

# **The Basics of Enforcement Actions and Civil Litigation Related to Derivatives**

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In Fiscal Year 2016-2017, the U.S. Commodity Futures Trading Commission (CFTC) brought 49 enforcement actions, obtained orders totaling \$444,830 in civil penalties, \$78,896,162 in restitution and disgorgement orders, and collected for the U.S. Treasury over \$265 million.<sup>1</sup> Through enforcement actions, the CFTC successfully investigated violations of the Commodity Exchange Act (CEA) ranging from retail fraud, manipulation and attempted manipulation to issues with reporting and recordkeeping.<sup>2</sup> In light of the central role that both enforcement actions and civil litigation play in protecting the integrity of the futures, options, and derivatives market, this paper will discuss: (1) how these methodologies intersect with one another, (2) the attendant risks of enforcement actions and civil litigation, and (3) prevention and mitigation strategies.

## **PART I: THE RELATIONSHIP BETWEEN ENFORCEMENT ACTIONS AND CIVIL LITIGATION**

Enforcement actions and civil litigation intersect when the CFTC brings an enforcement action against an individual or firm prior to, concurrent with, or after a private plaintiff has brought a civil lawsuit. This is possible because § 25 of the CEA provides for a private right of action against any person who violates or willfully counsels, induces, or otherwise assists another in violating any part of the Act.<sup>3</sup> The following two cases provide illustrative examples of how enforcement actions and civil litigation can work in tandem to address fraud, manipulation, and other abusive practices.

In 2008, the CFTC settled an enforcement action against the Dairy Farmers of America, Inc. (DFA) for § 9 violations of the CEA involving manipulation of cheddar cheese prices and Class III milk futures prices.<sup>4</sup> For its misconduct, the milk cooperative agreed to pay a \$12 million civil monetary penalty.<sup>5</sup> Subsequently, in December 2010, the DFA also settled for an undisclosed sum with private plaintiffs who brought a class action against them for their CEA violations.<sup>6</sup>

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<sup>1</sup> Press Release, U.S. Commodity Futures Trading Commission, CFTC Releases Annual Enforcement Results for Fiscal Year 2017 (Nov. 22, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7650-17>.

<sup>2</sup> *Id.*

<sup>3</sup> 7 U.S.C. § 25 (2012).

<sup>4</sup> See SUSAN ERVIN ET AL., CIVIL LITIGATION DEVELOPMENTS: CLASS ACTIONS ALLEGING MANIPULATION 2 (2013).

<sup>5</sup> Press Release, U.S. Commodity Futures Trading Commission, Dairy Farmers of America (DFA) and Two Former Executives to Pay \$12 Million Penalty to Settle CFTC Charges of Attempted Manipulation and Speculative Position Limit Violations (Dec. 16, 2008), <http://www.cftc.gov/PressRoom/PressReleases/pr5584-08>.

<sup>6</sup> See *Anderson v. Dairy Farmers of American, Inc.*, No. 08-4726, (D. Minn. Dec. 8, 2010).

In 2018, the CFTC ordered Deutsche Bank to pay \$70 million after bringing an enforcement action against the banking company for “mak[ing] false reports and through the acts of multiple traders attempt[ing] to manipulate the U.S. Dollar International Swaps and Derivatives Association Fix (USD ISDAFIX), a leading global benchmark referenced in a range of interest rate products, to benefit its derivatives positions [. . .].”<sup>7</sup> The CFTC’s order followed Deutsche Bank’s 2017 agreement to pay \$190 million to settle a class action suit arising from its role in the manipulation of benchmark interest rates.<sup>8</sup>

The civil monetary penalties assessed against the DFA and Deutsche Bank and the millions that both entities paid to settle class action suits demonstrates how enforcement actions and civil litigation can work together to deter market misconduct and promote accountability. On the significance of civil litigation with respect to the CFTC’s responsibilities, former Chairman of the CFTC, Timothy Massad, has stated that private rights of action “augment the limited enforcement resources of the CFTC, and serve[s] the public interest by allowing harmed parties to seek damages in instances where the Commission lacks the resources to do so on their behalf.”<sup>9</sup> According to Massad, private rights of action are an “instrumental” means of deterring CEA violations.<sup>10</sup>

