

July 14, 2011

CFTC Anti-Fraud and Manipulation Enforcement Authority

Commodity Futures Trading Commission Implements Expanded Anti-manipulation Authority to Prohibit Fraudulent and Manipulative Behavior

SUMMARY

On July 7, 2011, by a vote of 5-0 the Commodity Futures Trading Commission adopted and issued its final rules prohibiting the employment, or attempted employment, of manipulative or deceptive conduct. Rules 180.1 and 180.2 were adopted pursuant to Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to implement amended Sections 6(c)(1) and 6(c)(3) of the Commodity Exchange Act, respectively. Rule 180.1 was modeled after Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934. The rule broadly prohibits fraud and fraud-based manipulations, including any such attempts. Rule 180.2 codifies Section 6(c)(3) and makes it unlawful for any person directly or indirectly to manipulate or attempt to manipulate the price of any swap or commodity in interstate commerce. The final rules take effect 30 days after today's publication in the Federal Register.

BACKGROUND

Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") expanded the authority of the Commodity Futures Trading Commission (the "Commission") to prohibit fraudulent and manipulative behavior. In particular, Section 753 amended Section 6(c)(1) of the CEA to prohibit the use or employment of any manipulative or deceptive device or contrivance in contravention of the Commission's proposed rules. Additionally, Section 753 amended CEA Section 6(c)(3) to make it

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unlawful to manipulate or attempt to manipulate the price of any swap or commodity. In November of 2010, the Commission issued a notice of proposed rulemaking to implement this new authority.¹

The Commission follows in the footsteps of the Federal Energy Regulatory Commission and the Federal Trade Commission in adopting a rule based on the language of SEC Rule 10b-5 to prohibit fraudulent and manipulative behavior. The Commission noted that the similarity between Section 6(c)(1) and Exchange Act Section 10(b) made it appropriate and in the public interest to model the rule after SEC Rule 10b-5. To account for the differences between the securities and derivatives market, the Commission reiterated that it would be “guided, but not controlled” by SEC Rule 10b-5 precedents. It is unclear how the Commission will apply the new authority in practice.

FRAMEWORK OF RULE 180.1

Rule 180.1 makes it unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity, or contract for future delivery on or subject to the rules of any regulated exchange or trading facility, to intentionally or recklessly:

- Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
- Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
- Engage, or attempt to engage, in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person; or
- Deliver or cause to be delivered, or attempt to deliver or cause to be delivered . . . a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate. Notwithstanding the foregoing, no violation of this subsection shall exist where the person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.²

Except for the addition of the word “inaccurate” in the last sentence of 180.1(a)(4), the text of the final rule is unchanged from the language the Commission initially proposed.

The Commission takes a broad view of the rule’s reach and indicated in the release that it will interpret the rule “not technically and restrictively, but flexibly to effectuate its remedial purposes.”³ For example, a violation of Rule 180.1 need not require proof of a market or price effect. In addition, the Commission

¹ Prohibition of Market Manipulation, 75 Fed. Reg. 67,657 (2010); see also Recent CFTC Issuances, Nov. 9, 2010, http://www.sullcrom.com/files/Publication/92f16b37-d127-4331-8668-2d63cdf800a3/Presentation/PublicationAttachment/170995b5-5a91-4a9f-9e62-2da27d0a0245/SC_Publication_Recent_CFTC_Issuances.pdf.

² Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398 (2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-07-14/pdf/2011-17549.pdf> [hereinafter *Final Rules*].

³ *Id.*, 76 Fed. Reg. at 41,401.

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declined to limit the rule's prohibitions to only statements and acts pertaining to transactions in futures and derivatives, and instead, stated that it expects to exercise its authority to cover transactions "related to futures or swaps markets, or prices of commodities . . . or where fraud or manipulation has the *potential* to affect cash commodity, futures, or swaps markets or participants in these markets."⁴ Rule 180.1 will also reach all manipulative and deceptive conduct in connection with the purchase or sale of, and will include all continuing performance obligations arising under, swaps. In clarifying the limitation placed by the "in connection with" element, the Commission stated that it would be guided by securities law precedent and cited an example given in *SEC v. Zandford* as illustrative of the limits of Rule 180.1.⁵

