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**Long arm, iron fist: the CFTC, the new riders on the storm**

**Features**

**Long Arm, Iron Fist**

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*Richard Lissack QC and Farhaz Khan examine the different approaches of the CFTC and the FSA to market manipulation in the commodity futures markets.*

**KEY POINTS**

- Both the Financial Services Authority ('FSA') and the US Commodity Futures Trading Association ('CFTC') allow self-regulation of commodity exchanges, but the CFTC imposes position limits and Commitments of Traders reports to reduce the risk of 'excessive speculation', which may give rise to market manipulation.
- ICE Europe, an FSA Regulated Investment Exchange ('RIE'), requires permission from the CFTC to access US customers.
- By imposing US equivalent standards on ICE Europe, the CFTC is enforcing US rules on a UK RIE, to close a perceived regulatory loophole.

- The real material difference between the FSA and US regulators is the historic appetite for bringing enforcement proceedings.

ICE Futures Europe (ICE Europe), the energy futures exchange based in London, has attracted the attention of US regulators in recent months. The Commodity Futures Trading Association ('CFTC') has imposed rules on ICE that apply to US exchanges, despite the fact that ICE is regulated by the Financial Services Authority ('FSA') and is, ostensibly, not a US exchange (or what US regulators refer to as a 'foreign board of trade'). The move was triggered by Congressional hearings into alleged speculative trading in relation to futures contracts derived from West Texas Intermediary crude oil ('WTI'), which are traded both on ICE Europe and the New York Mercantile Exchange ('NYMEX'). One view is that possible market manipulation, or 'excessive speculation', in relation to WTI futures contracts on ICE Europe is contributing to artificially high oil prices.

Members of the US Congressional Committee on Agriculture, which has responsibility for commodities and related markets, have stated in strong terms that the FSA lacks the regulatory zeal to ensure that ICE Europe is a clean market. The CFTC's intervention is intended to close what has been referred to, rather inelegantly, as the 'London/Dubai loophole'.

## MARKET MANIPULATION

Market manipulation is a species of market abuse that has its own, very particular application, to commodity futures markets. A market participant can effect what the FSA considers *manipulating transactions* for the purposes of s 118(5) Financial Services and Markets Act 2000 ('FSMA'), or an 'abusive squeeze' (see FSA Code of Market Conduct, MAR 1.6.4E).

When 'squeezing' a market, a manipulator builds up a large position in the *underlying* commodity market in order to create an artificial shortage. This is done in conjunction with long positions in the relevant commodity derivative market. The manipulator will then demand delivery of the commodity (that is, squeeze the market). As he simultaneously withholds the stock of supply, the sellers of the futures derivative will find it difficult to acquire sufficient commodity to fulfil their contracts. The manipulator can then use his long position in the commodity market to profit from artificially high prices (see *UK discussion paper on the Commission's review of the financial regulatory framework for commodity and exotic derivatives*, HM Treasury, December 2007).

## ICE EUROPE AND THE FSA

ICE Europe, formerly the International Petroleum Exchange in London, was acquired by the US IntercontinentalExchange Inc ('ICE') in 2001. ICE Europe is a Recognised Investment Exchange ('RIE') for the purposes of Pt XVIII of the Financial Services Markets Act 2000 ('FSMA'). RIEs are exempt from the general prohibition rules (requiring authorisation by the FSA), and instead require recognition by the FSA to carry out business as an investment exchange as an exempted person (see Recognition Requirements Regulations SI 2001/995). The RIE must, nevertheless, be a fit and proper person to perform the function of an investment exchange (Schedule to Regulations, para 2). These requirements are reflected in the REC manual of the *FSA Handbook*.

