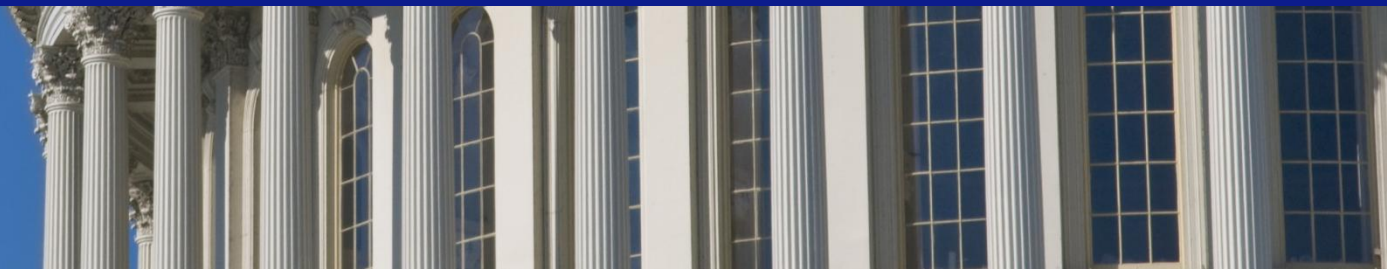




# Swap Trading and Sales Compliance and Dodd-Frank (Interest Rates, FX, Commodities and Broad-based Securities Indices)

May 2011

**C L I F F O R D**  
**C H A N C E**



# Trading and Sales Prohibitions & Requirements for Interest Rate, Foreign Exchange, Commodities and Broad-based Securities Index Swaps

- I. Overview
- II. Prohibitions Applicable Beginning July 16, 2011
- III. Prohibitions Applicable on the Later of July 16, 2011 or the Date When Swaps Are Traded on DCMs or SEFs

# Trading and Sales Prohibitions for Swaps: The Dodd-Frank Amendments to the CEA

- Imposes a regulated central markets system to swaps (with certain exceptions).
- Extends several preexisting CEA trading and sales prohibitions to apply to swaps traded OTC and on registered central markets.
- Creates several new trading and sales prohibitions that will be applicable to swaps traded competitively on registered central markets.

# DFA Status of Effectiveness & Rulemaking

- Certain DFA provisions are self-actuating become effective on July 16, 2011 on registered facilities.
- Others that require rulemaking and are in progress are beyond the scope of this presentation.

# Prohibitions Applicable Beginning July 16, 2011

# Private Bilateral Trades & Non-CEA Registered Multilateral Markets

# Prohibitions Applicable Beginning July 16, 2011

- Certain CEA prohibitions will be applicable to private bilateral swap trades and swaps traded on non-CEA registered multilateral markets beginning July 16, 2011.
  - Intentional manipulation of swap prices
  - Reckless false reporting to the CFTC, and willful false reporting to regulators and self-regulatory organizations (e.g., DCM, SEFs, SDRs, NFA etc.) respecting swaps
  - Fraud on counterparty or customers
  - Reckless disregard of counterparty fraudulent use of a swap
  - Abusive Trading Practices
    - Wash, accommodation, fictitious and non-bona fide sales
  - Private right of action for manipulation of swap prices & fraud on counterparty or customers

# Intentional Price Manipulation

## ■ Under Dodd-Frank, the CEA's existing prohibition on manipulation makes it unlawful

*“to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or of any swap.”* CEA § 9(a)(2).

## ■ Courts have used a four part test for establishing manipulation:

1. The defendant possessed the ability to influence prices;
2. An artificial price existed;
3. The defendant caused the artificial price; and
4. The defendant specifically intended to cause the artificial price.

## ■ Key Points:

- Intentional manipulation applies to all swaps (private, bilateral, multilateral facility, as well as on a registered entity).
  - Practical application to unreported bilateral trade markets is limited.
- Attempted manipulation does not require proof of an artificial price.
- CFTC has experienced difficulties in proving specific intent and artificial price.



