In early May, David Meister, the Director of the Division of Enforcement for the Commodity Futures Trading Commission (CFTC), announced at an industry conference that entities and individuals should expect more aggressive enforcement of the Commodity Exchange Act (CEA) and its regulations by the CFTC. Meister reportedly pointed to the notable increase in cases filed as evidence of the Division’s intent to move more aggressively and efficiently. Meister also indicated that the Division would utilize the enforcement tools provided by Congress under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which, among other things, expanded the types of conduct considered manipulative and subject to CFTC enforcement actions. On October 6, 2011, the CFTC announced that during its most recent fiscal year (October 1, 2010 to September 30, 2011), the Division filed 99 enforcement actions, an increase of 74 percent over the prior year. The Division also obtained double the amount of civil monetary penalties, restitution, and disgorgement, as compared to the prior fiscal year. In late November 2011, Meister announced at another industry conference the creation of two enforcement units to focus on the swaps market, and on fraud and manipulation.

This article provides a quick introduction to certain aspects of CFTC investigations and enforcement proceedings, particularly in comparison with investigative and administrative proceedings before the Securities and Exchange Commission (SEC).

Credits for Self-Policing, Self-Report, Remediation, and Cooperation

Cooperating with the CFTC’s Division of Enforcement

The CFTC’s Division of Enforcement has issued guidance on the credits available to corporations (Enforcement Advisory) for sanctions it will recommend for violations of the CEA. The Enforcement Advisory, first issued in 2004 and revised in 2007, states that the CFTC’s Division of Enforcement will focus on three general areas of corporate actions: good faith in uncovering and investigating misconduct; cooperation with the CFTC in reporting; and efforts to prevent future misconduct. These areas are similar to those described in the SEC’s Seaboard Report.

The Enforcement Advisory also provides a non-exhaustive list...
of examples of efforts similar to those in the Seaboard Report, such as implementation of additional controls or procedures designed to prevent reoccurrences of violations.

Despite the similarities between the CFTC and SEC approaches to cooperation, there are important distinctions. First, the Enforcement Advisory on its face relates only to the determination of sanctions. In contrast, the Seaboard Report states that the SEC may choose to forego an enforcement action entirely if appropriate.

Second, the Enforcement Advisory states that, when deciding whether to reduce sanctions, the CFTC’s Division of Enforcement will consider the following factors not discussed in the Seaboard Report or in the SEC Enforcement Manual:

- Whether a corporate officer or company attorney promptly met with the CFTC’s Division of Enforcement;
- Whether the company used “all available means” to make employee testimony available;
- Whether the company used “all available means” to “avoid entering into joint defense agreements”;
- Whether the company used “all available means” to “provide a financial analysis of its gain from” the misconduct; and
- Whether the company provided a “full and complete report of the internal investigation,” including “relevant communications between officers, directors and employees.”

The Enforcement Advisory places a premium on rapid reporting to the CFTC. A company that discovers misconduct potentially violative of the CEA therefore may wish to quickly decide whether it will attempt to meet all of the factors listed in the Enforcement Advisory. For example, because the CFTC’s Division of Enforcement considers production of a full and complete internal investigation report in its cooperation analysis, the company may need to decide early on how much information to include in the report, if it decides to go this route. The company may also need to weigh the potential risks of entering into joint defense agreements against their benefits.

Third, in addition to the “positive” factors the CFTC’s Division of Enforcement will consider in reducing sanctions, the Enforcement Advisory provides examples of conduct that will offset cooperation credits. Not only does the Enforcement Advisory state that obstructive conduct such as “misrepresenting the nature or extent of the company’s misconduct” can offset cooperation credits, it also states that cooperation credits can be offset if the CFTC’s Division of Enforcement believes that the company “turned a blind eye” to misconduct or “waited for a governmental inquiry to take action to uncover ongoing misconduct...”

Finally, the CFTC’s Division of Enforcement has not yet provided guidance on several issues that the SEC has addressed. First, since 2010, the SEC has had enforcement initiatives aimed at fostering cooperation from individuals. Second, the SEC approved the use of various formal written agreements such as deferred prosecution agreements for both individuals and corporations. Third, the SEC described a streamlined process for submitting immunity requests to the Department of Justice.