The FSA requires RIEs to ensure that appropriate measures are adopted to maintain the orderly functioning of the market and protect investors, thereby reducing the risk of market abuse and financial crime (Regulations, para 4; REC 2.10). The RIE is responsible for maintaining the systems and controls which are appropriate for the deterrence and detection of market abuse (Regulations, para 3; REC 2.5). This includes a scheme of rules and procedure which are consistent with, for example, the FSA's Code of Market Conduct (REC 2.6.28 and MAR 1). ICE Europe, under its own rules, monitors large positions held by members including details of customers responsible for such positions, such as daily position reports in the front two months of any particular contract. The REI must also have procedures for monitoring, detecting and enforcing compliance with its rules (Schedule to Regulations, para 8; REC 2.15). There are also trade

transparency requirements to reduce the risk of information asymmetry between parties (REC 2.6).

The RIE must *immediately notify* the FSA in case of a number of trigger events including significant breaches of rules and disorderly trading conditions (REC 3.25). The FSA has powers to give directions to the RIE to take specific steps in order to secure its compliance with the recognition requirements (s 296 FSMA; REC 4.6). The FSA also retains the nuclear option to revoke recognition or suspend a particular instrument from trading (s 297 FSMA; REC 4.7 and s 313A FSMA).

Ostensibly, then, Ice Europe is, in a self-regulatory capacity, responsible for maintaining a clean and orderly market, with the FSA carrying out an oversight function in line with its risk-based approach to regulating commodities markets.

What ICE is not required to do by the FSA is impose formal position limits, although it does, within its own rules, retain the authority to require members to reduce large positions. This relative regulatory inactivism -- which is broadly mirrored by the Dubai Financial Services Authority ('DFSA') that regulates the Dubai Mercantile Exchange (which has permission to trade WTI, but has not started doing so) -- is what the Congressional Committee has referred to as the London/Dubai loophole. That is, US WTI instruments are bought and sold by US customers, but without the US safeguards imposed by the CFTC.

## **THE CFTC AND EXCLUSIVE JURISDICTION**

The starting point for the CFTC's reach over foreign boards of trade such as ICE Europe is that, because such foreign markets have direct (electronic screen based) access to US customers, the CFTC retains 'exclusive jurisdiction', and thereby the right to place conditions on such access (for the purposes of the Commodity Exchange Act ('CEA')). This is done through 'no-action relief letters' which set the boundaries for the relationship between foreign markets and US customers (s 2 CEA).

As such, the CFTC does not need the FSA to approve or facilitate the provision of information, or the imposition of limits, on ICE Europe in relation to instruments over which it retains jurisdiction. Rather, if ICE Europe wants direct access to US customers, it needs to keep the CFTC on side. Nevertheless, the CFTC and the FSA do have a Memorandum of Understanding ('MoU') dating back to November 2006 for the purposes of market surveillance. The regulators shared large trader information with respect to linked contracts ICE Europe and NYMEX, on a weekly basis (daily in settlement week).

## **SPECULATIVE POSITION LIMITS**

The CFTC considers excessive speculation in a commodity future may cause *sudden or unreasonable* fluctuations in price (s 4a CEA). Excessive speculation is considered a type of market manipulation by the CFTC. It is unclear whether this would *necessarily* be the case under FSMA, though both FSMA and the CEA do envisage similar factual circumstances (see MAR 1.6.4E). Speculative position limits and position accountability rules are imposed by the CFTC on commodity derivative markets (s 5 CEA; CFTC reg 150.2). Interestingly, however, the CFTC allows certain exchanges, including NYMEX, to establish their own limits, by reference to the CFTC's guidance on acceptable practices (CFTC Regulations, appendix B, Pt 38). Violations of exchange-set limits are subject to NYMEX, not CFTC, disciplinary action in the first instance.

As such, the CFTC itself relies on *self-regulation*, while maintaining an oversight function.

## **ICE EUROPE AND NO-ACTION RELIEF LETTERS**

In May and June 2008 the CFTC amended and re-amended the no-action letter under which WTI was traded on ICE Europe, thereby 'formalising' the MoU with the FSA. One of the conditions is that ICE Europe must impose comparable position limits to those of NYMEX, that is, create its own position limit rules in line with the CFTC's acceptable practices regime. Further, such information must be provided, 'through the FSA', in a form which is compatible with the CFTC's Commitments of Traders reports, which the CFTC publishes to

ensure market participants enjoy access to the same level of market-sensitive information.

