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Rule 180.1: The CFTC Targets Fraud and Manipulation

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In 1934, following a stock market crash that brought the economy to its knees, Congress adopted a wide ranging anti-fraud provision for the securities markets. In describing the broad reach of §10(b) of the Securities Exchange Act of 1934, the U.S. Supreme Court has stated that "[s]ection 10(b) is aptly described as a catchall provision, but what it catches must be fraud." See *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980). Eight decades later, following a financial crisis that similarly wreaked economic havoc, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended the Commodity Exchange Act to provide the Commodity Futures Trading Commission (the Commission or CFTC) with broad authority to prohibit fraud and manipulation. As a result of that provision, which the Commission used to promulgate Commodity Futures Trading Commission Rules 180.1 and 180.2, the derivatives regulator has caught up to its sister securities regulator as the Commission now holds that same "catchall" authority to bring enforcement actions against fraud in the commodities, commodities futures, and swaps markets.

The Dodd-Frank Act was signed into law on July 21, 2010, amending subsections 6(c)(1) and 6(c)(3) of the Commodity Exchange Act, and Commission Rule 180 took effect on Aug. 15, 2011. As a result of Rule 180.1, the Commission's enforcement authority now extends to the intentional or reckless: (1) use of manipulative devices or schemes to defraud; (2) making of false or misleading statements and material omissions; (3) employment of practices that operate or would operate as a fraud or deceit; and (4) delivery of misleading or inaccurate reports concerning conditions that tend to affect the price of any commodity. The Commission has jurisdiction over such conduct where

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it occurs "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 registered entity. Dodd-Frank also gave the Commission, jointly with the U.S. Securities and Exchange Commission (SEC), joint control over the $600 trillion swaps market. In essence, the Commission now regulates all swaps other than the narrow category of security-based swaps, which are regulated solely by the SEC.

The Commission is poised to apply its authority to pursue manipulative devices and schemes to defraud as broadly as the amended Commodity Exchange Act and Rule 180.1 allow, consistent with the Commission's stated intention to interpret Rule 180.1 "flexibly, to effectuate its remedial purpose." Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation ("Prohibition of Manipulative and Deceptive Devices"), 76 Fed. Reg. 41,398, 41,401 (July 14, 2011) (codified at 17 C.F.R. pt. 180). The Commission has expressed its intention to broadly exercise its authority under §6(c)(1) of the Commodity Exchange Act to "cover transactions relating to the futures or swaps markets, or prices of commodities in interstate commerce, or where the fraud or manipulation has the potential to affect cash commodity, futures, or swaps markets or participants in these markets." Id.

Prior to the Dodd-Frank amendments to the Commodity Exchange Act and the adoption of Rule 180.1, the Commission had more restricted anti-fraud authority and more significant hurdles to overcome in manipulation actions. Fraud actions were previously brought, for example, pursuant to Commodity Exchange Act §4(b), which required the Commission to establish that the fraud related to a contract for a covered instrument that was made or to be made, for, on behalf of, or with the defrauded person. This section, which remains in effect, prohibits, for example, a broker from defrauding his customer in relation to the making of commodity futures contracts for or on behalf of that customer. Id. at 41,401. While §4(b) and other fraud provisions remain on the books and continue to be enforced, the Commission's authority now extends much more broadly, to deceptive or manipulative practices that occur "in connection with" any swap, contract of sale of any commodity, or futures contract. See Prohibition on Manipulation, 17 C.F.R. §180.1(a) (2011). A recent district court decision granting the Commission's request for a preliminary injunction against entities participating in a nationwide scheme to defraud retail commodities transaction investors confirms the Commission's view that Dodd-Frank's amendments to the Commodity Exchange Act were intended to substantially expand the Commission's authority to pursue fraud actions. The court stated that Dodd-Frank amended §6(c) "to broaden [the Commission's] anti-fraud jurisdiction as set out in Commission Regulation 180.1, which prohibits the 'intentional or reckless' use of deceptive or manipulative practices … in connection with," swaps, sales of commodities, or futures contracts. See *United States Commodity Futures Trading Comm'n v. Hunter Wise Commodities*, No. 12-81311-CIV—Middlebrooks/Brannon, 2013 U.S. Dist. LEXIS 35770 at *31, (S.D. Fla. Feb. 25, 2013) (citations omitted). The court further noted, in describing the fraudulent scheme employed by one of the defendants, that "whether [a specific defendant] had direct contact or dealings with retail customers is largely irrelevant … as CFTC Rule 180.1 merely requires fraud *in connection* with these transactions." See id. at *40, n.36 (emphasis in original).

