

# Morgan Lewis

## JANUARY 2017 TRADING AND MARKETS ENFORCEMENT REPORT



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## Trading and Markets Enforcement Report

**January 2017**

The last several years have seen law enforcement and regulatory bodies sharpen their focus on trading activity in the securities and derivatives markets. This focus has coincided with the advent of new and expanded reporting, surveillance, and enforcement powers that arose from responses to the financial crisis. Prosecutors and regulators are using those powers daily to enforce both newer and long-standing restrictions on trading activity.

New developments and precedents emerge nearly every day, and the key events merit full attention in the design of trading strategies, the implementation of compliance and supervision programs, and—when necessary—the development of legal defenses. The following report serves as a practical guide intended to keep asset managers, broker-dealers, and other trading firms current on important legal developments in this area.

### **INSIDER TRADING**

#### **The Supreme Court Weighs in on Insider Trading: *United States v. Salman***

For the first time in nearly 20 years, the US Supreme Court has weighed in on insider trading law and handed a victory to the government and its insider trading enforcement efforts. The *Salman* decision is very significant and resolves confusion that had been generated by the Second Circuit Court of Appeal's decision in *United States v. Newman*. Please see our firm's linked article to understand the import of the case and its potential effects in this area of trading enforcement: <https://www.morganlewis.com/pubs/the-salman-decision-the-supreme-court-weighs-in-on-insider-trading>.

#### **Jury Trial Held in Father-Son Insider Trading Case**

Following the Second Circuit's decision in *Newman*, which has made it harder for the government to prosecute tippees for insider trading (as discussed above), there had been some question as to whether the Southern District of New York's (SDNY's) insider trading dragnet was at an end. But a jury's recent conviction in a Southern District court after a hard-fought trial has shown that insider trading prosecutions are alive and well.

On August 17, 2016, following a two-week trial and six days of deliberation, an SDNY jury found Sean Stewart, a former investment banker at Perella Weinberg Partners LP, guilty on all nine counts, including securities fraud and conspiracy to commit securities fraud, based on the defendant's tipping of inside information to his father, Bob Stewart, an accountant. Prosecutors had argued at trial that Sean Stewart learned about several healthcare industry mergers from 2011 to 2014 as an employee of multiple financial services organizations and that he tipped his father to news of the mergers. Stewart testified in his own defense, arguing that he never intended for his father to trade on the tips and that Stewart senior "betrayed" him by doing so.

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Jurors heard from two prosecution witnesses who had traded on tips received from Bob Stewart, including Stewart's former friend Richard Cunniffe, who recorded meetings and a telephone call with Bob Stewart after agreeing to cooperate with federal authorities. In one meeting recorded at a midtown Manhattan coffee shop, Stewart senior allegedly recounted to Cunniffe a conversation in which Sean told his father: "I handed you this on a silver platter, and you didn't invest in this." Both Stewart senior and Cunniffe pleaded guilty, with Stewart senior sentenced to four years' probation, with the first year to be served in home detention, and \$150,000 in forfeiture.

Sean Stewart is scheduled to be sentenced in early 2017.

## **SIGNIFICANT REGULATORY DEVELOPMENTS**

### **Automated Trading Systems Under Scrutiny**

In November 2015, the CFTC proposed "Regulation Automated Trading," which encompasses risk controls, transparency measures, and other safeguards relating to automated trading on US designated contract markets. The CFTC's proposal underscores the focus that regulators across various asset classes have placed on automated trading activity and the firms and their personnel that are involved in such activity. More recently, the CFTC published for public comment a supplemental proposal to pending Regulation Automated Trading. The comment period will be for 60 days following publication of the supplemental proposal in the *Federal Register*.

One of the changes in the supplemental proposal relates to "Algorithmic Trading Source Code." Under the original CFTC proposal, "AT Persons" would be required to maintain a record of the source code and make the source code available to the CFTC upon request, without a subpoena. The supplemental proposal would grant the CFTC access to the Algorithmic Trading Source Code pursuant to a subpoena or a "special call" approved by the CFTC Commissioners.

