

Commodities Trading & the UK Market Abuse Regime:

Following the US Lead?

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THE EXPONENTIAL GROWTH of the commodities markets in recent years – which has attracted new classes of investors to a hitherto specialised marketplace – has caused the UK Financial Services Authority (FSA) to intensify its scrutiny of the sector. Significantly, in March this year, the FSA published a detailed review of the commodities markets identifying what it characterised as significant risks which need to be addressed by participants (Table 1).

The combination of increased cross-border cooperation between regulators and heightened alertness on the part of the FSA to the risks of market abuse in commodities markets heralds a dawn of greater regulatory interference in markets which have previously been largely unsupervised.

“There has been a significant expansion in commodities investment in recent years, bringing with it a range of new participants. These developments raise various risks and challenges for those involved. It is essential that all parties fully appreciate and address these risks.”¹

Source: UK Financial Services Authority

The FSA has stressed that the commodities markets are not necessarily more susceptible to improper practices than other markets and that, given the nature of trading in these markets, speculation may not be tantamount to market abuse. However, the FSA has stated that, this year, it will be monitoring potentially abusive trading practices more closely, and it will look to ensure that market participants have effective controls in place.

Therefore, it behoves UK market participants to fully understand the US experience in commodities markets.

Transatlantic Policing

Regulators are now cooperating more concertedly to supervise increasingly borderless financial markets. In November 2006, for example, the FSA and the CFTC signed a Memorandum of Understanding (MOU) to enhance cross-border oversight in rela-

tion to abusive or manipulative trading practices on UK and US derivatives exchanges (Table 2). The CFTC and the FSA have, in the past, cooperated and shared information for the purposes of enforcement. However, the MOU signifies a proactive rather than reactive approach to monitoring market activity.

In particular, the MOU focuses on “trading with cross-border implications to identify whether suspected abusive market activity is occurring”. As most trading in commodities markets is likely to have cross-border implications, it is clear that market participants should be sensitive to the regulatory approaches of both the CFTC and the FSA.

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The US Example

The US commodities markets have been under the regulatory spotlight for some time. The US Commodity Futures Trading Commission (CFTC), which regulates commodity derivatives trading, has taken high profile enforcement action against abusive activity. The number of cases filed by the CFTC has been grow-

TABLE 1: GROWTH IN COMMODITIES INVESTMENT: RISKS & CHALLENGES FOR MARKET PARTICIPANTS

- **System Capacity:** The systems and operations of existing trading platforms may not be able to handle the significant increases in volume.
- **Staff Expertise:** The growth of market entrants (both firms and exchanges) has led to a finite pool of staff expertise being stretched in an unprecedented manner.
- **Market Volatility:** Increased volatility in some markets has made it even more important that market participants have appropriate risk management systems and controls in place. Related to this is the risk portfolio effect of the increasing investment trend of acquiring physical assets (e.g. power stations).
- **New Market Participants:** The relative lack of experience and new techniques of participants who are unfamiliar with established trading practices will alter the risk profile of the market.
- **Market Abuse:** Firms and exchanges need to put in place appropriate measures to detect and prevent improper practices.

Source: www.fsa.gov.uk/pubs/other/commodity_invest.pdf

TABLE 2: TRANSATLANTIC REGULATORY COOPERATION

CFTC & FSA MOU

On 17th November 2006, the FSA and the CFTC signed an MOU, designed to strengthen and encourage cooperation between the two agencies on the exchange of regulatory information which will support cross-market surveillance operations. The MOU is not legally binding and confers no rights. However, each agency makes the following statements of intention:

- To regularly consult, cooperate and exchange information regarding general supervisory developments and issues relevant to the cross-border operations of investment exchanges.
- To inform the other agency of activities taking place in its jurisdiction that may assist the other agency with surveillance of market abuse.
- To provide the other agency with full cooperation in identifying market abuse practices and, to the extent reasonably practicable, to provide specific types of information.
- To periodically institute programs to share information that will assist with the detection of market abuse.

Source: www.fsa.gov.uk/pubs/mou/cftc.pdf

ing by an average of 30% annually and, over the last 20 years, it has obtained judgments or settlements totaling US\$2.6bn in civil monetary penalties.

The regulatory focus on commodities in the US may reflect the heightened political sensitivity over speculation in commodity markets, following fears over price manipulation in the US energy markets. In the UK, such issues do not seem to make headlines to the same extent, and there have been no recent major public enforcement actions in the commodities markets.

Therefore, market participants potentially are subject to overlapping regulatory regimes, particularly when trading in products or financial instruments traded in different jurisdictions. The CFTC can exercise jurisdiction if the case meets the US Federal personal and subject matter jurisdiction tests. In practice, where an individual or entity has contact with the US, and the trading in question impacts US markets, it is likely that the CFTC will be able to exercise its extra-territorial jurisdiction.

Market Manipulation: The US Standard

Manipulation or attempted manipulation of the market price of any commodity or any future or option contract is prohibited by the Commodity Exchange Act, as amended.

The constituent elements of market manipulation will exist when the CFTC has reason to believe that:

- (i) Any person has the ability to influence prices;
- (ii) The person has the specific intent to create an artificial price;

(iii) An artificial price exists;

(iv) The artificial price has been caused by alleged manipulative acts.