Similarly, the Commission's authority to prosecute manipulation was broadened by the Dodd-Frank amendments to Commodity Exchange Act §6(c) and Rule 180.1. To prevail in a manipulation case, the Commission was previously required to prove: (1) that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or affect a price or price trend not reflective of legitimate forces of supply and demand; (3) the existence of artificial prices; and (4) that the accused caused the artificial prices. That standard has been extremely difficult to meet—prompting at least one CFTC Commissioner to lament that as a result of that "high hurdle" the Commission successfully litigated only one contested market manipulation case in its 38-year history, prior to the adoption of Rule 180.1. The new fraud provisions of §6(c)(1) and Rule 180.1, by contrast, more broadly prohibit employment of "any manipulative device, scheme, or artifice to defraud." In proving a violation of these regulations, the Commission need not prove specific intent, but merely a reckless mental state, and need not prove that the conduct did, or was intended to, create an artificial price.

In promulgating Rule 180.1, the Commission relied heavily on the language of, and judicial precedent supporting, SEC Rule 10b-5. Commodity Exchange Act §6(c)(1), as amended by §753 of Dodd-Frank, and §10(b) of the Securities Exchange Act of 1934, include virtually identical prohibitions against any "manipulative or deceptive device or contrivance." Therefore, to give effect to that statutory language, and to harmonize the regulation of the commodities, commodities futures, and swaps markets with the existing regulation of the securities markets, the Commission modeled Rule 180.1 on SEC Rule 10b-5. Prohibition of Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,399. The Commission noted, however, that it will be guided by, but not controlled by, the substantial body of judicial precedent applying Rule 10b-5, due to the differences between the securities markets and the derivatives markets.

Rule 180.1, like SEC Rule 10b-5, brings within the Commission's authority conduct "in connection with" any swap, contract of sale of any commodity, or contract for future delivery. The Preamble to Rule 180.1 states that the Commission will interpret this language "broadly, not technically or restrictively … [to] reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap," commodities contract or futures contract. Id. at 41,405. While the Preamble notes the "in connection with" language is not "limitless," the authority cited for that proposition in fact reflects that the "in connection with" language renders the Commission's reach extensive. Those authorities, arising under SEC Rule 10b-5, hold that the "in connection with" language is intended to be expansive and requires only that the conduct at issue "relate[s] to" the instruments at issue. Id. at 41,405-06 & n.99.

Rule 180.1 also tracks SEC Rule 10b-5 in that the Commission need only prove reckless, as opposed to intentional, conduct to establish a violation of the rule. As the Commission explained in the Rule's Preamble, a scienter standard of "specific intent" would unduly limit the scope of final Rule 180.1. Id. at 41,404. The Commission has made clear that proof of knowledge is not required, and has defined recklessness for these purposes consistent with the use of that term in the securities law context. 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.'" Id. (citation omitted). The Commission also declined certain commenters' request to bifurcate the scienter standards applicable to "non-fraud based manipulations" and "fraud-based manipulations," and to require specific intent to effect an artificial price in the first category and an "extreme recklessness" standard in the second. In response to that request,

the Commission simply stated that it would be guided by SEC precedent and that Rule 180.1 will not reach "inadvertent mistakes or negligence." Id. at 41,405. The Commission further noted that it must prove any violation—including the scienter element of any violation—by a preponderance of the evidence. Id.

In addressing scienter, the Commission left open the possibility that knowledge of individual corporate agents could be aggregated in order to establish the requisite state of mind to hold a corporation liable for fraud pursuant to Rule 180.1. Id. The Commission noted the disagreement among the circuits on the so-called "collective knowledge theory." The Commission observed that, to date, no judicial decisions have addressed the applicability of that theory in an action where the government is the plaintiff, and the Supreme Court has not yet spoken on the issue. The Commission flatly refused to foreclose the application of the collective knowledge theory to future actions pursuant to Rule 180.1. Indeed, the Commission expressed a favorable opinion of the collective knowledge theory, noting that its "policy rationale … [is] in the public interest" because the application of the theory "creates incentives for the corporate entity to create and maintain effective internal communications and controls to prevent wrongful and harmful conduct." Id.