The source code is extremely valuable and sensitive, and requiring access by the CFTC without a subpoena has elicited significant pushback from industry participants. CFTC Commissioner Giancarlo is in favor of requiring a subpoena to gain access to the source code, at a minimum because of the due process afforded to the source code owners. However, several recent actions discussed below underscore the CFTC's interest in accessing the source code quickly and without the need to seek a subpoena. Most notably are circumstances where automated trading systems (ATSs) produce unintended results that impact the markets (see, e.g., CME and CBOT settlements discussed below) or when intentional manipulation wreaks havoc as a result of the interconnected environment in which our markets operate (see, e.g., discussion below of CFTC proposed consent order regarding price manipulation and spoofing action against UK resident relating to the May 6, 2010 Flash Crash).



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## **ICE and CME Loosen Rules on Prehedging for Block Trades**

In late October and early November, the Intercontinental Exchange (ICE) and the Chicago Mercantile Exchange (CME) eliminated restrictions on prehedging or anticipatory hedging of block trades, except where an intermediary takes the opposite side of its own customer order. Parties to a potential block trade may now engage in prehedging or anticipatory hedging of the position that they believe in good faith will result from the consummation of the block trade. This development should allow intermediaries to better hedge against volatility between the time when the block trade is arranged and when it is formally executed.

Both ICE and CME cautioned intermediaries that prehedging suggestive of deceptive or manipulative conduct is subject to enforcement action, including where an intermediary handling a customer order acts against its customer's best interests. Both markets will continue to be on the lookout for signs of potential front-running of another person's block orders when acting on material nonpublic information regarding an impending transaction by another person obtained through a confidential employee/employer relationship or broker/customer relationship, or in breach of a preexisting duty to such person.

## **Swap Execution Facilities (SEFs) Adopt New Rule Prohibiting Disruptive Practices**

Several SEFs adopted new rules in recent months to explicitly prohibit disruptive practices such as spoofing, layering, and wash sales. These new rules are in response to the CFTC's call to action for all registered SEFs to adopt such prohibitions. For example, new CME SEF Rule 575 requires all orders to be entered for executing bona fide transactions and all non-actionable messages must be entered in good faith for legitimate purposes. ICAP, TW, and Javelin SEFs adopted similar rules. These new rules arrived on the heels of similar rules enacted in the equities markets, including on BATS and NASDAQ, each of which adopted rules earlier this year to prohibit disruptive quoting and trading activity.

### **WHAT IS A SEF?**

*An SEF is a facility for the trading of swaps. SEFs are required to register with the CFTC, and provide an order book functionality as well as alternative means of order execution, such as through RFQ or block trade mechanisms. SEFs are intended to contribute to pretrade price transparency for swaps.*

## **CME Amends EFRP Rules and Guidance**

Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), New York Mercantile Exchange (NYMEX), and Commodity Exchange, Inc. (COMEX) issued an Advisory Notice in early October describing several amendments to Rule 538 and related guidance on Exchange for Related Positions (EFRPs). The changes to Rule 538 and related guidance include:

- Allowing a non-transitory EFRP to contain multiple Exchange components, eliminating the requirement that such Exchange components have the same market bias, although the execution of transitory EFRPs in any products continues to be prohibited;

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- Allowing a third party to facilitate, as principal, the related position component of an EFRP, eliminating the requirement that such parties be member firms;
- Modifying the requirements with respect to commodity trading advisors or other account controllers, facilitating immediately offsetting foreign currency Exchange of Futures for Physical;
- Clarifying the responsibility of firms executing or clearing EFRPs on behalf of customers;
- Clarifying that the related position component of an Exchange of Option for Option must be an over-the-counter (OTC) option;
- Modifying submission time requirements for EFRPs to CME Clearing;
- Clarifying that all underlying account statements are required to uniquely identify EFRP transactions;
- Clarifying that the facilitation of the execution of a non-bona fide EFRP by any party constitutes a violation of the Rule; and
- Eliminating the use of summary fines under Rule 512 for failure to provide requested records to Market Regulation in a complete and timely manner.

