA claims for transactions with significant foreign ties, particularly given that: (i) the futures orders at issue in *Choi* were placed in Korea (and related to the price of a Korean stock index); (ii) the named plaintiffs were all Korean citizens; and (iii) the futures transactions at issue all settled and cleared in Korea. In reaching its conclusion that the transactions at issue in *Choi* qualified as "domestic transactions" under *Morrison*, the Second Circuit did not mention its prior decision in *Parkcentral Global HUB, Ltd. v. Porsche Automobile Holdings SE*, 763 F. 3d 198 (2d Cir. 2014). In *Parkcentral*, the Second Circuit concluded that even though the securities-based swap agreements at issue likely qualified as "domestic transactions" under *Morrison* and *Absolute Activist*, the plaintiffs' claims were nonetheless so "predominantly foreign" that the CEA could not be applied. The same result should have been obtained in *Choi*. In light of the court's failure to mention *Parkcentral* in *Choi*, there is still uncertainty in the Second Circuit about how broadly the trial courts should interpret the "domestic transactions" prong of *Morrison*, and how "foreign" a transaction must be before it qualifies as "predominantly foreign" and, therefore, outside the reach of the U.S. commodities and securities laws.

Pleading Actual Injury Under the CEA

The Second Circuit issued a second significant decision regarding the pleading requirements for claims under the CEA in *Harry v. Total Gas & Power North America, Inc.*, 889 F. 3d 104 (2018). In *Harry*, the Second Circuit was called upon to determine whether the plaintiffs adequately pled that they were injured by the defendants' alleged conduct, which involved the alleged manipulation of natural gas derivatives during the 2009 to 2012 time period. In particular, the plaintiffs alleged that the defendants manipulated the market for natural gas swaps and futures that were based on the price of natural gas traded at several regional hubs in the western United States. These derivatives were traded over-the-counter rather than on an exchange. The plaintiffs, on the other hand, only traded natural gas derivatives that were based on the price of natural gas traded at the major hub in the United States (the "Henry Hub"), and those derivatives were traded on major national exchanges. Although the plaintiffs acknowledged that they did not trade the same derivatives as the defendants, they argued that the defendants' alleged manipulation at the smaller hubs harmed them as it "reverberated through to trading at the Henry Hub."

The Second Circuit first evaluated whether the plaintiffs had adequately alleged the "injury-in-fact" element of Article III standing, which it characterized as being a "lower threshold" than the standard for pleading a substantive cause of action under the CEA. The court concluded that the plaintiffs' allegations were sufficient to make its manipulation claim "within the realm of possibility," which it determined was sufficient for Article III standing purposes. The Second Circuit then assessed whether the plaintiffs adequately pled that they suffered an "actual injury" under Section 22 of the CEA, which required facts demonstrating that their alleged injuries were "plausible, not just colorable." The Second Circuit concluded that the plaintiffs failed to meet this higher threshold, primarily because the plaintiffs traded in different natural gas derivatives than the ones that were allegedly manipulated. While the plaintiffs asserted that the defendants' alleged manipulation of derivatives based on regional hub prices resulted in distortion of the prices of derivatives based on the Henry Hub, the Second Circuit held that the plaintiffs failed to plead a plausible connection between the two markets. In reaching this conclusion, the Second Circuit relied heavily on the size disparity between the regional hubs and the Henry Hub, which made it unlikely that the alleged manipulation of derivatives based on prices at the much smaller regional hubs would have any impact on derivatives based on prices at the much larger Henry Hub.

The *Harry* decision was welcome news to parties seeking to defend market manipulation claims under the CEA, as it will make it more difficult for plaintiffs to assert attenuated claims based on derivatives that are not directly linked to the product that was allegedly manipulated. However, the *Henry* decision makes clear that the burden for pleading the actual injury element of CEA claims is not particularly high where the plaintiff traded in the product that was allegedly manipulated, so it may not meaningfully reduce the number of CEA claims that are filed in the future.

