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before a
Joint Meeting of the Securities and Exchange Commission (“SEC”)
and the Commodity Futures Trading Commission (“CFTC”)

on

“Harmonization of Enforcement”

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This memorandum constitutes only an outline of
Professor Coffee’s comments and testimony.

The scope of my comments is limited to harmonization of the enforcement programs of the SEC and CFTC. Pursuant to President Obama's request, both agencies are seeking ways to reduce or eliminate needless differences in their approaches, and consistent enforcement seems particularly appropriate. Under this broad heading, I will very briefly address the following topics: (1) Insider trading enforcement; (2) Market manipulation enforcement; (3) enforcement through self-regulatory organizations ("SROs"), including the issues of a suitability rule and a possible fiduciary duty; (4) differences in enforcement policies, as set forth in both agencies' policy statements; (5) penalty levels; (6) "Fair Funds for Investors"; (7) the professional responsibilities of attorneys who become aware of evidence of a material violation; (8) differences in private enforcement; (9) Pre-dispute arbitration; and (10) Agency Enforcement Powers. No attempt has been made to do much more than note these disparities.

1. Insider Trading. Here, there is a day and night difference. Predicated only on the prohibition, set forth in §10(b) of the Securities Exchange Act of 1934, against the use "of any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe," the federal securities laws have generated an elaborate body of judge-made law proscribing insider trading. This body of law reaches (1) "classical" insider trading,[1] (2) the misappropriation of confidential information for securities trading purposes, in breach of a duty owed to the source of the

[1] See Dirks v. SEC, 463 U.S. 646 (1983). As discussed below, this will be the variety of insider trading least applicable to futures and most derivatives.

information;[2] and (3) the use of deceitful means (such as computer hacking) to exploit material non-public information, even when no fiduciary duty is breached.[3]

In contrast, the Commodities Exchange Act ("CEA") contains only two minimalist provisions that prohibit some forms of insider trading. Section 13(f) of the CEA does criminalize trading on the basis of "material nonpublic information" by a very limited number of persons: basically, employees and members of a board of trade or a registered entity or registered futures association. This provision also reaches the tippees of such persons who trade. Similarly, Section 6(j) of the CEA instructs the CFTC to issue regulations prohibiting "the privilege of dual trading" – which in substance is a form of "front running" (in the parlance of securities lawyers). Otherwise, the CEA does not prohibit insider trading.

Alone, this disparity calls out for harmonization. But it is aggravated by a further difference: at the time of the Commodities Futures Modernization Act in 2000, Section 10b of the Securities Exchange Act was amended to give the SEC authority to enforce insider trading in the case of "security-based swap agreements." Thus, the misuse of material, nonpublic information to trade, for example, equity swaps can be both criminally and civilly enforced. But neither the SEC nor the CFTC can act with respect to the use of identical practices in the case of other swaps. Consider then the following cases:

A. A commodities or financial futures trader bribes someone in a governmental agency to give the trader early access to material, nonpublic information that, when

[2] United States v. O'Hagan, 521 U.S. 642 (1997).
[3] See SEC v. Dorozhko, 2009 U.S. App. LEXIS 16057 (2d Cir. July 22, 2009) (computer hacking to obtain material nonpublic information amounts to a "deceptive" device, even though no fiduciary duty is breached).

released, will move the market. For example, a trader in interest rate futures may bribe a Federal Reserve employee to divulge to the trader the Federal Reserve's future actions with respect to the U.S. money supply. Although criminal prosecutions may be possible where actual bribery is involved, neither the SEC nor the CFTC can act in these cases (whether the trading is in swaps or futures).

B. A hedge fund buys a credit default swap that is triggered by a default on XYZ Corporation's principal bank loan, after learning from an employee of XYZ that such a default is imminent. Because the bank loan is not a security and the swap is not therefore a "security-based swap agreement," neither the SEC nor the CFTC has jurisdiction.

C. Using a computer hacker, a trader is able to penetrate a governmental agency to learn material, nonpublic information about the future supply of a particular commodity and exploits this information to take a sizable short position in the futures market.

