9-2021

What Will The Tower Research Capital II Ruling Mean For CFTC Enforcement Actions Against Non-U.S. Firms?

Ronald Filler

REPORT

Futures & Derivatives Law

The Journal on the Law of Investment & Risk Management Products

September 2021 ▪ Volume 41 ▪ Issue 8

WHAT WILL THE *TOWER RESEARCH CAPITAL II* RULING MEAN FOR CFTC ENFORCEMENT ACTIONS AGAINST NON-U.S. FIRMS?

By Professor Emeritus Ronald Filler

Ronald Filler is a Professor Emeritus and the Chair of the Ronald H. Filler Institute on Financial Services Law at New York Law School ("NYLS"). He has taught courses on Derivatives Law, Securities Regulation, the Regulation of Broker-Dealers and FCMs and other financial law issues since 1977 at four different U.S. law schools. Prof. Filler is a Public Director of the National Futures Association, a Public Director and Member and Chair of the Regulatory Oversight Committee ("ROC") of Swap-Ex, a swap execution facility owned by the State Street Corp. and has served on a number of boards of various exchanges, clearing houses and industry trade associations. Before joining the NYLS faculty in 2008, he was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers Inc. in its New York headquarters. Prof. Filler has co-authored, with Prof. Jerry Markham, "Regulation of Derivative Financial Instruments (Swaps, Options and Futures)." Prof. Filler provides expert witness testimony and consulting services relating to a variety of issues involving the financial services industry. You can reach Prof. Filler via email at: ronald.filler@nyls.edu

INTRODUCTION

In 2018, in a highly controversial and unusual opinion, Judge Kimba Wood, writing for the U.S. Court of Appeals for the Second Circuit, held in *Tower Research Capital* that the matching of trades at night on the CME Globex platform of the KOSPI 200 Futures Contracts traded on the Korea Exchange ("KRX") gave five Korean traders the right to bring a "spoofing" allegation against Tower Research Capital ("Tower"), a hedge fund.[1]

The opinion noted that Tower traded 4,000,000 trades of the KOSPI contract on Globex in 2012, which represented approximately 54% of the market share, whereas these five Korean traders traded 1,000 such contracts in 2012.[2] All of the trades at issue were deemed to be "night trades." For the KOSPI contract, even though it is cleared at KRX, the CME agreed to allow KRX to use its CME Globex platform to execute and "match" these night trades as the KRX did not offer any night trading platforms.[3] The federal district court in this first *Tower Research Capital* case had issued two decisions,[4] both of which denied the plaintiffs' claims, citing *Morrison*.[5] The U.S. Court of Appeals for the Second Circuit then remanded the case back to the district court.

The plaintiffs had alleged "spoofing" by the defendants as their large market share and high frequency trading allegedly

caused injury to the plaintiffs.[6] Even though the plaintiffs could not prove that the defendants were on the opposite side of any of their KOSPI orders placed via Globex, they argued that, given the fact that the defendants placed 4,000,000 orders on Globex in 2012, statistically, one or more of the plaintiffs' orders had to be matched by the defendants.

In *Morrison*, the U.S. Supreme Court ruled that Section 10b of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b), or SEC Rule 10b-5, does not apply to extraterritorial securities transactions unless it can be proven that such transactions were listed on a domestic exchange.[7] *Morrison* was strictly a securities case and did not involve the Commodity Exchange Act ("CEA"), 7 U.S.C. A. § 1 et seq., or any regulation promulgated by the Commodity Futures Trading Commission ("CFTC"). The district court in the first *Tower Research Capital* ("TRC") case, citing *Morrison,* reasoned that the defendants' alleged conduct was within the territorial reach of the CEA only if the KOSPI contracts were purchased or sold in the United States or were listed on a domestic exchange.[8] The district court in the first *TRC* case noted that the KOSPI orders were placed in Korea, and not in the U.S., and the fact that they were merely matched on Globex, which is located in Illinois, were final only when cleared the next day in South Korea.[9] This district court then held that, while the CME is a domestic exchange, its Globex platform is not.[10] Therefore, no trading took place on a "domestic" exchange.