Proving Proximate Causation for Restitution Claims

The U.S. Court of Appeals for the Eleventh Circuit also issued an important decision involving CEA claims in 2018. In *U.S. Commodity Futures Trading Commission v. Southern Trust Metals, Inc.*, 894 F. 3d 1313 (11th Cir. 2018), the Eleventh Circuit addressed whether the defendants' alleged violations of the CEA proximately caused investors' losses and, therefore, permitted an award of restitution to the victims of the alleged fraud. In *Southern Trust*, the CFTC alleged that the defendants, a commodities investment firm and its CEO, engaged in two fraudulent schemes in violation of the CEA. First, the defendants accepted money from customers who wanted to invest in futures, but then indirectly invested those funds in futures through foreign brokerage firms because the defendants were not registered to engage in such trading activities themselves (the "unregistered-futures scheme"). Second, the defendants represented to other customers that their funds would be invested in precious metals, but then actually invested those funds in metals derivatives (the "metals derivatives scheme"). The district court concluded that the defendants had engaged in two fraudulent schemes and ordered them to pay restitution to the victims, but in doing so, the district court relied on a definition of proximate cause that was later rejected by the U.S. Supreme Court in *Bank of America Corp. v. City of Miami*, 137 S.Ct. 1296 (2017).

On appeal, the Eleventh Circuit analyzed the standard that should be applied for proximate causation for restitution claims under 7 U.S.C. § 13a-1(d)(3), which the court indicated had not yet been addressed by any other circuit court. The court concluded that in the absence of direction from Congress, common law rules governing proximate cause should apply to the CEA, and that under such principles, the fraud must be a "substantial" or "significant contributing cause" of the alleged losses. Applying these principles, the Eleventh Circuit concluded that the unregistered futures scheme was not the proximate cause of any investor losses because the defendants' investment strategy, rather than their failure to register as futures commission merchants, was the more likely cause of those losses. Conversely, the Eleventh Circuit concluded that the metals derivatives scheme did proximately cause investor losses because the defendants took investor funds intended for one product and invested them in an entirely different product (which the National Futures Association forced defendants to sell once the fraud was uncovered). The court also expressly rejected the defendants' argument that market fluctuations were an intervening cause of the investors' losses, concluding that such fluctuations were foreseeable and, therefore, did not break the chain of causation.

The *Southern Trust* decision is useful in that it provides some guidance regarding how the courts might apply the proximate cause requirement in 7 U.S.C. § 13a-1(d)(3) going forward. However, the Eleventh Circuit made several statements in its analysis that suggest that proximate cause determinations are fact specific and difficult to generalize. As a result, litigants will still have considerable room to argue about proximate and intervening causes in the years to come.

CASES TO WATCH IN 2019

In re: North Sea Brent Crude Oil

As explained above, the Second Circuit's failure to address the "predominantly foreign" exception it created in *Parkcentral* in the *Choi* decision left considerable uncertainty about when (if ever) that exception should apply in CEA cases. The Second Circuit will have another chance to address the territorial reach of the CEA in 2019.

In *In re: North Sea Brent Crude Oil*, 17-02233 (2d Cir., appeal filed July 17, 2017), the plaintiffs alleged that a group of Brent crude oil producers and traders conspired to manipulate the prices of Brent crude oil and Brent crude oil futures and derivatives in the 2010 to 2012 time period in violation of Sections 6(c) and 9(a) of the CEA. In particular, the plaintiffs alleged that the defendants engaged in manipulative physical trades of Brent crude oil (which is extracted from fields in the North Sea and traded in cargoes in the North Sea) and also misrepresented their physical trading activity to price reporting agencies, which allegedly distorted the prices of Brent crude oil futures and derivatives traded on the New York Mercantile Exchange ("NYMEX") and the Intercontinental Exchange ("ICE Futures Europe"). The district court concluded that even if the plaintiffs' transactions on domestic exchanges were the appropriate transactions to consider for purposes of its *Morrison* extraterritoriality analysis, dismissal was nonetheless warranted because the plaintiffs' CEA claims were "predominantly foreign" under *Parkcentral*. In reaching this conclusion, the district court relied heavily on the fact that the plaintiffs' claims were based on allegedly misleading reporting of prices to a reporting agency in London "about physical crude oil transactions conducted entirely outside the United States that indirectly affected the price of Brent futures and derivatives contracts traded on exchanges."