To reach these cases, the CFTC needs legislation prohibiting insider trading (as defined) on commodities and transactions within its jurisdiction. The appropriate definition of "insider trading" for purposes of the CEA should not be that set forth in the "classical" Dirks-based theory that the SEC employs, because in most cases breaches of "classical" fiduciary duties will not be involved. Rather, in the foregoing cases, the trader is either (1) misappropriating information by inducing an employee or agent of the source of the information to breach its duty, or (2) using a deceptive means in effect to embezzle or steal the information by stealth. Criminalizing such conduct and authorizing the CFTC to employ civil remedies to enforce this prohibition would not interfere with legitimate research, hedging or even speculative investments by arbitrageurs and others.

2. Market Manipulation. Both the CEA and the Securities Exchange Act prohibit market manipulation. Both the SEC and the CFTC have had only limited success in seeking to prosecute manipulation cases.[4] But the similarities largely end there. In securities cases, manipulation usually involves false statements or a very short term attempt to raise or lower a security's price. In commodities cases, manipulation essentially involves the use of market power that forces the short side to deal with the long side on terms dictated by the latter. Such manipulation of commodity futures prices through market power has been aptly described as "the unprosecutable crime."[5]

Although courts and the CFTC have struggled to define market manipulation, most cases continue to pivot around the elusive concept of "the creation of an artificial price by planned action."[6] As the law has evolved, a four part test has become accepted as establishing the necessary elements of market manipulation in commodities cases: (1) the ability to influence market prices; (2) the intent to execute a squeeze or corner; (3) that an artificial price existed at the time of the offense; and (4) that the accused caused the artificial price.[7] Each of these elements (and particularly the element of intent) has definitional problems and is generally difficult to prove. Only in a few cases – most

[4] Criminal market manipulation has been successfully proven in securities cases. See United States v. Regan, 937 F.2d 823 (2d Cir. 1991) (defendants sought to reduce stock price through concentrated sales). See also Steve Thel, $850,000 in Six Minutes – The Mechanics of Securities Manipulation, 79 Cornell L. Rev. 219 (1994). This difference may reflect the special sensitivity of securities markets to distributions and the significance of closing prices at certain sensitive moments.
[5] See Jerry W. Markham, Manipulation of Commodity Futures Prices – The Unprosecutable Crime, 8 Yale J. on Reg. 281 (1991).
[6] See General Foods Corporation v. Brannan, 170 F.2d 220 (7th Cir. 1948). More recently, the Seventh Circuit opined that a "'know it when you see' test may appear more useful." Frey v. Commodity Futures Trading Commission, 931 F.2d 1171, 1175 (7th Cir. 1991).
[7] See Frey v. CFTC, 931 F.2d at 1175.

notably the Sumitomo Copper litigation[8] – has either the CFTC or the plaintiffs bar been able to establish liability on a significant scale.

The SEC does not face the same obstacles. Attempts to corner a market in a particular stock (or to squeeze the shorts) in the securities markets are relatively rare, and the more common manipulation case in the securities field is the "pump and dump" scheme, where evidence is abundantly available if one co-conspirator elects to cooperate and plea bargain. Market power manipulation cases tend to predominate in the commodities market. One reason for this disparity is that an individual or group who exceeds the 5% level in a stock must normally disclose its position (and update that disclosure in a timely fashion) under the Williams Act.

Given that "market power manipulations" are more likely in the commodities markets, what measures could feasibly restrict such behavior? Numerous academic efforts have attempted to redefine the term "manipulation,"[9] but it is unclear that any of these revisions would significantly simplify the task of enforcement (and some might complicate it further).

What then are the alternatives? Section 4a(a) of the CEA ("Excessive Speculation – Limits on Trading") authorizes the CFTC to set limits on both the positions (i.e., the quantity of futures contracts a trader may either purchase or sell) and the daily volume of trading in a particular contract.[10] This provision applies only to speculators, because

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[8] See In re Sumitomo Copper Litig., 74 F. Supp. 2d 393 (S.D.N.Y. 1999) (describing $134 million class action settlement).

[9] See, e.g., Wendy Collins Perdue, Manipulation of Futures Market: Redefining the Offense, 56 Fordham L. Rev. 345 (1987); Richard D. Friedman, Stalking the Squeeze: Understanding Commodities Market Manipulation, 89 Mich. L. Rev. 30 (1990); Craig Pirrong, Commodity Market Manipulation Law: A (Very) Critical Analysis and a Proposed Alternative, 51 Wash. & Lee L. Rev. 745 (1994).