— Waiver of Privilege

The Enforcement Advisory provides a brief statement regarding the CFTC Division of Enforcement’s position on waiver of the attorney-client privilege or the work product doctrine in the context of cooperation credits, concluding that the protections “are not intended to be eroded or heightened by this advisory.”

In a footnote to the Seaboard Report, the SEC stated that it recognized the importance of the attorney-client privilege and the work product doctrine and would “not view a company’s waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the [SEC] staff.” However, in light of guidance from the Department of Justice, the SEC has sought to downplay the importance of privilege waivers. Accordingly, the SEC’s Enforcement Manual expressly states that cooperation does not require the production of privileged or protected documents, and that staff must obtain prior approval before asking a party to waive the attorney-client privilege or work product doctrine.

The revised Enforcement Advisory was written before the Filip Memorandum, which prohibited federal prosecutors from considering waiver as a factor in cooperation. Therefore, the CFTC’s Division of Enforcement’s stance on this issue may well change as the SEC’s has.

The Wells Process

— The SEC’s Wells Process

As respondents and practitioners familiar with SEC enforcement proceedings are aware, before the Division of Enforcement makes a formal enforcement recommendation to the SEC Commissioners, it provides respondents with an opportunity to respond to the Division’s proposed charges (a “Wells notice”). Proposed respondents can submit a response to the Wells notice (a “Wells submission”), which presents the proposed respondent’s or defendant’s position on why there was no violation of the securities laws, or why the sanction proposed is inappropriate.

Although providing a Wells notice is discretionary, the SEC’s Division of Enforcement will do so absent exceptional circumstances. Indeed, the SEC’s Enforcement Manual states that, not only must the staff of the SEC’s Division of Enforcement obtain approval from the Associate Director or Regional Director before issuing a Wells notice, the staff must also obtain approval before recommending enforcement action without issuing a Wells notice. If a Wells submission is made, it must be forwarded to the SEC Commissioners together with the Division of Enforcement’s recommendation of an enforcement action.
The CFTC also has informal procedures for providing notice of charges very similar to the SEC’s Wells process. In the past, the CFTC’s Division of Enforcement viewed the Wells process as discretionary and thus did not necessarily provide Wells notices as a matter of course. However, at the recent industry conference, Meister reportedly stated that prospective respondents should presume that the Wells process will be available to them. Although Meister’s statement may signal a shift in how the CFTC’s Division of Enforcement at least will approach the Wells process, potential respondents should note that there are differences between the SEC’s and the CFTC’s procedures. First, a CFTC informal rule includes a specified page limit and time period for response not found in the SEC’s informal rule. Second, the prospective respondent must affirmatively request that the Wells submission be provided to the CFTC Commissioners. Finally, and most critically, “any statement of fact included in the submission must be sworn to by a person with personal knowledge of such fact.”

Secondary Liability

Another area in which CFTC and SEC practices differ is in the area of secondary liability. While the SEC can impose liability on control persons under the Securities Exchange Act of 1934 (Exchange Act), the CFTC can impose liability on a far more expansive group of respondents under the CEA.

Control Person Liability under the Exchange Act

Section 20(a) of the Exchange Act provides that a person who directly or indirectly controls another is liable for the violations of that other person unless the control person acted in good faith. The federal courts have split on the necessary elements of establishing a prima facie case. Some circuit courts have held that control person liability exists, even without culpable participation, if the following are established:

1. that a primary violator violated the federal securities laws;
2. that the alleged control person actually exercised control over the general operations of the primary violator; and
3. that the alleged control person possessed, but did not necessarily exercise, the power to determine the specific acts or omissions upon which the underlying violation is predicated.

Whether a person is an agent does not depend solely on whether that person is acting as an agent of another. The CFTC will consider several factors when determining whether one person is acting as an agent of another.

Control Person Liability under the CEA

The CEA also contains a provision imposing control person liability, but places the initial burden on the CFTC to establish a lack of good faith and knowing inducement of the violation. According to the CFTC, controlling person liability attaches if a person possesses the ability to control the activities upon which the primary liability is predicated, even if that ability was not exercised. In addition, Section 13(b) of the Act requires that the controlling person “did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.” All that is required to constitute “knowing inducement” under Section 13(b) of the Act is that the controlling person “had actual or constructive knowledge of the core activities that constitute the violation at issue and allowed them to continue.”