## **PART II: CIRCUMSTANCES WHICH PRESENT THE GREATEST LITIGATION RISKS**

There are litigation risks for both plaintiffs alleging manipulation claims under the CEA and for the defendant individuals and firms in these cases. Defendants should be aware that cases where plaintiffs are able to obtain class certification and “demonstrate the defendant’s intent to manipulate the markets,” usually result in a settlement.<sup>11</sup> Conversely, for plaintiffs, there are also significant litigation risks in bringing manipulation or attempted manipulation claims. Sufficiently pleading facts to demonstrate “specific intent” under the CEA is a challenging legal hurdle. In large part, this is because plaintiffs must be able to show that the alleged violator exercised adequate control over the market to manipulate *and* that changes in market prices are traceable to the defendant’s actions.<sup>12</sup> Consequently, defendant individuals and firms may face significant litigation risks when they are named as a defendant in a civil suit after or concurrent to being investigated by the CFTC. In cases where a CFTC investigation or settlement include the finding that a defendant intended and succeeded in price manipulation, it is exponentially easier for plaintiffs to sufficiently draft their complaint.<sup>13</sup>

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<sup>7</sup> Press Release, U.S. Commodity Futures Trading Commission, Dairy Farmers of America (DFA) and Two Former Executives to Pay \$12 Million Penalty to Settle CFTC Charges of Attempted Manipulation and Speculative Position Limit Violations (Dec. 16, 2008), <http://www.cftc.gov/PressRoom/PressReleases/pr7692-18>.

<sup>8</sup> B. Colby Hamilton, Deutsche Bank Agrees to \$190M Preliminary Settlement in Foreign Exchange Suit, N.Y. L. J. (Sept. 29, 2017, 4:06 PM), <https://www.law.com/newyorklawjournal/almID/1202799318505/Deutsche-Bank-Agrees-to-190M-Preliminary-Settlement-in-Foreign-Exchange-Suit/>.

<sup>9</sup> Timothy Massad, Chairman, U.S. COMMODITY FUTURES TRADING COMM’N, Statement of Chairman Timothy Massad in Support of the Proposed Amendment to the RTO-ISO Order (May 10, 2016).

<sup>10</sup> *Id.*

<sup>11</sup> ERVIN, *supra* note 4, at 16.

<sup>12</sup> LOUIS F. BURKE ET AL., CIVIL LITIGATION DEVELOPMENTS: CLASS ACTIONS ALLEGING MANIPULATION 11 (2011).

<sup>13</sup> Mark D. Young et al., Southern District Decision Highlights Challenges for Private Litigants Pursuing Manipulation Claims Under the CEA, SKADDEN (Apr. 19, 2017),

Looking forward, predicted areas of increased CFTC regulatory scrutiny and litigation risk in 2018 include: virtual currencies and spoofing.<sup>14</sup> The value and popularity of the virtual currency bitcoin has soared in recent years. Virtual currencies “pose high risks in terms of price volatility, platform instability, and cyber-threats,” and prompt regulatory oversight when these currencies are used in a contract involving derivatives, or when there is alleged fraudulent conduct impacting interstate commerce.<sup>15</sup> Comments from Christopher Giancarlo, Chairman of the CFTC, during testimony to the Senate Banking Committee suggest plans to increase regulatory oversight over cryptocurrency exchanges.<sup>16</sup>

Spoofing refers to market manipulation through the use of “complex computer algorithms that rapidly display and then cancel bids or orders so that the spoofer may advantageously buy low and sell high, or vice versa.”<sup>17</sup> The CFTC’s heavy investment in anti-spoofing surveillance technology indicates that there will be vigorous investigation of this form of market manipulation in the coming years. New surveillance technology allows the CFTC to utilize “big data” to “analyze billions of market transactions in a fraction of the time necessary under older systems.”<sup>18</sup>

### **PART III: ENFORCEMENT ACTIONS – PREVENTION AND MITIGATION STRATEGIES, RISKS, AND INTERNAL INVESTIGATIONS**

#### **A. PREVENTION AND MITIGATION STRATEGIES**

The two major strategies for mitigating or preventing an enforcement action are cooperation and self-reporting, respectively.