[10] See CEA § 4a(a), 7 U.S.C. 6a.

hedges are expressly exempted from this provision.[11] Unquestionably, imposing position limits would be controversial, because trading is profitable for market participants. The other alternative is greatly increased surveillance. Professor Markham long ago recommended daily surveillance and suggested that the CFTC's staff's inability to prove manipulation often stemmed from "the lack of precise trade timing information."[12] Although the CFTC's record keeping and surveillance has improved since Professor Markham wrote in 1991, his core recommendation still makes sense. These two approaches could be used in tandem. For example, when it suspected market manipulation, the CFTC could adopt an emergency finding that a particular market was "subject to congestion"[13] and then restrict trading by large traders, including by directing large traders to liquidate or reduce their positions. This seems more feasible than charging them with actual manipulation.

In essence, this is a form of quasi-enforcement, because it would require the imposition of temporary position limits, based on surveillance, but it would not require the imposition of penalties or the finding of violations. In the background, of course, the threat of enforcement would hopefully induce traders to comply.

3. <u>Enforcement through SROs: Suitability and Fiduciary Duty</u>. An initial significant difference between the SEC's and the CFTC's regulatory regimes is the "suitability requirement." Broker-dealers are under a duty, imposed today by FINRA's rules, not to recommend unsuitable investments to investors in light of the investor's disclosed investment goals and needs. Although the "suitability rule" does not give rise to a private cause of action, it is enforceable both in proceedings brought by FINRA, the

[11] See CEA § 4a(c), 7 U.S.C. 6a(c).
[12] See Markham, supra note _, at 365.
[13] Id. at 366.

securities industry's SRO, and in arbitration proceedings. In contrast, futures commission merchants ("FCMs") are not subject to any similar duty under the CEA.[14] Although the National Futures Association ("NFA"), the SRO for the commodities industry, has adopted a "know your customer rule" that resembles FINRA's similar rule, it is considered only a business conduct standard and does not give rise to any liability.[15]

Alone, this disparity between the duties of brokers and FCMs to their clients is significant. But it is aggravated further by the fact that some instruments traded in the OTC derivatives market (for example, credit default swaps) seem entirely unsuitable for most investors, including smaller pension funds. Still, the current factor that most heightens this contrast is that the Investors Protection Act of 2009, as proposed by the Administration, seeks to subject brokers to at least a modest fiduciary duty. The disparity here requires some justification. If brokers are made subject to a fiduciary duty (however defined), should FCMs have no similar responsibility to their clients, including even a minimal obligation to avoid unsuitable recommendations? Moreover, because legislation is pending, the time seems opportune to re-examine the status of the FCM.

From an enforcement perspective, this difference matters because FINRA is a powerful SRO that can (and does) engage in a significant range of enforcement actions, while the NFA does not appear to play a corresponding role. Creating either a suitability obligation or a fiduciary duty for FCMs would make the NFA at least a potential enforcement arm.

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[14] See Trustman v. Merrill Lynch, Pierce Fenner & Smith, Inc., 1985 WL 28 at 15 (C.D. Cal. 1985).

[15] See NFA Interpretive Notice, CFA Compliance Rule 2-30: Customer Information and Risk Disclosure (June, 1986); see also Pardieck, Kegs, Crude and Commodities Law: On Why It Is Time to Rethink the Suitability Doctrine, 7 Nev. L. J. 301 (2007).

