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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

The CFTC's Fraud-Based Manipulation Authority Raises Questions

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In October 2013, the Commodity Futures Trading Commission used enforcement powers it gained under the Dodd-Frank Act in an order finding that a major financial institution recklessly employed manipulative devices in trading credit default swaps.[1] In doing so, the CFTC wielded its fraud-based manipulation rule in a manner that has raised additional questions about CFTC powers that market observers already found troubling — and potentially unconstitutional — since the CFTC implemented its authority two years earlier.

The CFTC and Dodd-Frank

Over the years, the CFTC has used its powers to fight price manipulation, false reporting and fraud in the commodity markets aggressively and capably. In 2010, Congress added to the agency's already robust arsenal through Dodd-Frank when it enacted a fraud-based manipulation standard for the CFTC that largely mimicked the SEC's authority under Section 10(b) of the Securities Exchange Act.

Under this standard, the CFTC was authorized to adopt regulations prohibiting "manipulative or deceptive devices or contrivances." Market observers and participants wondered what conduct would be prohibited that was not already unlawful prior to the enforcement of Dodd-Frank. Observers also questioned how the CFTC would provide adequate notice to market participants of these forms of misconduct that carried significant civil and possibly criminal penalties, or if these powers would allow the CFTC to label as manipulation trading behavior it decided years after the fact was inappropriate or irresponsible.

Rule Adoption and Reaction. In 2011, the CFTC adopted its fraud-based manipulation prohibition, CFTC Rule 180.1, modeled after SEC Rule 10b-5.[2] The CFTC seemed to recognize that market participants needed notice of what new kind of misconduct was prohibited but was no more helpful than stating "Rule 180.1 *augments* the Commission's existing authority to prohibit fraud and manipulation."[3] The CFTC did clarify, however, that unlike its existing authority to prohibit manipulation, it only would have to prove that the forms of misconduct were committed recklessly rather than intentionally, a point which offered little comfort to market participants.

Commenters on the proposed rules warned the CFTC that, without further clarification, Rule 180.1 could be unconstitutionally vague because it failed to provide sufficient notice regarding whether a practice ran afoul of the rule and exposed market "participants to the threat of arbitrary and unfair enforcement."[4] The CFTC, however, adopted the rule as proposed.

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[1] *In re J.P. Morgan Chase*, Docket No. 14-01 (CFTC Oct. 16, 2013).

[2] Section 6(c) of the Commodity Exchange Act makes it unlawful to employ any manipulative or deceptive device or contrivance in connection with a swap, future or contract of sale of any commodity in contravention of CFTC rules. CFTC Rule 180.1 implements Section 6(c) and makes it unlawful to intentionally or recklessly employ any manipulative device, scheme or artifice to defraud in connection with a swap, future or contract of sale of any commodity.

[3] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41401 (July 14, 2011).

[4] 76 Fed. Reg. at 41400.

The 2013 CFTC Order

In 2013, the CFTC found certain credit default swap (CDS) trading in violation of Rule 180.1. The CFTC alleged that a bank's CDS traders established positions during a price settlement period with the intent to create an artificial settlement price. The traders allegedly did this because the settlement price was used for marking-to-market the bank's CDS position, and an artificial price would mask significant losses the bank suffered on its CDS positions. If true, these facts could reasonably fit the CFTC's often relied-upon "banging the close" theory (entering trades at the end of a trading period in a manner designed to exert artificial pressure on the settlement prices) in violation of the CFTC's pre-Dodd-Frank market manipulation prohibitions.

However, the CFTC did not allege such a violation; instead, the order found that the traders employed a manipulative device "because they sold enormous volumes of [CDS] in a very short period of time at month-end." Their actions were reckless because they were "operating out of desperation to avoid further losses," the size of the position had the potential to affect the market, and the traders sold during a concentrated time period of the market. Thus, the traders "interfered with free and open markets" and traded with a "reckless disregard to obvious dangers to legitimate market forces … ."

The CFTC's order raises a host of unanswered questions regarding a Rule 180.1 violation:

- At what point did the volume of trading become "enormous" such that it embodied reckless behavior?
- How short is a "very short period of time"?
- What constitutes "interference"?
- What are "legitimate market forces" or "free and open markets"?[5]

The most troublesome questions, however, are raised by the CFTC statement in the order that a trader can be held liable even if motivated by a "desire to obtain compensation rather than by a desire to affect a market price." Is the CFTC suggesting that trading to avoid losses or trading to obtain compensation in the absence of any intent to affect the market price is not a legitimate market force? Does such trading truly interfere with free and open markets? Can trading to minimize losses and maximize profits by itself be illegitimate or deemed to interfere with free and open markets?

Implications

As market participants consider how the CFTC's order may affect their 2014 trading activity, the CFTC's statement adds another layer of complexity and uncertainty. Ironically, under the CFTC's rationale, trading large amounts of derivatives in a market exclusively with a motive to profit from that trading can be a manipulative or deceptive device and can violate Rule 180.1, even though the same trading activity, but in smaller volumes or in the same volume stretched out over a longer period of time, apparently would not be a violation. Market participants may find themselves asking how the CFTC will distinguish acceptable trading volumes from "enormous" quantities, as regulatory direction remains far from clear.

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[5] Another unanswered question is how the CFTC views the temporal reach of its jurisdiction over swaps. The conduct at issue in the order occurred in January and February 2012, and the order cites CFTC Rule 1.3(zzz) as its jurisdictional basis. Rule 1.3(zzz) defines which security-based swaps are subject to CFTC as opposed to SEC oversight; however, Rule 1.3(zzz) was not adopted until August 2012 and was not effective until October 2012 — more than seven months after the alleged conduct.