In addition to leaving open the possibility that the Commission might assert recklessness based on collective knowledge, some might contend that one aspect of Rule 180.1 may well allow an enforcement action where the Commission cannot establish intentional or reckless conduct, but only negligence. Rule 180.1(a)(3) prohibits intentionally or recklessly engaging in any act, practice or course of business, which *operates or would operate* as a fraud or deceit upon any person. See 17 C.F.R. §180.1(a)(3). Section 180.1(a)(3) mirrors §17(a)(3) of the Securities Exchange Act, which makes it unlawful for any person "in the offer or sale of any securities … to engage in any transaction, practice, or course of business which *operates or would operate* as a fraud or deceit upon the purchaser." 15 U.S.C. §77q(a)(3). It is well-established that §77q(a) does not require scienter. This is because the key language, which relates to conduct that "operates or would operate as a fraud or deceit," has been held to "quite plainly focus[] upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible." See *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980) (emphasis in original).

Given the Commission's position that the Securities Exchange Act and the amended Commodity Exchange Act share a similar purpose, and given that the Commission has interpreted those provisions of Rule 180.1 that parallel SEC Rule 10b-5 consistently with Rule 10b-5, the Commission may take the position that the language of Rule 180.1(a)(3) should be interpreted consistently with §17(a)(3), its parallel in the Securities Exchange Act (which has no enabling rule). It is true that Rule 180.1(a), unlike §17(a), includes a scienter requirement. It is also true that the Commission, in the Preamble to Rule 180, has stated that Rule 180.1 will not apply to inadvertent mistakes or negligence. Nonetheless, the Commission could take the position that "intentionally or recklessly" in 180.1(a) modifies only "[e]ngage, or attempt to engage in any act, practice or course of business," within 180.1(a)(3), but does not modify the remainder of that provision—the fact that the business "operates or would operate as a fraud." See 17 C.F.R. §180.1(a)(3). That approach arguably would be consistent with the long-standing interpretation of the "operates or would operate" language in §17(a)(3), and would essentially eliminate a scienter requirement from 180.1(a)(3).

On the other hand, §6(c)(1) of the Commodity Exchange Act is modeled on and closely parallels the language of §10(b) of the Securities and Exchange Act, which has a scienter requirement, as opposed to §17(a), which does not. See *Aaron*, 446 U.S. at 695. To the extent that §6(c)(1) is interpreted consistently with §10(b) to require scienter, Commission rules giving effect to §6(c)(1) would be required to include a scienter element as well. See *Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 842-43 (1984). Should the Commission pursue an enforcement action involving solely negligent conduct, a defendant may have a well-founded argument that the charge exceeds the Commission's authority.

Despite the Commission's use of SEC Rule 10b-5 as a model for Rule 180.1, in some respects Rule 180.1 and the amendments to the Commodity Exchange Act grant the Commission greater authority than Rule 10b-5 confers on the SEC. First, the Rule reaches attempts to use manipulative devices or schemes to defraud, attempts to make false or misleading statements or omissions, and attempts to engage in practices which operate or would operate as a fraud. Rule 10b-5 does not have an attempt provision. As the Commission explained in declining commenters' requests to remove the attempt provisions in its proposed rule, the language of the Commodity Exchange Act specifically directs the Commission to prohibit both actual and attempted use or employment of any manipulative or deceptive device or contrivance. Prohibition of Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,401. Second, Rule 10b-5 applies to fraud and manipulation "in connection with the purchase or sale of any security." As discussed above, the Commission need not establish that the fraud or manipulative device was employed in the context of a purchase or sale of a covered instrument, but sweeps more broadly, applying to misconduct that arises more generally "in connection with" any swap, contract of sale of commodities, and futures contracts. A transaction is not required.

The Commodity Exchange Act provides for both a criminal penalty and a private right of action. A willful and knowing violation of Rule 180 is punishable as a felony pursuant to §9(a)(5) of the Act, and carries a maximum fine of $1 million and a sentence of imprisonment of not more than 10 years. See 7 U.S.C. §13(a)(5). Section 22 of the Act also provides for a private right of action for violations of the Act, for several categories of conduct, available to "any person who sustains loss as a result of any alleged violation of the chapter." See 7 U.S.C. §25(a)(2). The amount and type of damages available depends on the nature of the violation proved.

The Dodd-Frank amendments to the Commodity Exchange Act and Rule 180.1 position the Commission, for the first time in its history, to pursue any and all deceptive conduct in connection with the products it oversees, even in the absence of a specific transaction. The market that the Commission regulates is vast—by some accounts up to $600 trillion globally. The CFTC's Rule is in its infancy—particularly as compared to the SEC's 80-year old rule—and the Commission has only just begun to employ it against deceptive and manipulative conduct. While it remains to be seen how far the Commission will go in using the extensive authority conferred by the Act and Rule 180.1, the Commission's own statements suggest it will seek to enforce the Rule to the fullest extent of the law, which in these days of aggressive regulation should come as no surprise.

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