4. Enforcement Policies. Both the SEC and CFTC have broadly articulated their enforcement policies in several policy statements and releases (as have a number of other federal agencies with jurisdiction over financial markets, including the Department of Justice and the Federal Energy Regulatory Commission ("FERC")). In the case of the SEC, its two most important enforcement policy statements are the Seaboard Report[16] and its 2006 Statement of the Securities and Exchange Commission Concerning Financial Penalties.[17] The former lists the criteria – including self-policing, self-reporting, remediation, and cooperation – that the SEC will consider in deciding whether to bring an enforcement proceeding, and it gives special prominence to cooperation with the SEC's investigation efforts. The latter statement addresses when the SEC will impose a monetary penalty on a corporation and indicates that civil penalties should be normally imposed on responsible officers (except when the corporation derives a "direct benefit" from the misconduct).[18]

The CFTC has its own policy statements on enforcement, which date back to 1994 and were updated in 2004.[19] As with the SEC's Seaboard Report, the CFTC's Policy Statement also places considerable emphasis on the respondents' cooperative conduct. In its 2004 Cooperation Advisory, the CFTC identified three varieties of

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[16] See Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation in Agency Enforcement Decisions, Sec. Exch. Act Rel. No. 44,969 (Oct. 23, 2001).
[17] See Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006).
[18] There is some question whether the SEC continues to abide by this policy statement, which it has not updated. This is the subject of a continuing judicial inquiry in the ongoing Bank of America case.
[19] See Policy Statement Relating to the Commission's Authority to Impose Civil Monetary Penalties and Futures Self-Regulatory Organizations' Authority to Impose Sanctions; Penalty Guidelines, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) Para. 26,265 (CFTC 1994). See also, C.F.T.C. Enforcement Advisory: Cooperation Factors in Enforcement Division Sanction Recommendations (2004) (available at http://www.cftc.gov/files/enf/cooperation-advisory.pdf).

cooperation on which it would place weight: (1) the company's good faith in investigating misconduct; (2) cooperation with the CFTC; and (3) efforts to prevent future violations.

The enforcement and sanction policies of the SEC and CFTC seem broadly consistent, but there are differences. In 2005, the CFTC's enforcement staff took the position that the CFTC will not require a target corporation to waive the attorney-client privilege.[20] In contrast, the SEC's Seaboard Report does require such a waiver. In light of much recent controversy in the wake of United States v. Stein[21] (which reversed the convictions of KPMG officers where the Department of Justice had pressured KPMG not to indemnify their legal expenses), the issue of waiver of the attorney-client privilege is sensitive and probably undergoing re-consideration at both agencies. Still, this is an area where harmonizing the approach of both agencies seems essential.

The Investor Protection Act of 2009 would also broadly authorize the SEC to pay bounties to informers in securities fraud cases who provide useful information under specified circumstances (the SEC is already authorized to do this in the case of insider trading investigations). Again, no reason is apparent why the enforcement policies of the SEC and CFTC should differ on this point, and thus expanding the proposed legislation to cover the CFTC also would make considerable sense.

5. Penalty Levels. Under § 13 of the CEA, the maximum criminal sentence is ten years, and the maximum fine is $1,000,000. Under § 32 of the Securities Exchange Act of 1934, the maximum criminal sentence is 20 years, and the maximum fine is $25

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[20] See Allan Horwick, Warnings to the Unwary: MultiJurisdictional Federal Enforcement of Manipulation and Deception in the Energy Markets After the Energy Policy Act of 2005, 27 Energy L.J. 363, at 410 n. 312 (2006) (quoting Joan Manley, Deputy Director of Enforcement at the CFTC).

[21] 541 F.3d 130 (2d Cir. 2008).

million ($5 million in the case of a natural person). Although reasonable persons can dispute the need for lengthy prison sentences of 20 years, the $1,000,000 ceiling on a criminal fine in the case of the CFTC seems archaic, and the costs of defense counsel in many cases will likely exceed this maximum level. Here, legislation to update these trivialized financial penalties seems necessary.

6. Fair Funds For Investors? Section 7246 of the Sarbanes-Oxley Act (15 U.S.C. § 7246) authorizes civil penalties obtained by the SEC, under certain circumstances, to become part of the disgorgement fund that will be paid to the victims of such violation. In cases involving market manipulation, for example, it may be appropriate for legislation to similarly authorize civil penalties obtained by the CFTC to be paid to victims of the violation.

7. Rules of Professional Responsibility for Attorneys. Section 7245 of the Sarbanes Oxley Act (15 U.S.C. § 7245) directed the SEC to issue rules requiring an attorney to report evidence of a material violation of the securities laws or a breach of fiduciary duty "or similar violation" to the chief legal counsel or chief executive of the company (and in certain instances to notify later the audit committee of the board). The SEC has adopted elaborate rules to this end.[22] Although these rules would have to be adapted to apply sensibly to the CFTC (where few attorneys are representing a corporate issuer), it could be an important enforcement tool if attorneys for a trader, market maker, investment bank, or a registered entity were under a similar obligation to notify the general counsel of such corporate entity that they were representing if they became aware of "evidence of a material violation."