The Second Circuit in the first *TRC case,* as noted above, then remanded the case back to the district court for further deliberation. In the second *TRC* district court case, the defendants had filed a motion to dismiss, arguing that its trading of the KOSPI 200 was not subject to the rules of any registered entity as required by Section 9 of the CEA.[11] The plaintiffs filed a second amended complaint and then moved for summary judgment. In December 2019, a magistrate recommended that the defendants' motion for summary judgment should be granted On May 11, 2020, the district court entered a summary judgment against the plaintiffs' claims in the second *TRC* case, finding that "Tower's overnight trading of KOSPI 200 futures was not 'subject to the rules of [a] registered entity' as required by Section 9 of the CEA."[12]

BACKGROUND

The Second Circuit in *TRC II* reasoned that:

1. The KOSPI 200 is an index of two hundred Korean stocks traded on the KRX, a securities and derivatives exchange headquartered in Busan, South Korea.

2. During daytime hours, orders for KOSPI 200 futures are placed and matched on the KRX in South Korea.

3. During overnight hours, orders for KOSPI 200 futures are placed on the KRX in South Korea but are matched with a counterparty on CME Globex located in Illinois.

4. Unlike the KRX, CME Globex is not an exchange but merely provides a trade-matching engine used by both U.S. and non-U.S. exchanges.[13]

The Second Circuit in *TRC II* affirmed the summary judgment granted by the district court in this second *TRC* case.[14]

ANALYSIS OF THIS OPINION

While the prior Second Circuit decision in 2018 gave some hope that the plaintiffs had a right to bring an action against the defendants, this more recent Second Circuit decision clearly negated any such expectations, especially if no "registered entity" was involved in the transactions at issue. The Second Circuit relied on the literal language of Section 9 of the CEA and stated that, to find a claim of manipulation or attempted manipulation, the transaction must be "subject to the rules of a registered entity."[15] It then stated: "(n)either the KRX nor the CME Globex is a registered entity under the CEA."[16]

The plaintiffs had argued that the overnight trading of the KOSPI 200 was in fact subject to the rules of the CME, a registered entity.[17] The Second Circuit then stated:

> "First, the CME Rulebook—the source of the CME's rules—specifies that it applies only to futures contracts that are created by and listed on the CME itself. It states that its rules apply to trading and clearing of 'Exchange' futures and defined 'Exchange' exclusively as the 'Chicago Mercantile Exchange.' It is undisputed that KOSPI 200 futures are not CME futures; they are KRX futures created and listed on the KRX. If there were any doubt, the CME Rules explicitly lists hundreds of CME futures contracts subject to its rules. Nothing on that list mentions KOSPI 200 futures - let alone the KRX."[18]

> "Second, both the CME and its parent, CME Group, Inc, have confirmed that the CME does not regulate the trading of KOSPI 200 futures, even when trades are matched using CME Globex and . . .. 'CME does not regulate, review or monitor the trading activity that occurs in the KOSPI Futures contracts as such activity is done by the Korea Exchange.' ''[19]

The Second Circuit then addressed the provisions of the CEA that require exchanges to "establish, monitor and enforce" their rules.[20] It held that "absent an affirmative statement to the contrary, trading in a futures contract is confined to, and regulated by, the exchange that creates it."[21] It then stated:

> "Moreover, linking KOSPI 200 futures to Chapter 5 of the CME Rulebook—which plaintiffs claim governs all trading through CME Globex—would yield absurd results."[22]

> "Plaintiffs' theory would require us to conclude that *any* futures contract matched on CME Globex is regulated by every exchange with rules governing the use of the platform. A CBOT trade would thus be subject to the rules of the CBOT, but also the rules of the CME, the NYMEX, the COMEX, and perhaps even the KRX."[23]

The Securities Industry and Financial Markets Association ("SIFMA") filed an amicus brief before the Second Circuit arguing that the plaintiffs were improperly allowed to plead unjust enrichment under New York law before the district court based on mere allegations of market manipulation without first alleging a direct trading relationship with the defendants.[24]

As noted above, Tower Research Capital had traded approximately 4,000,000 KOSPI 200 contracts, which was a rather large market share. The plaintiffs had argued that, based on this large position, Tower Research Capital statistically had to be a counterparty to some of its trades. SIFMA argued that the plaintiffs must prove a direct relationship between the counterparties citing *In Re Amaranth Natural Gas Commodities Litigation.*[25] The district court in *TRC II* did not rule on plaintiff's state law claim of unjust enrichment so this issue was thus not addressed by the Second Circuit.

The plaintiffs then raised three other argu-

ments, none of which were accepted by the Second Circuit, and none of which apply directly to the requirement of trading on a registered entity, and thus are not addressed here.