On January 19, 2017, the CFTC Division of Enforcement (“the Division”) issued an Enforcement Advisory detailing the Commission’s policy on cooperation.<sup>19</sup> To maximize transparency, the Division outlined the following criteria to be considered in determining the credit and weight that will be afforded for a company or individual’s cooperation:<sup>20</sup>

- “the value of the cooperation to the Division’s investigation(s) and enforcement action(s);
- the value of the cooperation to the Commission’s broader law enforcement interests;
- the culpability of the company or individual and other relevant factors; and
- uncooperative conduct that offsets or limits credit that the company or individual would otherwise receive.”<sup>21</sup>

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<sup>14</sup> See Zach Brez, *CFTC 2018 Enforcement: Where the Puck is Going*, N. Y. L. J. (Jan. 29, 2018, 3:56 PM), <https://www.law.com/newyorklawjournal/sites/newyorklawjournal/2018/01/26/cftc-2018-enforcement-where-the-puck-is-going/?sreturn=20180203231319>.

<sup>15</sup> *Id.*

<sup>16</sup> Michelle Price & Pete Schroeder, *U.S. Regulators to Back More Oversight of Virtual Currencies*, REUTERS (Feb. 5, 2018, 1:04 PM), <https://www.reuters.com/article/us-global-bitcoin-congress/u-s-regulators-to-back-more-oversight-of-virtual-currencies-idUSKBN1FP2FJ>.

<sup>17</sup> Brez, *supra* note 14.

<sup>18</sup> *Id.*

<sup>19</sup> Press Release, U.S. Commodity Futures Trading Commission, CFTC’s Enforcement Division Issues New Advisories on Cooperation (Jan. 19, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7518-17>.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

Ultimately, the CFTC’s decision of whether to bring an enforcement action and the nature of the charges and penalties or sanctions sought will depend on the quality and value of the cooperation.<sup>22</sup> In September 2017, the CFTC updated the January 2017 Enforcement Advisory to provide supplementary information on the Division’s policy for self-reporting.<sup>23</sup>

In the updated Advisory, the Division placed a heavy emphasis on voluntary compliance. Specifically, the Division stated that they would recommend a substantial reduction in civil monetary penalties for any individual or company that “self-reports, fully cooperates, and remediates.”<sup>24</sup> The Division specified that determinations of credit for self-reporting and cooperation will be guided by the following factors:<sup>25</sup>

- Timeliness of the disclosure
- The nature of the disclosure and whether the disclosure reflects all relevant facts known by the reporting party
- Disclosure of information prior to imminent threat of exposure emerged

Commenting on the updated Advisory, Director of the Division, James McDonald, stated that self-reporting and full cooperation could result in an approximately 50 to 75 percent reduction in penalties.<sup>26</sup> McDonald also explained that “[e]ntities that are true self-reporters will be treated as belonging to a different category from entities that cooperate only after being approached by the Division.”<sup>27</sup> Important to note, however, is that self-reporting and full cooperation credit will only affect the amount of the penalty reduction; companies and individuals will still be required to pay restitution and disgorge illicitly obtained profits.<sup>28</sup>

## **B. RISKS OF ENFORCEMENT ACTIONS**

Although cooperation represents one of the primary strategies for mitigation, the choice to cooperate with the CFTC is a weighty decision. One risk companies and individuals under investigation must keep in mind is the flow of information between civil and criminal authorities such as the Department of Justice.<sup>29</sup> On the partnership between civil and criminal authorities, former Chair of the U.S. Securities and Exchange Commission, Mary Jo White, remarked “And my message today is that a robust combination of criminal and regulatory enforcement of the securities laws is not only appropriate, but also critical to deterring securities violators, punishing

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<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> COMMODITY FUTURES TRADING COMM’N, DIV. OF ENFORCEMENT, UPDATED ADVISORY ON SELF REPORTING AND FULL COOPERATION (2017).