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[22] See "Standards of Professional Conduct for Attorneys, Appearing and Practicing Before the Commission in the Representation of an Issuer," 17 C.F.R. § 205.1 to 205.7.

8. Private Enforcement. Class actions are possible under both the federal securities laws and the CEA (chiefly for manipulation in the case of the CEA). Sections 21D and 21E were added to the Securities Exchange Act of 1934 in 1995 by the Private Securities Litigation Reform Act to chill frivolous actions. These provisions have no complementary provision in the CEA. Moreover, Section 25 of the CEA confers a private right of action against both primary violators and any person "who willfully aids, abets, counsels, induces or procures the commission of a violation of this Act." This is in direct conflict with Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), which immunizes such secondary participants from liability in private actions. In addition, punitive and exemplary damages of not more than twice the actual damages are also available under the CEA in specified circumstances.[23]

No position is here taken on in which direction harmonization should move, but the disparity here is striking.

9. Pre-Dispute Arbitration. Section 14(g) of the CEA authorizes pre-dispute arbitration provisions, at least in the case of institutional investors. Currently, the proposed Investor Protection Act of 2009 would authorize the SEC to either invalidate or limit the enforceability of such arbitration provisions. If the SEC is to be given such power, arguably the CFTC should receive similar authority. Or, it should explain why it does not need similar authority.

10. Enforcement Powers. For many years, the SEC had greater enforcement powers. Since 2008, this has changed, as the CFTC now has authority to seek an injunction (§ 13a-1 of the CEA) and can seek civil penalties in court of up to $100,000 or three times the monetary gain in most cases (and a maximum of $1,000,000 or a similar

[23] See Section 25(a)(3)(B) of the CEA, 17 U.S.C. § 25(a)(3)(B).

treble damages multiple in manipulation cases) (see § 13a-1(d) of the CEA). The CFTC also now has authority to issue cease and desist orders (as the SEC long has had).

The SEC can levy administrative penalties of up to $100,000 for a natural person and $500,000 for other persons if the misconduct involved fraud, deceit, manipulation or a deliberate or reckless disregard of a regulatory requirement (Section 21B(b)(2) of the Securities Exchange Act). The SEC's ability to seek treble damages is limited to insider trading violations (Section 21A(a)(2) of the Securities Exchange Act).

Viewed simply in terms of penalty levels, because the SEC can seek an administrative penalty of $500,000 from a person other than a natural person in a case not involving insider trading or manipulation, it is armed with a greater enforcement club; however, to the extent that the CFTC can seek a treble damages penalty outside of the insider trading context, it arguably has greater ability to impose stiff penalties. The bottom line here is that it would make sense to harmonize these penalty levels so that both agencies had equivalent powers. In any event, the $100,000 ceiling on CFTC penalties not involving manipulation does seem low.

Overshadowing all other differences, however, is the fact that only the SEC can impose administrative penalties without going to court. Administrative penalties are cost efficient (although they are probably most useful in lesser cases not involving suspected manipulation). Although the CFTC can impose a penalty for failure to comply with its cease and desist orders, it should be given equivalent power to the SEC to impose administrative penalties to achieve full harmonization.

CONCLUSION

A few of these proposals would require legislation: (1) to define insider trading; (2) to raise penalty levels; (3) to authorize a "Fair Funds" provision; (4) to pay informers a bounty; (5) possibly to impose a modest fiduciary duty on FCMs; (6) to restrict pre-dispute arbitration; and (7) to authorize administrative penalties for the CFTC. Other objectives might be achieved without legislation by: (1) imposing a suitability obligation on FCMs; (2) imposing an ethical duty on counsel to report evidence of a material violation; and (3) coordinating policies on cooperation and when penalties should be imposed on officers versus the corporate entity. Market manipulation is probably the greatest challenge facing the CFTC, and here legislation does not appear to be the answer (but tougher surveillance and position limits may be).