Because of the Commission's statement in its proposing release that it would draw from securities law precedent, a number of comments expressed concerns that new duties would be imposed on market participants. However, the Commission clarified that Rule 180.1 did not impose any new affirmative duties of inquiry, diligence or disclosure. The Commission cited Section 6(c)(1), which explicitly states that no rule promulgated by the Commission shall require any person to disclose to another person any material nonpublic information, except as is necessary to make any statement made not materially misleading. As such, the Commission clarified that failure to disclose market information will not, by itself, violate the rule. Further, it is not a violation of the rule to withhold information that a market participant lawfully possesses about market conditions. Absent a pre-existing duty to disclose, silence or statements of "no comment" will not be considered deceptive within the meaning of Rule 180.1. However, a failure to disclose when a duty to do so exists will be actionable. Fraud by partial omission or half-truths also could violate Rule 180.1 under a "facts and circumstances" test.

The Commission further stated that Rule 180.1 does not prohibit trading on the basis of material nonpublic information. However, the Commission clarified that, depending on the facts and circumstances, a person may be violating Rule 180.1 and engaging in deceptive or manipulative conduct if (i) that person trades on the material nonpublic information in breach of a pre-existing duty established by law, rule, agreement, understanding or "some other source," or if (ii) that person obtains the information fraudulently.⁶

The Commission's assertion that it will be guided, but not controlled, by securities law precedents offers little guidance to market participants. While the Commission's statements attempt to reconcile securities

⁴ *Id.*, 76 Fed. Reg. at 41,401 (emphasis added).

⁵ In *Zandford* the Supreme Court explained:

If . . . a broker embezzles cash from a client's account or takes advantage of the fiduciary relationship to induce his client into a fraudulent real estate transaction, then the fraud would not include the requisite connection to a purchase or sale of securities. Likewise if the broker told his client he was stealing the client's assets, that breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud. *SEC v. Zandford*, 535 U.S. 813 (2002).

⁶ *Final Rules*, 76 Fed. Reg. at 41,403.

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law precedent with the different characteristics of the futures and derivatives markets, in some instances the only guidance that the Commission provides is that it has declined to foreclose the possibility of applying securities law precedent.⁷ Additionally, the Commission establishes a “facts and circumstances” standard in a number of instances.⁸ Simply stated, it is unclear at this point how the Commission will apply securities law precedents.

The Commission declined to adopt a scienter element of specific intent or extreme recklessness and instead adopted a rule requiring only a showing of recklessness in order to prove a violation of Rule 180.1. In drawing from securities law precedent, the Commission explained that recklessness is an act or omission that “departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.”⁹ The burden of proof remains on the plaintiff, and the violation must be proven by a preponderance of the evidence.

The Commission did not foreclose the possibility of proving scienter by way of the collective knowledge theory—a showing of scienter premised on the collective knowledge of an entire company. The Commission believes that such a theory creates incentives for corporate entities to create and maintain effective internal communications and controls to prevent wrongful conduct, and that it would consider the totality of the facts and circumstances of a particular case when deciding whether enforcement action is appropriate and in the public interest.

In some respects, this new authority overlaps with traditional enforcement authorities relied upon by the Commission previous to Dodd-Frank’s enactment. For example, the Commission did not respond to comments requesting clarification as to how Rule 180.1 relates to existing CEA Sections 4b and 9(a)(2) other than to point out that Dodd-Frank Section 753(a) states that nothing in new Section 6(c)(1) should

⁷ See, e.g., *id.*, 76 Fed. Reg. at 41,403 (“The Commission declines to adopt comments recommending outright rejection of the potential application of “fraud-on-the-market” theory”); *id.*, 76 Fed. Reg. at 41,403 (“[W]e decline to opine on the required elements of a private right of action under CEA section 6(c)(1) and final Rule 180.1 as it is beyond the purview of this rulemaking.”).

⁸ See, e.g., *id.*, 76 Fed. Reg. at 41,401 n.37 (“[I]f an entity employed a deceptive device to sell an agricultural commodity to persons seeking to hedge price risk in that commodity, depending on the facts and circumstances, the Commission would exercise its authority”); *id.*, 76 Fed. Reg. at 41,402 n.55 (“The CEA has many provisions designed to protect market participants through disclosure requirements Depending on the facts and circumstances, violation of such duties could constitute a violation of the final Rule”); *id.*, 76 Fed. Reg. at 41,403 (“Depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with any swap . . . for example by trading on the basis of material nonpublic information in breach of a pre-existing duty . . . may be in violation of final Rule 180.1”); *id.*, 76 Fed. Reg. at 41,403 (“Fraud-by-partial-omission or half-truths could violate final Rule 180.1 if the facts and circumstances of a particular case so warrant”); *id.*, 76 Fed. Reg. at 41,405 (“the Commission intends to follow the law of the various circuits and, in all cases, consider the totality of the facts and circumstances of a particular case before deciding whether enforcement action is appropriate”).