Interestingly, the FSA and HM Treasury carried out a cost-benefit analysis on maintaining their own Commitments of Traders reporting mechanism, but decided against the idea (*UK Discussion paper*, HM Treasury, December 2008). One reason was that there was very little evidence of direct retail investment in commodity derivative markets such as ICE Europe (see *Growth in commodity investment: risk and challenges for commodity market participants*, FSA Occasional Paper, March 2007). It was thought that institutional and other sophisticated investors had sufficient access to information and expertise to protect their interests.

It is also a reflection of the FSA's continuing commitment, despite the current climate of uncertainty in UK and global financial markets, to risk-based regulation. This explains the reliance, in the first instance, on exchanges such as ICE Europe to keep their house in order, with FSA intervention as a backstop in exceptional circumstances.

This is, as set out above, not dissimilar to the way the CFTC operates with respect to such markets. Both regulators rely, largely, on self-regulation.

### **ENFORCEMENT: SAME BEGINNING, DIFFERENT CONCLUSION**

The FSA, however, has never brought an action for market manipulation in the commodities markets.

By contrast, the CFTC maintains a healthy zeal for enforcement action. The CFTC has a strong record of bringing administrative actions. In October 2007 it came to a \$303m settlement deal with *BP Products North America* for alleged price manipulation in propane markets. This has included actions against traders in markets ostensibly 'foreign' for the purposes of regulatory jurisdiction. In the *Sumitomo* case the CFTC reached a settlement with the Japanese corporation for manipulating prices of US copper on the London Metal Exchange (see *In the Matter of Sumitomo Corporation*, 1998 CFTC Lexis 96 (1998)). Overall, the CFTC and related government agencies (including the Department of Justice) have brought 25 administrative actions and 42 criminal indictments against firms and individuals in relation to energy market abuse.

On 24 July 2008 the CFTC announced its first case relating to its current 'Nationwide Crude Oil Investigation'. The matter arose from alleged market manipulation on the NYMEX exchange in March 2007, brought against a propriety trading firm, Optiver, and several other defendants. Optiver is alleged to have amassed large positions in several contracts and then conducted trading in a way so as to squeeze, or 'bully' and 'hammer', in the CFTC's own colourful language, the markets to benefit their own position (see *Statement of Acting Chairman of CFTC Walter L Lukken*, CFTC, 24 July 2008). Further, the CFTC states that the action 'is a reminder that the [CFTC] stands ready to fully utilize its enforcement powers to track down anyone who is illegally trying to game the markets'.

### **CONCLUSION**

It is clear that political pressure in the US caused by rising oil prices has triggered regulatory action by the CFTC in the commodity markets. It is equally clear that the CFTC has sufficient reach to intervene in foreign markets such as ICE Europe where important US interests are at stake, including imposing disclosure rules and taking enforcement where, perhaps, the FSA could have taken a similar view but, to date, has not.

This partly reflects the divergence in the regulatory culture which separates the FSA, with its risk-based approach, from US bodies. But rising oil prices and worries about transparency and the risks of market abuse in commodities markets are a shared concern. The Committee of European Securities Regulators ('CESR') is currently involved in two related legislative initiatives coming out of Brussels; first, the review of the post-trade transparency regime for non-equity financial instruments, as set out in the Markets in Financial Instruments Directive, and secondly, in the context of the EU's Third Energy Package, CESR and European Regulators' Group for Electricity and Gas ('ERGEG') have advised the European Commission to explore a

tailor-made market abuse regime for the electricity and gas sectors (*CESR and ERGEG Advice to the European Commission*, July 2008). The advice identifies the concentration of market participants in physical and derivative markets, and the risk of market abuse as a result.

Put simply, there is more risk, possibly actual, certainly perceived, in financial markets at present. Recent high-profile enforcement actions by the FSA in criminal insider-dealing matters have, perhaps, reflected the FSA's new response to these risks. Whether the FSA is ready to enforce its market-abuse regime in the energy markets is less clear.