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# COMMODITIES LITIGATION

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REPRINTED FROM:  
CORPORATE DISPUTES MAGAZINE  
JAN-MAR 2017 ISSUE



[www.corporatedisputesmagazine.com](http://www.corporatedisputesmagazine.com)

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New York | Washington DC | London | [www.srz.com](http://www.srz.com)

Published by Financier Worldwide Ltd  
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HOT TOPIC

# COMMODITIES LITIGATION



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**Brian T. Daly** advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organisational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the National Futures Association.

**CD: Could you provide a brief overview of the key issues currently facing commodities markets? To what extent are these issues causing disputes resulting in litigation?**

**Daly:** There are two sources of litigation exposure in the commodities markets – CFTC-level violations and exchange-level violations. At the CFTC level, we are seeing more traditional allegations of fraud, such as Ponzi schemes and garden-variety fraudulent misrepresentations, and actions focusing on improper, manipulative or deceptive trading. The trading bucket encompasses enforcement triggers such as insider trading, where the CFTC is now actively exercising its enforcement muscles

under the relatively new Rule 180.1, ‘spoofing’ and other manipulative trading. We have also seen a surge in enforcement activity at the commodities exchange and – even more recently – at the swap exchange facility level. These actions are generally quite technical in nature and do not involve any manipulative intent or effect, but can result in a public order that hedge fund managers are required to disclose to investors. These are the most frustrating cases to defend because all sides will readily agree that the violation did not cause any harm and that there was no scienter on the part of the manager, but the exchanges feel that the CFTC is demanding that they fine and punish even inadvertent offences.

**CD: What are some of the common types of commodities-related litigation that you have seen over the last year or so?**

**Daly:** Some of the most interesting matters that we have seen are related to EFRP violations. An exchange for a related position occurs when a futures broker facilitates the migration of a bilateral, OTC exposure to a look-alike futures contract that is traded on a futures exchange. We have seen actions where this exchange of an OTC swap position for a listed, 'physical' position was deemed to be non-bona fide because it involved multiple, simultaneous steps, or because slight differences in relative exposure resulted where multiple accounts were traded in tandem. The frustration in these matters is that the exchange finds – and publicly sanctions – an accidental, technical non-compliance with the exchange rules that did not result in any price or volume distortion. We also see many examinations of managers by the National Futures Association (NFA). The NFA exam is often relatively straightforward, but there are situations where managers are alleged to have violated CFTC regulations and a CFTC enforcement referral is implicated. Obviously, in these kinds of situations

a manager should be working closely with outside counsel from the start of the regulatory interaction.

**“Reach out to outside counsel immediately following any contact from a futures regulator on a trading or examination matter, even if it seems to be ‘routine’.”**

*Brian T. Daly,  
Schulte Roth & Zabel*

**CD: In what ways is the current regulatory environment impacting the commodities markets? Are you seeing, for example, greater monitoring and enforcement actions?**

**Daly:** The exchanges and swap exchange facilities have all developed very sophisticated monitoring systems, and have fairly deep benches of market surveillance personnel. We find that the CME, in particular, is quite quick to spot anomalies and to reach out to traders.

**CD: What general advice can you offer to companies facing commodities-related litigation? What initial steps, such as case evaluation, settlement analysis and expert witnesses engagement, should parties take?**

**Daly:** What is shocking, but is not uncommon, is managers waiting far too long to engage outside counsel. When managers hear from the SEC, they generally reach out to outside counsel specialising in securities law and generally do so immediately. For some reason, incoming calls and letters from the futures exchanges and the NFA do not generate the same response. I think that is because the NFA and the exchanges play several roles, in addition to their enforcement function, and managers become

habituated to responding to them. However, if there was one piece of advice we would give, it would be to reach out to outside counsel immediately following any contact from a futures regulator on a trading or examination matter, even if it seems to be 'routine'.

**CD: How do you expect commodities litigation issues to develop over the next 12 months or so? What are likely to be the major challenges that define this market?**

**Daly:** We expect to see more and more actions in this area as hedge funds continue to trade in the futures and swaps market, and as trading becomes ever more sophisticated. **CD**