⁹ *Id.*, 76 Fed. Reg. at 41,404 (citing *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1998)).

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be construed to affect the applicability of these existing provisions. Additionally, the Commission rejected comments urging the deletion of “attempted” manipulation as an offense.

The Commission declined to adopt recommendations of heightened supervision of algorithmic and automated trading systems. It added, however, that supervisory failure would be one of the facts and circumstances considered when determining whether a violation exists. With respect to penalties, the Commission will follow CEA section 6(c)(10)(C)(ii), and may assess a civil penalty of not more than an amount equal to the greater of (i) \$1,000,000 or (ii) triple the monetary gain to the person for each such violation.

FRAMEWORK OF RULE 180.2

Using its general rulemaking authority under CEA Section 8a(5), the Commission proposed and adopted Rule 180.2, which is based on Section 6(c)(3) and makes it “unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap or commodity”

The Commission clarified that it would be guided by the traditional four-part test for manipulation that has developed in case law under CEA Section 6(c) and 9(a)(2). Under this test, a violation is found where:

- The alleged manipulator had the ability to influence market prices;
- The alleged manipulator specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand;
- Artificial prices existed; and
- The alleged manipulator caused the artificial prices.

The Commission reaffirmed its requirement that a person must act with the requisite specific intent, and it clarified that recklessness would not suffice.

The Commission declined to limit the application of Rule 180.2 to any specific set of facts, including case law upholding the Commission’s application of its four-part test stated above.¹⁰ Moreover, the Commission emphasized that artificial prices would not be conclusively presumed in the absence of evidence but rather that extensive economic analysis may not be necessary to meet a showing of the artificial price prong. The Commission denied that such a position would not in any way collapse the third and fourth elements of the traditional four-part test. Finally, the Commission clarified that “directly or indirectly” is interpreted to include circumstances where the violator uses a third party.

¹⁰ *Id.*, 76 Fed. Reg. at 41,408.

OUTLOOK GOING FORWARD

It is clear from the language of Rule 180.1 and the Commission's interpretation in the final release that the Commission seeks to expand its anti-fraud authority. In a statement, Commission Chairman Gary Gensler explained:

In the past, the CFTC had the ability to prosecute manipulation, but to prevail, it had to prove the specific intent of the accused to create an artificial price. Under the new law and one of the rules before us today, the Commission's anti-manipulation reach is extended to prohibit the reckless use of fraud-based manipulative schemes. This closes a significant gap, as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.¹¹

The Commission did not substantively change any of the major outlines of its proposed rules. While the release attempts to explain the limits and standards of Rule 180.1, in many instances it falls short of clarity. Additionally, the Commission reserved its interpretation on many important issues, including the collective knowledge theory. While neither FERC nor the FTC have made extensive use of their own anti-fraud authority, only time will tell how aggressively the Commission's enforcement division will exercise this new authority. Comparatively, the Commission regulates a far larger share of the derivatives markets.

Additionally, market participants should be aware that in November of 2010 the SEC proposed Rule 9j-1, which would prohibit fraud, manipulation and deception in connection with security-based swaps.¹² Authorized under Dodd-Frank Section 763, the proposed rule would also extend to the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of any such exercise or performance. The SEC has yet to issue a final rule.

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¹¹ *Id.*, 76 Fed. Reg. at 41,410.

¹² Prohibition Against Fraud, Manipulation and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 215 (Nov. 8, 2010); see also SEC Proposes Anti-Fraud Rule Under Title VII of Dodd-Frank, Nov. 9, 2010, http://www.sullcrom.com/files/Publication/d558d759-8f09-49dc-a193-20075aa5ebf4/Presentation/PublicationAttachment/64451dc1-ee06-45d4-a295-215c784ecb60/SC_Publication_SEC_Proposes_Anti_Fraud_Rule_Under_Title_VII_of_Dodd_Frank.pdf.

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