The term “manipulate” has not been statutorily defined, and there are no fixed standards or tests to apply in determining whether manipulation has occurred. The US courts apply a practical test which aims to discover whether intentional conduct has resulted in a price which does not reflect market forces.

Manipulation is difficult to prove because it is necessary to establish what the ‘true’ market price should have been, while prices of futures contracts are frequently volatile and subject to fluctuation. It is also difficult to show that the artificial price is causally linked to the allegedly manipulative acts. Therefore, a defendant who did not actually cause an artificial price cannot be guilty of manipulation.

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By contrast, most cases are brought under the less onerous “attempted manipulation”, which only requires:

- (i) The specific intent to create an artificial price;
- (ii) An overt act attempting to create such a price.

A key element of both manipulation and attempted manipulation is the specific intent to create an artificial price. In the case of attempted manipulation, it is not even necessary that the conduct would have been likely to cause an artificial price, as long as it can be shown that there was a *conscious* and *specific* (rather than a negligent or general) intention to manipulate the market. For example, in the *Indiana Farm Bureau* case, the defendant had a legitimate commercial reason for reducing supplies of corn, therefore the inference was not drawn that the relevant actions could only have been taken with the intention to manipulate prices.

The standard of proof to be met for manipulation and attempted manipulation is that of a balance of probabilities, i.e. it must be more probable than not that a person intended to manipulate the market. The courts often will infer the probability of such an intention from the facts, even if there is no direct evidence to prove the intention.

Manipulation was found in the *Avista Energy Inc.* case, which involved electricity futures settlement price manipulation by Avista traders. The CFTC considered whether Avista was able to create arti-

ficial settlement prices in the futures contracts by placing large orders on the options' expiration days. The CFTC found that the traders had engaged in manipulative practices by selling electricity futures contracts at lower prices than the prevailing bids and by purchasing electricity futures contracts at prices higher than the prevailing offers.

Market Abuse: The UK Standard

The UK market abuse regime prohibits offences equivalent to US market manipulation. The offence of market abuse is set out in the Financial Services and Markets Act 2000. It is categorised as a civil regulatory offence but, in practice, has a hybrid criminal character which reflects its serious nature.

The FSA must prove its case to the civil standard, i.e. market abuse must be proven to have occurred on a balance of probabilities rather than beyond reasonable doubt. However, the case of *Davidson and Tatham* clarified that market abuse allegations require very cogent evidence to be proven. Therefore, in serious cases, the evidential standard is akin to the criminal standard. Potential penalties for market abuse are unlimited fines, public censure and regulatory sanctions such as prohibition orders banning an individual or a firm from conducting regulated business in the financial services industry.

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The offence most analogous to the US market manipulation offence is "manipulating transactions". It consists of affecting transactions or orders to trade, other than for legitimate reasons and in accordance with market practice, which:

- (i) Give or are likely to give a false or misleading impression as to the supply of, or demand for, an investment; or
- (ii) Secure the price of an investment at an abnormally high level.

Similar to the US attempted manipulation standard, the offence can be committed even if the trader did not influence the price and had no ability to do so.

An example of a manipulating transaction is an 'abusive squeeze' where a trader controls a large and dominating position in the market to deliberately increase the price. The Code confirms that squeezes occur frequently and legitimately through the proper interplay of market forces. The Code also states that having a significant influence over an investment is not in itself abusive conduct. Instead, wider factors will be taken into account in determining whether the conduct is abusive, such as the extent to which the trader relaxes control in the market, e.g. by lending the investment.

"Misleading behaviour" or "market distortion" are also prohibited. Misleading behavior is defined as that which is:

- (i) Likely to give a regular user of the market a false or misleading impression as to the supply of, demand for, or price or value of investments; or
- (ii) Would be, or would be likely to be regarded as, behaviour that would, or would be likely to, distort the market in such investments.

The Code gives the example of the movement of physical commodity stocks, which might create a misleading impression as to the supply of, or demand for, or price or value of a commodity or

the deliverable into a commodity futures contract.

The UK market abuse regime, therefore, concentrates on whether conduct gives a false or misleading impression as to supply or demand rather than whether an artificial price was secured, which may be difficult to show in complex commodities market transactions. Under the UK regime, there is no concept of "attempted market abuse", but the more flexible standards capture conduct even if it does not result in artificial prices. Furthermore, conduct which falls short of market abuse still can result in charges of breaching the FSA Principles, for which the FSA can impose fines and prohibition orders on regulated firms and individuals.

Conclusion

It is important to note that the UK market abuse regime was not specifically designed for the commodities market, and has not yet been clarified by case law applying the legislation to this trading sector. Therefore, the challenge for the FSA going forward will be to ensure that its staff have the requisite commodity-specific expertise (which the CFTC already has) to effectively supervise market participants and police the markets. Given the MOU signed between the CFTC and the FSA, the FSA's Review, and the CFTC's experience in these markets, it seems likely that the CFTC will have a formative influence over upcoming FSA enforcement actions and policies in the commodities area •

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1. *Growth in Commodity Investment: Risks and Challenges for Commodity Market Participants*, By Emmet Doyle, Jonathan Hill, Ian Jack: FSA Markets Infrastructure Department, March 2007: The Full Report can be downloaded from the *Commodities Now* website: www.commodities-now.com/content/research