The district court's decision in *Brent Crude* raises at least three interesting issues that the Second Circuit may address in 2019. First, the *Choi* decision suggested that the "domestic exchange" prong of *Morrison* may not apply to claims under the CEA. The Second Circuit could resolve this issue in *Brent Crude*, which would then require the court to analyze the plaintiffs' allegations under the "domestic transaction" prong of *Morrison*. Second, it will be interesting to see which transactions the Second Circuit decides are relevant to its extraterritoriality analysis in *Brent Crude*. The plaintiffs have contended that their derivatives transactions on the NYMEX and ICE Futures Europe exchanges should be considered, whereas the defendants have argued that their allegedly manipulative transactions in the physical crude oil market in Europe are relevant. Finally, it will be interesting to see how the Second Circuit addresses the district court's reliance on the "predominantly foreign" exception in *Brent Crude*, particularly given that the Second Circuit ignored the exception entirely in *Choi*.

Briefing and oral argument before the Second Circuit were completed in 2018, so market participants should be on the lookout for the Second Circuit's decision in *Brent Crude* this year.

Stoyas v. Toshiba

While it does not address claims under the CEA, the Ninth Circuit's recent decision in *Stoyas v. Toshiba Corp.*, 896 F. 3d 933 (9th Cir. 2018), also bears mention because it could result in U.S. Supreme Court review of *Parkcentral*. In *Stoyas*, the Ninth Circuit expressly adopted the Second Circuit's irrevocable liability test for determining whether a securities transaction qualifies as a domestic transaction under *Morrison*. The Ninth Circuit then concluded that, while the plaintiffs had initially failed to adequately plead that the parties to the transactions at issue had incurred irrevocable liability in the United States, they could likely do so in an amended complaint. The court, therefore, reversed the district court's decision and granted the plaintiffs leave to replead their Exchange Act claims. In reaching this conclusion, the Ninth Circuit rejected the defendants' argument that the plaintiffs' claims should be dismissed under *Parkcentral* and stated that *Parkcentral*'s "predominantly foreign" exception was inconsistent with both the text of Section 10(b) of the Exchange Act and the intent of *Morrison*.

The defendants in *Stoyas* filed a petition for *certiorari* in the U.S. Supreme Court in October 2018, and the Supreme Court invited the solicitor general to file a brief expressing the views of the United States on January 14, 2019. If the Supreme Court grants the defendants' petition for *certiorari*, it could provide market participants with much needed clarity on the "domestic transaction" prong of *Morrison* (including for claims brought under the CEA, such as those asserted in *Brent Crude*).

CFTC ENFORCEMENT TRENDS TO WATCH IN 2019

Insider Trading

On September 28, 2018, the CFTC announced that it had formed an Insider Trading and Information Protection Task Force ("Insider Trading Task Force") charged with investigating and prosecuting, among other things, the misappropriation of confidential information, the improper disclosure of clients' trading information, front running, and the use of confidential information to unlawfully prearrange trades in markets regulated by the CFTC. On the same day this announcement was made, the CFTC filed a complaint in the U.S. District Court for the Southern District of New York against the commodities brokerage firm EOX Holdings, LLC ("EOX"), and one of its brokers, alleging that the defendants engaged in insider trading in violation of Section 6(c)(1) of the CEA and Regulation 180.1(a) promulgated thereunder. In particular, the CFTC alleged that in an effort to curry favor with a longstanding friend and customer, the broker used material, nonpublic information he learned about the trading activities of other EOX clients to trade on the customer's behalf.

