CLIENT ALERT

CEA Jurisdiction Attaches When Irrevocable Foreign Futures Trades Are Executed via Globex

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On March 29, 2018, the United States Court of Appeals for the Second Circuit held that a private claim by Korean traders alleging that they incurred losses caused by the "spoofing" activity of a New York high-frequency trading firm that executed trades in the KOSPI 200 futures contract via Globex stated a claim under the Commodity Exchange Act, as amended (the "CEA").[1] The decision highlights the expansive reach of the CEA's anti-manipulation provisions, and may encourage the Commodity Futures Trading Commission (the "CFTC") and U.S.-based exchanges to pursue enforcement actions against spoofing activity (*i.e.*, submitting bids/offers with the intent to cancel at the time the person submits the bid/offer) in foreign futures contracts when those transactions are executed via U.S.-based trading systems.[2]

Jurisdictional Hook: Using Globex for After-Hours Trading on the Korea Exchange

The alleged spoofing activity occurred during after-hours trading in the KOSPI 200 contract listed on the Korea Exchange ("KRX"). During after-hours trading (referred to as the "night-market"), KRX utilizes CME Group's electronic trading platform, Globex, located in Illinois, to facilitate the execution of futures trades. Trades executed after-hours through Globex are cleared and settled by KRX in Korea the next morning. According to the Second Circuit, the use of Globex to execute irrevocably binding transactions provided a sufficient basis for the plaintiffs to allege that the trades were domestic (*i.e.*, U.S.) transactions.[3] Applying the U.S. Supreme Court's analysis in *Morrison v. National Australia Bank*

1 *Choi v. Tower Research Capital*, No. 17-648-cv (2d Cir. Mar. 29, 2018).

2 *See* Willkie Farr & Gallagher, LLP Client Alert summarizing recent CFTC and criminal actions regarding spoofing available here.

3 *Choi* at 12, 14-15.

regarding the extraterritorial application of U.S. securities laws, the Second Circuit determined that a private right of action alleging manipulation under CEA Section 22(a)(1)(D)(i) could reach the alleged spoofing during the after-hours trading in the KOSPI 200 contract.[4]

Section 22(a)(1)(D)(i) of the CEA authorizes private rights of action for actual damages against persons that employ "any manipulative device or contrivance" contrary to the CFTC's anti-manipulation rule "in connection with . . . a [futures contract] on or subject to the rules of any registered entity."[5] The private right of action in CEA Section 22(a)(1)(D)(i) effectively replicates the authority in CEA Section 6(c)(1) and is the underlying authority for CFTC Rule180.2, both of which the CFTC relies upon to pursue manipulation claims in the futures markets.[6]

Interestingly, the Second Circuit did not address the defendant's arguments that neither KRX nor Globex is a registered entity.[7] Instead, the Second Circuit determined that the relevant question was whether the transactions met the standard of a "domestic transaction," which, as described in *Morrison*, occurs when "irrevocable liability is incurred or title passes within the United States."[8] Because Globex is located in Illinois, and the matching of trades through Globex resulted in irrevocable liability, the Second Circuit concluded that the trades were domestic transactions.[9] The court rejected the defendant's argument that the trades matched through Globex were not irrevocable until settled and cleared the next day in Korea. Consequently, because the trades were domestic transactions, the plaintiffs' complaint stated a private cause of action under CEA Section 22(a)(1)(D)(i) for damages caused by alleged manipulation.

<u>Expansive Reach</u>

The Second Circuit decision shows that the CFTC's anti-manipulation authority may extend farther than some might realize. Both CEA Section 22(a)(1)(D)(i), which establishes a private right of action, and CEA Section 6(c)(1), which prohibits manipulation, are limited to futures contracts traded "on or subject to the rules of a registered entity."[10] The

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4 *See Morrison v. National Australia Bank*, 561 U.S. 247 (2010).

5 The decision does not address the scope of CEA Section 22(a)(1)(D)(ii), which is not expressly limited to claims based upon futures contracts traded on a registered entity. Although not addressed in the Second Circuit decision, we note that a private right of action under CEA Section 22(a)(1)(D)(i) also applies to manipulative activity in connection with purchases and sales of swaps and cash commodities in interstate commerce.

6 The prohibition of manipulation in CEA Section 6(c)(1) also applies to swaps and underlying cash commodities, similar to that in CEA Section 22(a)(1)(D)(i). Different statutes of limitations apply to private claims (two years) and CFTC enforcement claims (five years).

7 Registered entities include a designated contract market; derivatives clearing organization; swap execution facility; and a swap data repository. *See* CEA Section 1a(40). Globex is an electronic trading platform for the various CME Group exchanges that are registered entities.

8 The Second Circuit also cited *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

9 *Choi* at 14-15.

10 Although the private right of action in CEA Section 22(a)(1)(D)(ii) arguably may be broader than the private right of action in subparagraph (i) because subparagraph (ii) references manipulation of "such contract" without referring to a registered entity, the Second Circuit decision did not

Second Circuit appears to have ignored the requirement in CEA Section 22(a)(1)(D)(i) that the manipulation occur in connection with futures trades "on or pursuant to the rules of a registered entity." In this case, the trades occurred on Globex and pursuant to the rules of KRX, neither of which is a registered entity. Given that the CFTC's anti-manipulation authority in CEA Section 6(c)(1) uses nearly identical language, the CFTC may rely on the Second's Circuit's decision to support an expansive view of its authority to pursue manipulative activity in connection with foreign futures contracts, provided that it can demonstrate that execution occurred in the United States (*e.g.*, via Globex).

The decision may also encourage the CFTC and the exchanges to continue to pursue spoofing activity in foreign futures contracts that occurs through U.S.-based trade execution systems. Although the CEA includes a specific prohibition of the disruptive trading practice known as spoofing in Section 4c(a)(5)(C), the CFTC previously has explained that the prohibition applies only to trading activity on a registered entity such as a designated contract market or swap execution facility.[11] When spoofing activity occurs in connection with foreign futures contracts, the CFTC has not relied upon the anti-spoofing provision in CEA, but rather upon the CFTC's supervision rules.[12] However, the supervision rules in CFTC Rule 166.3 apply only to specified persons registered with the CFTC (*e.g.*, futures commission merchants, commodity pool operators, etc.). By comparison, the prohibition of manipulation in the CEA and CFTC rules applies to all market participants. Therefore, the Second Circuit decision may encourage the CFTC to pursue spoofing activity in reliance on its general anti-manipulation authority for trades on a foreign exchange when the execution occurs in the United States.

address subparagraph (ii). Furthermore, the prohibition of manipulation in each of CEA Sections 6(c) and CFTC Rule 180.2 refers to futures contracts traded "on or pursuant to the rules of a registered entity."

[11] *See Antidisruptive Practices Authority*, 78 Fed. Reg. 31890, 31892 (May 28, 2013).

[12] *See, e.g., In re Logista Advisors LLC*, CFTC Docket No. 17-29 (Sept. 29, 2017) (available here).

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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