# False Reporting to Regulators

- Under Dodd-Frank, there will be two prohibitions applicable to swaps regarding false reporting to regulators:
  - **Reckless false reporting to the CFTC** (new) - making any false or misleading statement of a material fact to the Commission if the person knew, or reasonably should have known, the statement to be false or misleading. CEA § 6(c)(2).
  - **Intentional false reporting to self-regulatory organizations** (preexisting) - “*willfully to falsify, conceal, or cover up by any trick, scheme, or artifice a material fact, make any false, fictitious, or fraudulent statements or representations, or make or use any false writing or document knowing the same to contain any false, fictitious, or fraudulent statement or entry to a registered entity, board of trade, swap data repository, or futures association designated or registered under [the CEA] acting in furtherance of its official duties under [the CEA].*” CEA § 9(a)(4).
- **Key Point:**
  - Reckless false reporting to the CFTC will apply to *any statement of material fact made to the CFTC in any context.*

# Fraud

## ■ Dodd-Frank extends the CEA's existing broad prohibition on fraud to swaps.

### CEA § 4b(a).

- Includes both fraud on any counterparty or any customer and unconsented front running, disclosure of customer orders or positions, unconsented cross-trading or material misrepresentations or omissions.

## ■ Key Points:

- Swaps have already been subject to common law causes of action for fraud.
- The CEA's § 4b(a) prohibition on fraud largely codifies common law, requiring (1) a misrepresentation/omission; (2) materiality; and (3) knowledge or a reckless disregard of the falsity of the information.
- With respect to counterparties, § 4b(a) does not impose a duty to speak, but any statements made must be true and complete; fraud can be established by an omission which renders a statement untrue or deceptive.
- A private right of action is available for 4b violations, provided the CEA's privity requirement is met.

# Reckless Disregard of a Counterparty's Fraudulent Use of a Swap

■ Dodd-Frank creates a new provision for "recklessly disregarding a counterparty's fraudulent use of a swap." CEA § 4c(a)(7).

■ Key Points:

- The CFTC has not provided guidance on what would constitute “recklessly disregarding a counterparty’s fraudulent use of a swap.”
- Benchmarks standards may be based upon the 2007 Joint Statement of the Treasury, Federal Reserve, FDC, and SEC.
- There does not appear to be a private right of action for reckless disregard of a counterparty’s fraudulent use of a swap.

# Abusive Trading Practices

As amended by Dodd Frank, CEA § 4c(a)(1) prohibits any swap transaction that is “of the character of ... a wash sale or accommodation trade ... or is a fictitious sale or ... is used to cause any price to be reported, registered or recorded that is not a true and bona fide price,” if the swap is or may be used to “hedge any transaction in interstate commerce ...[or] ... determine the price basis of any transaction in interstate commerce or deliver such commodity in interstate commerce.”

The statute does not restrict itself to transactions on registered exchanges or necessarily any organized market.

This raises a question as to whether it may prohibit certain common practices in the private, bilateral swap market, or on unregulated trading platforms or swap execution facilities, such as:

- Simultaneous or near simultaneous back-to-back riskless principal transactions
- Transactions entered into at historical or other non-market prices
- Repo-like transactions whereby a party takes no market risk

Key Issue: Should CFTC publish an interpretative order confirming that CEA § 4c(a) applies only to transactions made on a DCM or SEF?

# Abusive Trading Practices (Cont'd)

- § 4c(a)(1) has been the basis for past CFTC actions against trades executed on public markets without the intent to take a genuine market position.
  - The most common allegation has been that the trader, in order to “paint the type” or otherwise, engaged in two or more linked trades (wash sales) which gave the impression of genuine trading when in actuality there was no material price risk.
  - Another basis for § 4c(a)(1) actions had been that a trade was “pre-arranged” by the parties rather than submitted to public market auction.
- The underlying public policy appears to be protection of the integrity of published market prices and fostering price and liquidity discovery.
- However, § 4c(a)(1) is not expressly limited to transactions or public markets which may be used for price or liquidity discovery. It extends to any transaction that may be used for hedging of the underlying “commodity” in interstate commerce.

# Private Rights of Action

- Dodd-Frank extends private rights of action under the CEA to include swaps. CEA § 22.
- The CEA provides a private right of action to any person who suffered actual damages resulting from any violation of the CEA, provided the injured person:
  - received trading advice from the defendant for a fee;
  - made through the defendant a contract of sale of any swap, or paid the defendant money in connection with an order to make a swap;
  - purchased a swap from or sold a swap to the defendant; or
  - purchased or sold a swap if the violation constitutes a manipulation of the price of the swap or the commodity underlying the swap

# Aiding and Abetting

- Under the CEA, those who willfully aid and abet any violation of the CEA are liable as principals. CEA § 13(a).