These developments are significant because they appear to reflect a new area of focus for the CFTC. While the CFTC has had the authority to prosecute insider trading since the adoption of Regulation 180.1 (which is modeled after Securities and Exchange Commission Rule 10b-5), it had exercised that authority just twice prior to 2018 (and reached a consensual resolution in each prior case). The commencement of the CFTC's action against EOX and the formation of the Insider Trading Task Force suggest that the CFTC will more actively police the misuse of confidential information by commodities market participants in 2019.

Market Manipulation

On November 30, 2018, Judge Richard Sullivan, then of the Southern District of New York, determined that the CFTC had failed to prove its market manipulation and attempted market manipulation claims in a closely watched case it had filed against DRW Investments, LLC, and CEO Donald R. Wilson in 2013. *U.S. Commodity Futures Trading Commission v. Wilson*, No. 13 Civ 7884, 2018 U.S. Dist. LEXIS 207376 (S.D.N.Y. Nov. 30, 2018). In particular, Judge Sullivan concluded that while the defendants had the ability to influence the settlement price of the interest rate swap futures product at issue in the case, the CFTC had failed to prove that the defendants' conduct resulted in an "artificial" price. Judge Sullivan also noted that: "[I]t is not illegal to be smarter than your counterparties in a swap transaction, nor is it improper to understand a financial product better than the people who invented that product."

In the wake of this defeat, CFTC Chairman J. Christopher Giancarlo publicly stated that the CFTC would continue pursuing market manipulation cases and sought to limit the significance of the *Wilson* decision by noting that it was based on the pre-Dodd-Frank version of the CEA. These comments followed a forceful statement that the CFTC issued in April 2018 that indicated that "manufactured credit events" (i.e., intentionally causing a credit event on a credit default swap) could constitute market manipulation and that the CFTC would "carefully consider all available actions to help ensure market integrity and combat manipulation or fraud involving CDS…."

When read together, these public statements suggest that the *Wilson* decision will not result in a decrease in the CFTC's efforts to curtail market manipulation and that the CFTC may actually increase its focus on market manipulation in 2019 (including to target new and emerging trading and business strategies).

Spoofing

In January 2018, the CFTC announced that its newly formed Spoofing Task Force had entered into settlements with three large financial institutions accused of engaging in spoofing of precious metals futures contracts (i.e., placing buy or sell orders with the intent to cancel such orders prior to execution) that required the respondents to pay civil monetary penalties of approximately $46.6 million. The CFTC simultaneously announced that it had filed civil enforcement actions against several individuals for spoofing or attempted spoofing in violation of Section 4c(a)(5)(C) of the CEA. The CFTC entered into spoofing settlements with several additional banks and trading firms later in the year (including at least one involving "cross-market spoofing," or spoofing in one market to benefit a position in another) and issued public statements reiterating its "commitment to root out spoofing in all of its forms." These settlements and public statements demonstrate that combatting spoofing is a clear priority for the CFTC that will undoubtedly continue in 2019.

Virtual Currencies

The CFTC obtained rulings in three different enforcement actions in 2018 that virtual currencies (also commonly referred to as cryptocurrencies or digital currencies) qualify as commodities under the CEA and may be regulated by the CFTC. *See Commodity Futures Trading Commission v. McDonnell*, 332 F. Supp. 3d 641 (S.D.N.Y. 2018); *Commodity Futures Trading Commission v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492 (D. Mass. 2018); *Commodity Futures Trading Commission v. Gelfman Blueprint, Inc.*, No. 17-7181, 2018 U.S. Dist. LEXIS 205706 (S.D.N.Y. Oct. 16, 2018). The CFTC also issued several "customer advisories" regarding virtual currencies and digital tokens in 2018 and publicly stated that it intends to continue policing virtual currency markets in the future. Thus, fraud and manipulation involving virtual currencies will likely continue to be an area of enforcement focus for the CFTC in 2019.

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