## WHAT IS AN EFRP?

*EFRPs are an exception from the requirement under the Commodity Exchange Act (CEA) and CFTC rules that all futures contracts be executed competitively. EFRPs are privately negotiated futures transactions, executed subject to the rules of a futures exchange, and include:*

- **Exchange for Physical (EFP)** – An exchange of a position in the underlying physical instrument for a corresponding futures position.
- **Exchange for Risk (EFR)** – An exchange of a position in an OTC swap or other OTC derivative in the same or related instrument for a position in the corresponding futures contract.
- **Exchange of Options for Options (EOO)** – An exchange of a position in an OTC option (or other OTC contract with similar characteristics) in the same or related instrument for an option position.

## **CFTC Signs Memorandum of Understanding with UK Regulator**

The CFTC announced in October that Chairman Timothy Massad and the Chief Executive of the UK Financial Conduct Authority (FCA), Andrew Bailey, had signed a Memorandum of Understanding (MOU) stating the regulators' intent to "consult, cooperate and exchange information" in connection with the supervision and oversight of certain firms operating on a cross-border basis in the United States and United Kingdom. The MOU covers firms that are both registered as either swap dealers or major swap participants with the CFTC and authorized and regulated by the FCA under UK and EU law, which includes 20 CFTC-registered swap dealers. The MOU is intended to complement but not alter existing MOUs between the CFTC and other domestic and foreign regulators, and includes procedures for coordinating event-based notifications, request-based information sharing, periodic meetings, execution of requests for information, and on-site visits to covered firms. Permissible uses for information obtained and related confidentiality provisions are outlined as well.

## **RECENT GOVERNMENT LITIGATION & ENFORCEMENT ACTIVITY**

### **Continued Scrutiny of Spoofing, Layering, Wash Trades, and Prearranged Trades**

As discussed in our previous Report, regulators have continued to crack down on market manipulation schemes such as spoofing, layering, wash trades, and prearranged trades. CME has been particularly vigilant in the fight against these practices and has disciplined several traders and firms in recent months. In many instances, CME alleged that traders entered large two-sided or layered orders to create the appearance of liquidity imbalance to obtain favorable executions of the smaller orders they entered. CME concluded that this activity violated CME Rules in particular, inconsistent with just and equitable principles of trade (CME Rule 432.B.2) and detrimental to the interest or welfare of the CME (CME Rule 432.Q), and constituted dishonorable and uncommercial conduct (CME Rule 432.T). The settlements resulted in disgorgement and fines against traders and firms (strict liability of firms for the actions of its agents—the traders) ranging from \$45,000 to \$90,000 and temporary bans for traders ranging from 14 days to 60 days.

Related to wash trades, CME alleged that traders entered into matching buy and sell orders, for accounts with common beneficial ownership on both sides of the market, to avoid taking a bona fide market position or incurring any exposure to market risk. According to CME, this activity artificially increased trading volume and gave the false impression of demand, which is expressly prohibited by CME Rule 534. CME imposed fines for this activity ranging from \$10,000 to \$55,000 and temporarily banned traders for up to 10 days.

In September, FINRA settled a matter with an NYSE Arca agency-based equities trading firm for failure to have appropriate systems in place to detect and prevent potential wash trades. The firm consented to a censure and penalty of \$22,500. Under NYSE Arca Equities rules, a firm may be liable for the actions of its traders in violation of the wash trade prohibition and for the failure to adequately monitor, detect, and prevent potential wash trades.

In September, ICE Futures US disciplined and permanently barred two traders who engaged in prearranged transactions for the purpose of transferring funds between their accounts. ICE Futures US considered this activity inconsistent with just and equitable principles of trade and detrimental to the best interests of the exchange (ICE Rule 404). It permanently barred the traders and levied fines of \$25,000 and \$100,000.

### **SEC Denies Request for Review of ALJ's Refusal to Change Hearing Dates in Antifraud Proceeding Against Defendant and Private Equity Firm**

On August 24, 2016, the SEC denied a request by Lynn Tilton, the embattled head of private equity firm Patriarch Partners, for a review of a decision by the administrative law judge (ALJ), denying Tilton and Patriarch's request to change the hearing date in ongoing antifraud proceedings against them. Noting that the proper application of the operative rule was best left to the ALJ, the SEC's Division of Enforcement determined that the ALJ's rulings "are not appropriate for immediate commission review."