Vicarious Liability under the CEA

Where SEC and CFTC practices are most divergent is in the area of vicarious liability. In addition to enforcement actions against control persons, the CFTC may also bring actions against principals for the acts of their agents. No parallel provision exists under the securities laws. Section 20(a)(1)(B) of the CEA, states:

The CFTC conducts “an overall assessment of the totality of the circumstances in each case” when determining whether one person is acting as an agent of another. Whether a person is an agent does not depend solely on whether that person is an employee. The CFTC will consider several factors to determine whether an agency relationship exists, such as the following: commission-splitting or other compensation agreement; business generated by the agent inuring to the benefit of the principal; solicitation of accounts by the agent for the principal; use of the principal’s written materials; and supervision by the principal. Accordingly, the CFTC concluded that an agency relationship existed where a commodity trading advisor used a...
futures commission merchant’s (FCM) forms, solicited customers on behalf of the FCM, and received per-trade compensation. Berisko v. Eastern Capital Corp., CFTC No. R81-35-82-435, Comm. Fut. L. Rep. (CCH) ¶ 22,772 (CFTC 1985). If an agency relationship does exist, “strict liability is imposed on principals for the actions of their agents.” In the Matter of UBS Securities, LLC, CFTC No. 10-11, (CFTC 2010) (citing Rosenthal & Co. v. CFTC, 802 F. 2d 963, 966 (7th Cir. 1986) and Dohnen-Ramirez & Wellington Advisory, Inc. v. CFTC, 837 F.2d 847, 857-58 (9th Cir. 1988)).

Conclusion

Although there are many similarities between administrative proceedings before the CFTC and the SEC, respondents and counsel familiar with SEC proceedings should be aware that several important differences exist, particularly in light of the CFTC’s increasing enforcement activity. Respondents and counsel may wish to be aware of the differences between the CFTC and the SEC even before the CFTC initiates an investigation, as cooperation credits can be influenced by conduct occurring before the CFTC begins an investigation.

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1 Christopher Doering, New CFTC Enforcement Chief Vows to be Aggressive, Reuters (May 5, 2011).
4 CFTC Enforcement Advisory, Cooperation Factors in Enforcement Division Sanction Recommendations.
5 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (Seaboard Report), Release No. 34-44969 (Oct. 23, 2001). In 2001, the SEC issued the Seaboard Report in which it explained that it was not taking enforcement action against a company because the SEC was “crediting” the company’s behavior in response to discovery of misconduct. The Seaboard Report provided guidance to companies by listing 13 non-exclusive factors that the SEC “will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation—from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents we use to announce and resolve enforcement actions.”
6 SEC Press Release, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations, No. PR-2010-6 (Jan. 13, 2010).
7 The 2004 version of the Enforcement Advisory expressly stated that waiver of privilege was a factor that the CFTC’s Division of Enforcement would consider in reducing sanctions.
9 In August 2008, then Deputy Attorney General Mark Filip announced that the Department of Justice’s Principles of Federal Prosecution of Business Organizations would, effective immediately, prohibit the DOJ from considering waiver of privilege in determining whether to credit a company’s cooperation.
10 As stated in Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Release No. 33-5310 (Sept. 27, 1972), such situations would generally involve the need for prompt action to avoid further harm.
11 See 17 C.F.R. § 11.1, Appendix A (“Such written statements shall be submitted within 14 days after persons are informed by the Division of Enforcement of the nature of the proposed allegations pertaining to them and shall be no more than 20 pages. . . .”).
12 Dodd-Frank resolved a split amongst the circuit courts as to whether the SEC could allege control person liability. Section 20(a) now provides that control person liability is available to the SEC for violations of the Exchange Act.
13 CEA Section 13(b) (“In such action, the Commission has the burden of proving that the controlling person did not act in good faith or knowingly induced, directly or indirectly, the act or acts constituting the violation.”).
14 Respondents in SEC enforcement actions are not subject to vicarious liability based on agency theory.
15 The Eleventh Circuit Court of Appeals recently rejected the CFTC’s totality of the circumstances test for determining the existence of an agency relationship. See CFTC v. Gibraltar Monetary Corp., 579 F.3d 1180, 1187-89 (11th Cir. 2009). However, the CFTC has not moved from application of the totality of the circumstances test in administrative proceedings or in court proceedings outside of the Eleventh Circuit.