<sup>25</sup> *Id.*

<sup>26</sup> Jennifer L. Achilles & Michael Selig, The CFTC’s New Policy on Self-Reporting and Cooperation, REED SMITH (Oct. 9, 2017), <https://www.reedsmith.com/en/perspectives/2017/10/the-cftcs-new-policy-on-self-reporting-and-cooperation>.

<sup>27</sup> David Meister et al., CFTC’s Enforcement Division Announces New Focus on Self-Reporting, SKADDEN (Oct. 4, 2017), <https://www.skadden.com/insights/publications/2017/10/cftcs-enforcement-division-announces-new-focus>.

<sup>28</sup> Douglas Yatter et al, *CFTC Self-Reporting Policy Leaves Open Several Questions*, LAW360 (Oct. 5, 2017, 6:25 PM), <https://www.law360.com/articles/966575/cftc-self-reporting-policy-leaves-open-several-questions>.

<sup>29</sup> See David I. Miller & Peter K.M. Chan, Defending Parallel Securities and Commodities Actions, MORGAN LEWIS (Feb. 6, 2016), <https://www.morganlewis.com/pubs/defending-parallel-securities-and-commodities-actions> (“[W]here a potential defendant has been contacted by criminal but not civil authorities—or vice versa—it should be assumed that both sides are pursuing and exchanging leads.”).

misconduct, and protecting investors.”<sup>30</sup> Moreover, in submitting requested documents, individuals and firms must consider how to protect commercially sensitive information, and whether significant redaction will impact the CFTC’s allocation of cooperation credit.<sup>31</sup>

The CFTC’s extensive jurisdictional reach presents another enforcement risk.<sup>32</sup> Under the CEA, the CFTC’s enforcement powers cover regulation of virtually all commodities and futures trading activities, ranging from those involving physical commodities to virtual currency derivatives. The CEA, however, does not provide a definition for “futures contract,” and the definition of “swap” has been criticized as “very broadly defined.”<sup>33</sup> Due to ambiguities with respect to definitions in the CEA and the broad jurisdiction of the CFTC, individuals and firms must always consider whether the business they are conducting involves derivative instruments or has “characteristics of a derivative instrument.”<sup>34</sup> Individuals and firms outside of the United States should also exercise caution as the CFTC’s jurisdiction is not limited to activities that occur inside the country. The CFTC’s enforcement powers extend, *inter alia*, to transactions that “have a direct and significant connection with activities in, or effect on, commerce of the United States.”<sup>35</sup>

### C. THE ROLE OF INTERNAL INVESTIGATIONS

To ensure and promote regulatory compliance, futures commission merchants must establish and implement a comprehensive risk management program. § 1.11 of the CEA requires futures commission merchants to “establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the futures commission merchant.”<sup>36</sup> At a minimum, the risk management program implemented must include the following principle components:<sup>37</sup>

- Procedures for the identification of risks and establishment of risk tolerance limits;
- Creation of periodic risk exposure reports, and delivery to upper management;
- Operational risk controls;
- Capital controls; and
- Policies and procedures for the safekeeping and separation of customer funds

Irrespective of whether the CFTC has initiated an investigation, firms and individuals must be prepared and able to conduct thorough internal investigations. The ability to earn self-reporting and full cooperation credit is heavily dependent on the individual or company’s timely detection of CEA violations and noncompliance with CFTC regulations.

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<sup>30</sup> Mary Jo White, Chair, U.S. Sec. & Exchange Comm’n, All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets (Mar. 31, 2014).