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The SEC commenced administrative proceedings against Tilton and Patriarch in March 2015, alleging that Tilton and Patriarch violated the antifraud provisions of the Investment Advisers Act of 1940. The SEC alleged that Tilton and Patriarch concealed their investments' shoddy performance by bucking the valuation methodology outlined in documents sent to the firm's investors. Those tactics enabled Tilton and Patriarch to wrongly pocket \$200 million in management fees and retain control over their funds' operations.

Tilton subsequently brought a civil action, in which she asserted that the presiding ALJ's appointment violated the appointments clause of the US Constitution. The US District Court for the Southern District of New York refused to hear Tilton's constitutional challenge, and a divided panel of the US Court of Appeals for the Second Circuit affirmed the district court's ruling, holding that such constitutional challenges must await the conclusion of the SEC's fraud case. The majority also made clear that Tilton could raise her constitutional challenges at that time in the SEC's in-house court, and file an appeal thereafter, if necessary.

The Second Circuit's decision blesses the SEC's in-house administrative proceedings, bolstering the agency's effort to pursue perceived violations in its "home court" forum, rather than in federal court. The decision also reflects courts' continued willingness to defer to in-house proceedings for initial review of ALJ decisions.

The three-week trial against Tilton and Patriarch concluded in November, post-trial briefs are due in January 2017, and a decision is expected in early 2017.

## **"Spoofing Statute" Survives Constitutional Challenge**

In August 2016, a federal district court rejected several constitutional challenges to the anti-spoofing provisions of the Commodity Exchange Act (CEA), enabling the CFTC's suit against high-speed trading firm 3Red Trading, LLC and its principal, Igor Oystacher, to proceed.

The CFTC charged Oystacher and 3Red Trading with "spoofing"—that is, manipulating the market by placing and rapidly cancelling large orders, just before placing and filling smaller orders on the other side of the market after it moved in Oystacher's favor. The scheme allegedly lasted for four years.

The CEA's anti-spoofing provisions prohibit trading that "is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before the execution)." 7 U.S.C. § 6c(a)(5)(C). The court rejected Oystacher's contention that the statute was void for vagueness, reasoning that economic regulations are subject to a "less stringent" void-for-vagueness standard, and that the applicable scienter requirement effectively narrowed the statute's scope and constrained prosecutorial discretion.

The court separately rejected Oystacher's argument that the spoofing statute effected an unconstitutional delegation of power to the CFTC and federal courts. In the court's view, Congress's delegation of authority passed constitutional muster because it clearly delineated the operative policy, the agency to apply it, and the bounds of the authority delegated to the CFTC and the courts.



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The court also rebuffed Oystacher's challenge to the constitutionality of CFTC Regulation 180.1, which prohibits using "any manipulative device, scheme, or artifice to defraud." The court rejected, once more, Oystacher's contention that Regulation 180.1 was unconstitutionally vague, in light of the statute's scienter requirement, its clear proscription of manipulative schemes, and its likeness with Rule 10b-5 of the Securities Exchange Act of 1934, whose constitutionality has been upheld.

In October 2016, the parties reached a settlement in principle on the government's suit against Oystacher and 3Red Trading. The terms of the settlement are not yet public.

## **CFTC Takes Action Against Futures Commission Merchant for Alleged Failures in the Firm's Risk Management Program**

In September, the CFTC issued an order settling charges against a registered futures commission merchant (FCM), for allegedly failing to supervise the handling of certain commodity interest accounts after three exchanges raised questions with the FCM relating to potentially disruptive trading engaged in by the customer, risk management failures, and making inaccurate statements through the submission of required risk manuals and the Annual Chief Compliance Officer's Report. The order, in which the FCM neither admitted nor denied the allegations, required the FCM, its chief executive officer, and its chief risk officer to jointly and severally pay a \$1.5 million penalty while further undertaking to improve the implementation of its risk management policies.