IMPACT OF THIS CASE ON FUTURE CFTC ENFORCEMENT ACTIONS

In its decision, the Second Circuit clearly emphasized the need to find a "registered entity" in order for Section 9 of the CEA to apply. Section 9(1) states that "[i]t shall be unlawful for any person, directly or indirectly, to use or apply, . . . in connection with any swap or a contract of sale of any commodity . . ., subject to the rules of any registered entity, . . . any manipulative or deceptive device . . . ."[26] Section 1(40) of the CEA defines the term "registered entity" as, among other things, a "board of trade designated as a contract market under Section 7 of the CEA" or "with respect to a contract that the Commission determines is a significant price discovery contract, ... or any electronic trading facility on which the contract is executed or traded."[27] A significant price discovery contract deals with clearing of swaps.[28] While *TRC II* was strictly a civil proceedings between two private parties, this opinion could have impact on future CFTC enforcement proceedings as well.

How will this case impact future CFTC enforcement actions brought against a non-U.S. firm? Will there be a requirement to find that any such non-U.S. firm violates the CEA only if the non-U.S. firm falls within the definition of a "registered entity?" What about trading platform located outside the U.S. that allow U.S. persons to trade via the internet on them? Will these electronic trading platforms fall within the definition of as registered entity as noted above? The answers to these and other questions remain open.

CONCLUSION

To me, the *TRC II* case may in fact hinder CFTC's efforts to bring enforcement actions against non-U.S. persons and firms. It also means that U.S. persons trading on non-U.S. exchanges pursuant to Part 30 of the CFTC rules may not be able to bring a civil action before a federal district court. Query, should the CFTC amend Part 30 to require more disclosure language to protect U.S. persons as a result of this case? We shall see how case law will develop in this area.

ENDNOTES:

[1]*Myun-Uk Choi et al v. Tower Research Capital LLC et al*., No. 17-648-cv (2d Cir., March 29, 2018). The Second Circuit decision was an appeal from a Motion to Dismiss at the federal district court level. See also "Ask the Professor—What is the Impact of the Recent Second Circuit Decision in Tower Research Capital on the Global Futures Markets?," 38 Fut. Der. L. Rep. Issue 6, June 2018, which was written by this author. That article addressed the implications of the *Morrison* and other related cases.

[2]Please note that these 4,000,000 contracts represented actual fills whereas most "spoofing" cases imply that orders are not executed but are cancelled before any such execution.

[3]CME Globex allows traders to place orders on its platform for a large variety of underlying financial products traded on several different exchanges which are then "matched" with other traders so that the orders are executed at a confirmed quantity and price. The respective orders are then forwarded to the respective exchange or clearing house to be finalized or cleared depend-

ing on the underlying arrangement.

[4]*Myun-Uk Choi et al. v. Tower Research Capital, Ltd. et al,* 165 F. Supp. 3d 42 (S.D.N.Y 2016) and 232 F. Supp. 3d 337 (S.D.N.Y 2017), Docket No. 14-cv- 09912.

[5]*Morrison v. National Australia Bank, Ltd.,* 561 U.S. 247 (2010). Morrison was decided two months before the enactment of the Dodd-Frank Act. See also, Ronald H. Filler & Jerry W. Markham, Regulation Of Derivative Financial Instruments (Swaps, Options, And Futures) Cases And Materials, Chapter 12 (2014) (describing the *Morrison* case).

[6]*Supra,* n.4.

[7]*Supra,* n.5 at 267. See also *supra,* n.4.

[8]*Id*.

[9]*Id*. at 49.

[10]*Id.*

[11]7 U.S.C.A. § 9(1), (3).

[12]*Myun-Uk Choi et al. v. Tower Research Capital, LLC et al.,* Second Circuit, No- 20-1648-cv, June 22, 2021, at p. 3-8. See also *Myun-Uk Choi v. Tower Research Capital, LLC, et al. No. 14 Civ 9912, 2020 WL. 231763 at 1-2 (S.D.N.Y. May 11, 2020).*

[13]*Id* at 4.

[14]*Id.*

[15]*Id*. at 9.

[16]*Id.*

[17]*Id.*

[18]*Id.* at 10.

[19]*Id.* at 10-11.

[20]7 U.S.C.A. § 7(d)(2)(A)(ii).

[21]*Supra,* n. 11, *at 12.*

[22]*Id.*

[23]*Id* at 12-13.

[24]See Brief of Amicus Curiae Securities Industry and Financial Markets Association in Support of Defendants' Appellees' Petition for Panel Rehearing.

[25]*Id.* at 3-5. See also 730 F.3d 170, 173 (2d Cir. 2013).

[26]7 U.S.C.A. § 9(1).

[27]7 U.S.C.A. 1(40).

[28]7 U.S.C.A. 2(h).