<sup>31</sup> Paul Pantano Jr. et al., CFTC Cooperation Advisories Prescribe High Burdens – Has the Expectation of Above-and-Beyond Cooperation Across Federal Agencies Reached Its Apex?, WILLKIE FAR & GALLAGHER (Mar. 15, 2017), [http://www.willkie.com/~media/Files/Publications/2017/03/CFTC\\_Cooperation\\_Advisories\\_Prescribe\\_High\\_Burdens.pdf](http://www.willkie.com/~media/Files/Publications/2017/03/CFTC_Cooperation_Advisories_Prescribe_High_Burdens.pdf).

<sup>32</sup> See Geoffrey F. Aronow, Enforcement Risk: The Long Length of the CFTC’s Reach, 19 N.Y. BUS. L. J. 41 (2015).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*; 7 U.S.C. § 2(i) (2012).

<sup>36</sup> 17 C.F.R. § 1.11 (2013).

<sup>37</sup> *Id.*

In 2016, the CFTC launched an updated website for their Whistleblower Program, which rewards persons who report CEA violations if the tip results in a successful enforcement action and over \$1 million in monetary sanctions.<sup>38</sup> Upon satisfying this requirement, qualifying persons may receive between 10 and 30 percent of the resulting monetary sanctions ordered.<sup>39</sup> Consequently, companies which lack proactive risk management and internal investigative capabilities jeopardize their ability to detect violations and self-report before a whistleblower notifies the CFTC. On March 28, 2016, the CFTC awarded over \$10 million to a whistleblower whose information led to a successful enforcement action.<sup>40</sup> The identity of the whistleblower along with the subject of the enforcement action were kept confidential. In 2017, the CFTC received over 465 reports from purported whistleblowers.<sup>41</sup> The CFTC expects payouts resulting from those tips to total approximately \$45 million.<sup>42</sup>

After the CFTC initiates an investigation, internal assessments become crucial for both developing defense strategies and deciding if and to what extent a company should cooperate.<sup>43</sup> For one, conducting an internal fact-finding inquiry will assist an individual or firm in determining the scope of the Division's investigation. If allegations implicate senior management officials, firms must be able to ensure an independent investigation.<sup>44</sup> Ultimately, an effective internal investigation will help a firm weigh the risks and benefits of self-reporting and cooperation. And, consequently, if a firm or individual does choose to cooperate, not only does the CFTC require self-reporters to conduct an internal investigation for full cooperation credit,<sup>45</sup> but an internal investigation will also increase the firm's chances of being able to provide "material assistance to the CFTC."<sup>46</sup>

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<sup>38</sup> See Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Launches Whistleblower Program's Website (Jan. 21, 2016), <http://www.cftc.gov/PressRoom/PressReleases/pr7312-16>.

<sup>39</sup> *Id.*

<sup>40</sup> See Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Announces Whistleblower Award of More Than \$10 Million (Apr. 4, 2016), <http://www.cftc.gov/PressRoom/PressReleases/pr7351-16> (Director of the Whistleblower Office, Christopher Ehrman, commented "The Whistleblower Program is working. My hope is that this multimillion dollar award will encourage others to come forward with information that will assist the Commission in protecting our markets.").

<sup>41</sup> Aaron Jordan, CFTC Expanding Whistleblower Program, WHISTLEBLOWERSPROTECTIONBLOG (Dec. 4, 2017), <https://www.whistleblowersblog.org/2017/12/articles/corporate-whistleblowers/cftc-expanding-whistleblower-program/>.

<sup>42</sup> *Id.*

<sup>43</sup> Mary Hansen et al., CFTC Enforcement: Best Practices and Recent Developments, 50 REV. SEC. & COMMODITIES REG. 251 (2017).

<sup>44</sup> *Id.* at 254.

<sup>45</sup> Meister et al., *supra* note 27.

<sup>46</sup> See Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Enters into Non-Prosecution Agreements with Former Citigroup Global Markets Inc. Traders Jeremy Lao, Daniel Liao, and Shlomo Salant (June 29, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7581-17> (citing timeliness of cooperation, willingness to accept responsibility, absence of prior misconduct, and material assistance as central factors considered by the CFTC).