Notably, this was the CFTC's first action enforcing CFTC Regulations 1.11 and 1.73 (relating to FCM risk management programs and obligations), and the order suggests an increased regulatory scrutiny of not only the existence of required written policies and procedures, but an entity's adherence to them. This order also stresses the need for registrants to attend to "Red Flags" regarding client activities, and makes clear that the failure to follow established policies and procedures can be interpreted by the CFTC as a "misrepresentation" inasmuch as a firm has represented that such policies were in place and followed in its required filings.

## **NFA Takes Action Against Non-US Asset Manager for Alleged Failures in Disclosure and Handling of Client Assets**

In November, the National Futures Association (NFA) issued a decision settling charges against a non-US-based commodity pool operator and commodity trading advisor member firm. The decision followed a complaint alleging that the firm commingled offshore pool funds, distributed statements that contained errors, failed to receive funds in the name of the pool, failed to disclose the amount of all fees charged, and failed to fully supervise all of its operations in violation of NFA Compliance Rules 2-13, 2-29(b)(2), and 2-9(a).

Without admitting or denying the allegations, the firm agreed to pay a fine of \$60,000—exactly double the amount that the firm agreed to pay two years earlier to settle allegations that it had failed to timely file certain reports. This matter indicates that NFA is actively examining foreign-based member firms, and expects them to abide by NFA rules even with respect to offshore

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funds that are operated in compliance with foreign regulatory requirements. It also indicates that NFA will apply escalating fines for firms that have previously incurred a regulatory infraction. The decision acknowledged the firm's cooperation during the examination process and the steps taken to address the allegations, reaffirming the importance of prompt and complete cooperation in response to an NFA complaint.

## ***CFTC v. Wilson***

In September, the SDNY rejected the Commission's summary judgment argument that attempted manipulation under Sections 6(c) and 9(a)(2) of the Commodity Exchange Act (CEA) can be established by merely proving the "intent to affect market prices." Rather, the court held that "the CFTC must prove that Defendants had the specific intent to affect market prices that 'did not reflect the legitimate forces of supply and demand,'" concluding that "there is 'no manipulation without intent to cause artificial prices.'"

Notably, the foregoing holding was based on the pre-Dodd-Frank language of the CEA, and it remains unclear what impact this ruling will have—if any—on future interpretations of the current standard. As a general matter, however, the *Wilson* ruling marks at least a minor setback in the Commission's ongoing efforts to lower the standard for proving price manipulation.

## ***In the Matter of Jon P. Ruggles***

On September 29, 2016, the CFTC settled proceedings against a Delta Airlines employee alleged to have used material, nonpublic information regarding his trading on behalf of that company for a personal account in his wife's name. Specifically, the Commission alleged that Jon P. Ruggles sequenced his trading "so that the majority of the orders he placed in [his] personal accounts were executed against the orders he placed for his employer," and that his transactions generated approximately \$3.5 million in trading profits. Ruggles was ordered to disgorge his gains and pay a penalty of \$1.75 million and was permanently banned from trading and registering with the CFTC.

The September order follows companion findings in June 2016 by the NYMEX Business Conduct Committee that not only did Ruggles violate NYMEX rules, but that his wife, Ivonne Ruggles, improperly allowed the use of her Tag 50 I.D. to enter trades associated with her accounts. In those findings, both Mr. and Mrs. Ruggles were permanently barred from trading on CME exchanges, with Mr. Ruggles also ordered to pay a \$300,000 fine and disgorge profits of \$2.8 million.

From a regulatory perspective, it should be noted that the Commission's order based its finding of fraud under Section 4(b) upon the duties Mr. Ruggles owed to Delta to act in its best interests, keep confidential its material nonpublic information, not misappropriate such information for personal benefit, and to protect information under Delta's internal policies. More generally, this case indicates a continued aggressiveness on behalf of the Commission in exercising the broad antifraud authority provided to it under the Dodd-Frank Act.