# Prohibitions Applicable on the Later of July 16, 2011 or the Date When Swaps Are Traded on DCMs or SEFs



# CEA Registered Multilateral Markets

# Prohibitions Applicable Beginning on the Later of July 16, 2011 or the Date When Swaps Are Traded on DCMs or SEFs

## ■ Swap trading on any DCM or SEF will be subject to these prohibitions:

- Disruptive Trading Practices
  - Violation of bids/offers
  - Reckless disregard for orderly closing
  - Intentional spoofing

\* The comment period for the CFTC's Proposed Interpretive Order closes on May 17, 2011.  
76 Fed. Reg. 14826 (Mar. 18, 2011).

- Bucketing of customer orders
- Unconsented cross trading with customer orders

# Violation of Bids or Offers

## ■ Under Dodd-Frank,

“It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that . . . violates bids or offers.” CEA § 4c(a)(5)(A).

## ■ Violating a bid is trading whereby one bids at an amount higher than the prevailing offers. (Paying more than the market requires.)

## ■ Key Points:

- Limited to Swap Execution Facility (SEF) and Designated Contract Market (DCM) trading.
- The CFTC's Proposed Order states that the prohibition will not apply to block trades or exchanges for related positions (EFRPs), but is silent as to request for quote (RFQ) trades.
- The CFTC's Proposed Order states the prohibition will be considered a per se violation
  - No requirement of knowledge of prevailing bids or offers.
- Buying the board will not be violative.

# Reckless Disregard for Orderly Execution During the Closing Period

## ■ Under Dodd-Frank,

*“It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that . . . demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period.”* CEA § 4c(a)(5)(B).

## ■ To date, the CFTC has not provided a definition of reckless disregard for orderly execution during the closing period.

## ■ Key Points:

- Limited to SEF and DCM trading.
- According to the CFTC’s Proposed Order,
  - The provision also applies to “*potential* disruptive conduct” outside of the closing period that could affect the close.
  - A trader must – at the time of the transaction – intentionally or recklessly disregard its potentially disruptive effect that they knew or should have known.

# Reckless Disregard for Orderly Execution During the Closing Period

## ■ Key Points (Cont'd)

- Actual disorderly closing need not be proven; potential for disruption is adequate.
- Accidental or negligent conduct, or other legitimate or good faith trading behavior will not trigger liability, even when it causes actual disruption.
- Evidence of the subsequent disorderliness of the relevant market will be relevant in assessing whether an individual trader's behavior was violative.
- Disorderliness will be judged based upon such things as pricing gaps, undue volatility, divergence from prices or nearby maturities or underlying markets.

# Spoofing

## ■ Under Dodd-Frank,

“It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that . . . is, 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 execution).” CEA § 4c(a)(5)(C).

## ■ Spoofing is bidding or offering with the intent to cancel the bid or offer before execution.

## ■ Key Points:

- The relevant conduct requires bad faith at the time of the submission of a bid or offer.
- Partial fill orders will normally not be per se violative.
- The CFTC's Proposed Order states that reckless trading will not result in a violation. However, a proof of intent may be established by a pattern of behavior.
- The CFTC's Proposed Order exempts RFQs. or other non-executable market communications.

# Bucketing

- The existing CEA prohibition on bucketing is extended to swaps. CEA § 4b(a)(2).
- A broker buckets a customer's order by, rather than submitting the order to the intended DCM, trading opposite the order for the broker's own account or for an account in which the broker has an interest.

# Cross Trading

- The existing CEA prohibition on unconsented cross trading is extended to swaps. CEA § 4b(a)(2).
- Cross-trading is where one broker represents both the buyer and the seller of a security and executes both the purchase and the sell side of the transaction, and receives a commission for both.



# Best Practices & Training

- Certain Dodd-Frank provisions become effective July 16, 2011, others will become effective when swap trading on DCMs and SEFs commences.
- Market participants only have a short amount of time to prepare.
- Creating relevant trading/sales policies and procedures as well as best practices and providing advance training will be needed for the new regulatory environment.



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