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## **Coding Errors at ATSS Lead to Fines**

As described above, market participants' trading systems are squarely in the regulatory crosshairs. In October, CME and CBOT settled actions with two firms, Aardvark Trading LLC and Natixis, for alleged supervisory failures in the operation of their ATSS. CME alleged that Aardvark's supervisory errors led to its ATS not operating as intended, which resulted in the execution of 17,000 contracts in the associated legs of the Eurodollar Complex, thereby leading to price and volume aberrations. CME's allegations focused on Aardvark's improper configuration and modification of the ATS code, failure with respect to ATS deployment, and testing failures before launching code in the live trading environment. Separately, CBOT charged Aardvark for an error in the configuration of Aardvark's ATS, which caused the system to execute numerous wash trades and consequently created price and volume aberrations. CBOT found that Aardvark knew or should have known that the orders entered by the ATS would match each other, including that Aardvark reactivated the ATS in the market without having identified or adjusted its configuration after having shut the system down due to the number of orders filled. CME and CBOT fined Aardvark \$205,000 and \$40,000, respectively, for these incidents.

Separately, CBOT found that Natixis's deployment of its ATS caused price aberrations stemming from failing to deactivate a pricing tool after the close of regular trading hours, which caused the ATS to enter into one-lot orders and modifications in 29 contract months during the evening preopen period at progressively increasing prices. CBOT fined Natixis \$75,000.

## **CFTC Fines Barclays for EFRPs**

In September, the CFTC fined Barclays Bank PLC \$500,000 for recordkeeping violations. During the period under scrutiny, applicable regulations required FCM customers, like Barclays, to create, retain, and produce documentation relating to their EFRP transactions. The CFTC alleged that Barclays failed to create, maintain, and promptly produce at least 1,358 confirmations relating to at least 3,717 metals and energy EFRPs from at least September 1, 2009 to October 16, 2012. Barclays did not help its case by taking nearly 14 months to locate and produce confirmations for the remaining EFRPs. This fine highlights the emphasis that the CFTC and exchanges have placed on EFRPs.

## **CFTC Proposes \$38 Million Settlement in Price Manipulation and Automated Spoofing Case**

On November 9, Navinder Singh Sarao and the CFTC jointly filed a proposed consent order that would settle the civil enforcement action brought by the CFTC against Sarao in the US District Court for the Northern District of Illinois. According to the CFTC complaint, Sarao modified a commonly used off-the-shelf trading platform to automatically and simultaneously "layer" several exceptionally large orders into the CME's E-mini S&P 500 futures order book, with each order one price level from the other. As the market price moved, Sarao's algorithm allegedly modified the price of its orders so that they remained several layers away from the best price levels in the order book, remaining visible to other traders, but safely away from the best price levels. Eventually, the vast majority of these large layered orders were cancelled without resulting in any market transactions. Sarao admitted in the proposed order to using a

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manipulative device to defraud, manipulating prices, attempting to manipulate prices, and spoofing in connection with trading E-mini S&P 500 futures near-month contracts. The proposed order would require Sarao to pay \$12.9 million in disgorgement and a \$25.7 million penalty, plus post-judgment interest, and would impose a permanent injunction against further violations by Sarao and would permanently ban him from trading in futures or other commodity interest on his own and others' behalf and from registering with the CFTC or associating with a CFTC-registered entity. Sarao, a UK citizen who was recently extradited to the United States (as discussed in our previous Report), also pleaded guilty to one count of spoofing and one count of wire fraud in a related criminal action before the same court on the same day.

## **Energy Market Manipulation Class Action Suit**

Commodity traders who had brought a class action in December 2015 against the North American subsidiary of a French energy company for allegedly attempting to manipulate natural gas prices in the Southwest recently amended their complaint to add the French parent company and a British affiliate of the original defendant as additional defendants. The two non-US entities argued in September that the US District Court for the Southern District of New York lacks personal jurisdiction over them because neither entity has a US presence. A CFTC enforcement action against the US entity was filed and settled in December 2015, and a FERC enforcement action based on the same alleged conduct is currently in progress.

## **CFTC Files Enforcement Action Against Assistant Trader Who Made False Reports**

In September 2016, the CFTC filed an enforcement action against trader Fan "Alex" Wang, accusing the former clerk of entering false commodity futures orders while employed at an undisclosed financial services firm. According to the CFTC, Wang purchased more than 500 crude oil futures contracts for his employer's accounts in 2011. On the same date, Wang allegedly made false entries into the relevant trading records to create the appearance that more than half of those orders had closed out—when they actually remained open—and to conceal his role in placing such orders.

The CFTC seeks permanent registration and trading bans, as well as monetary penalties and restitution. The CFTC's suit comes on the heels of Wang's 2014 guilty plea to criminal charges that he made false reports, after which he was sentenced to three months' imprisonment, three years of supervised release, and ordered to pay \$2.2 million in restitution to his former employer.

These sanctions underscore regulators' emphasis on punishing false reporting to the full extent of the law.

## **CFTC Orders JSC VTB Bank and VTB Capital PLC to Pay \$5 Million Civil Penalty for Fictitious and Noncompetitive Block Trades**

In September 2016, the CFTC ordered JSC VTB Bank (VTB), a Russian banking institution, and its American subsidiary, VTB Capital PLC (VTB Capital), to pay a \$5 million civil penalty for executing fictitious and noncompetitive block trades in Russian Ruble/US Dollar futures contracts.

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Between December 2010 and June 2013, VTB and VTB Capital allegedly executed more than 100 block trades, with a notional value of approximately \$36 billion. These trades were purportedly structured to enable VTB to hedge its cross-currency risk at more favorable prices than were available to the Russian bank. Because of significant capital requirements imposed on OTC swap counterparties in transactions with Russian-domiciled VTB, VTB was unable to directly hedge its cross-currency risk. Instead, under the alleged scheme, VTB transferred its cross-currency risk, by noncompetitive, fictitious sales, to American-domiciled VTB Capital, which then hedged the risk in OTC swaps with other banks.

Anticipating administrative proceedings by the CFTC, VTB and VTB Capital entered into a settlement with the CFTC, under which they consented to an order instituting proceedings under Section 6(c) and (d) of the CEA, and imposing a \$5 million financial penalty. The defendants did not admit or deny any finding made, or conclusion reached, by the CFTC.

As part of the order entered, the CFTC required that VTB and VTB Capital strengthen their policies and procedures for detecting and preventing future fictitious or noncompetitive trading, including conducting internal ethics and compliance training focused on fictitious or noncompetitive trading. Finally, the CFTC imposed a two-year ban on VTB's and VTB Capital's entry into privately negotiated futures, options, or combination transactions with one another on or through any US-based futures exchange.

The hefty monetary penalty is yet another example of the CFTC's efforts to crack down on fraudulent trading.

## **CFTC Wins Precious Metals Fraud Trial**

In August 2016, the CFTC prevailed in its fraud suit against Robert Escobio and two of his companies, Southern Trust Metals, Inc. (Southern Trust) and Loreley Overseas Corporation (Loreley). Following trial, a federal court in Florida found that Southern Trust and Loreley perpetrated an "egregious" scheme to lure retail investors to purchase physical precious metals, allegedly held in overseas depositories. Rather than acquire precious metals with the amounts invested, however, Southern Trust and Loreley channeled the funds into offshore trading accounts, where they were used for margined derivatives trading. The scheme cost 78 customers losses totaling more than \$1.5 million.

The court's order incorporated an earlier finding that the Defendants violated the CEA by (i) conducting illegal off-exchange commodity transactions; and (ii) failing to register with the CFTC as an FCM. In its prior order, the court also rejected the defendants' claim that their earlier settlement with the NFA foreclosed the CFTC's enforcement action.

The court required Escobio, Southern Trust, and Loreley to pay combined restitution in the amount of approximately \$2.1 million, permanently banned the defendants from commodity trading, and imposed civil penalties of approximately \$880,000. Although the defendants attempted to attribute the customers' losses to falling market prices, the court rejected their attempt to displace responsibility for losses suffered as a result of their fraudulent scheme.



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The case demonstrates the CFTC's and courts' commitment to punishing and deterring fraud involving substantial customer harm.

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