

# Derivatives Alert

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## Recent Court Decisions Shine Spotlight on Scope of CFTC's Dodd-Frank Anti-Fraud and Anti-Manipulation Enforcement Authority

Recent federal court decisions, and a pending appeal in the Ninth Circuit, highlight disagreement among the courts as to the scope of the Commodity Futures Trading Commission's (CFTC) anti-fraud and anti-manipulation authority under the Dodd-Frank Act, with significant implications for virtual currency markets in particular.

Although the Commodity Exchange Act (CEA) grants the CFTC exclusive jurisdiction over only swaps and commodity futures contracts, the CFTC has historically had anti-fraud and anti-manipulation enforcement authority over markets for transactions that are actual purchases of a commodity, sometimes called "spot" or "physical" transactions.<sup>1</sup> Under the Dodd-Frank Act, Congress gave the CFTC new enforcement authority for futures, swaps and spot commodity markets mirroring the Securities and Exchange Commission's Rule 10b-5 enforcement authority.<sup>2</sup> Congress added CEA Section 6(c)(1), which prohibits manipulative or deceptive devices or contrivances, and the CFTC subsequently adopted Rule 180.1(a), which implements Section 6(c)(1) and prohibits any manipulative device, scheme or artifice to defraud. The CFTC has forcefully asserted those powers in a number of contexts, including alleged fraud in spot market sales of virtual currencies. The results have been mixed, reflecting the fact that the CFTC's enhanced enforcement powers have brought to the fore significant questions regarding the scope of the CFTC's spot market anti-fraud and anti-manipulation authority and the relationship of that authority to the CFTC's exclusive regulatory jurisdiction over swaps and commodity futures contracts.

In May, a California federal district court rejected the CFTC's contention that the agency has anti-fraud authority in connection with "contracts of sale of a commodity" in the over-the-counter spot market "in the absence of [an] actual or potential market manipulation."<sup>3</sup> In *CFTC v. Monex Credit Co.*, the CFTC alleged that the defendants had defrauded retail customers in connection with the sale of precious metals.<sup>4</sup> The CFTC

<sup>1</sup> See CEA Sections 4b; 6(c)(3); 9(a)(2); see also CFTC Rule 180.2.

<sup>2</sup> Compare CEA Section 6(c)(1) and CFTC Rule 180.1 with Securities Exchange Act Section 10(b) and SEC Rule 10b-5.

<sup>3</sup> *CFTC v. Monex Credit Co.*, 311 F. Supp. 3d 1173, 1189 (C.D. Cal. 2018), appeal docketed, No. 18-55815 (9th Cir. June 20, 2018).

<sup>4</sup> See *id.* at 1177-78.

# Derivatives Alert

charged that the defendants violated CEA Section 6(c)(1) and CFTC Rule 180.1(a).<sup>5</sup> Both Section 6(c)(1) and Rule 180.1(a) are operative “in connection with” any swap, futures contract or contract of sale of any commodity in interstate commerce.

The *Monex* defendants argued that the CFTC’s anti-fraud authority did not reach the sale of precious metals.<sup>6</sup> In response, the CFTC asserted that two CEA provisions granted anti-fraud authority. First, the CFTC pointed to its traditional anti-fraud authority in CEA Section 4b, which the Dodd-Frank Act extended to reach “retail commodity transactions” (e.g., sales of precious metals), which are contracts entered into on a leveraged or margined basis and are not actually delivered within 28 days.<sup>7</sup> (Section 4b does not apply to “a contract of sale of a commodity in interstate commerce” except for contracts that fall within the scope of a “retail commodity transaction.”)<sup>8</sup> Furthermore, the CFTC argued that the anti-fraud authority in CEA Section 6(c)(1) and Rule 180.1(a) also independently reached the sale of precious metals because the statute expressly references “contracts of sale of a commodity in interstate commerce.”<sup>9</sup>

The district court rejected both of the CFTC’s legal theories. First, the court found that *Monex*’s precious metals transactions met the “actual delivery” requirement; therefore, CEA Section 4b did not apply.<sup>10</sup> Second, the district court analyzed the plain language of CEA Section 6(c)(1), considering doctrines of statutory construction, legislative history and the agency’s interpretive statements in the Rule 180.1 rulemaking process. The *Monex* court concluded that read in its entirety, the CEA limits the application of Section 6(c)(1), and therefore, the application of Rule 180.1, to instances of manipulation that involve fraud. The court reasoned that reading Section 6(c)(1) and Rule 180.1 to prohibit fraud absent manipulation would render Section 4b superfluous.<sup>11</sup> This construction of the statute would mean that the CEA does not extend the CFTC’s anti-fraud authority to over-the-counter “contracts of sale of commodities in interstate commerce” unless the conduct also involves market manipulation or the contract qualifies as a “retail commodity transaction.”

<sup>5</sup> See *id.* at 1178.

<sup>6</sup> See *id.* at 1179-80.

<sup>7</sup> See CEA Section 2(c)(2)(D).

<sup>8</sup> CEA Section 4b also applies to commodity transactions that are executed on or subject to the rules of a designated contract market (i.e., a CFTC-registered exchange).

<sup>9</sup> See *Monex Credit Co.*, 311 F. Supp. 3d at 1185.

<sup>10</sup> See *id.* at 1183.

<sup>11</sup> See *id.* at 1189.

This decision is on appeal in the Ninth Circuit and, if upheld, could restrict or eliminate the CFTC’s ability to prosecute fraudulent or deceptive conduct in the over-the-counter spot market. Such an outcome would cast doubt on the CFTC’s enforcement authority in certain pending and future enforcement actions alleging fraud, but not price manipulation, in other over-the-counter spot markets, such as contracts for virtual currency<sup>12</sup> or precious metals.

A New York federal district court made clear that it disagrees with *Monex*.<sup>13</sup> In *CFTC v. McDonnell*, the CFTC alleged that the defendants had violated Section 6(c)(1) and Rule 180.1 by operating a fraudulent scheme involving virtual currency trading and had misappropriated investor funds.<sup>14</sup> The CFTC did not allege that the fraudulent scheme involved manipulation. Had the *McDonnell* court adopted the reasoning in *Monex*, the case therefore would have been dismissed. Instead, the *McDonnell* court rejected the reasoning in *Monex* and held that Section 6(c)(1) and Rule 180.1 prohibit manipulation *or* fraud alone, and do not require proof of both.<sup>15</sup>

A Massachusetts federal district court similarly rejected the *Monex* analysis in *CFTC v. My Big Coin Pay, Inc.*, in which the CFTC alleged that the defendants fraudulently offered the sale of a virtual currency.<sup>16</sup> In addition to ruling that the allegedly fraudulent virtual currency — “My Big Coin” — fell within the CEA’s definition of a “commodity,” even though no futures contracts existed for My Big Coin,<sup>17</sup> the court held that the CFTC’s anti-fraud enforcement authority under Section 6(c)(1) and Rule 180.1(a) extends to transactions in virtual currency even absent allegations of manipulation.

<sup>12</sup> See, e.g., Complaint, *CFTC v. Blue Bit Banc*, No. 18-cv-2247-SJF-ARL (E.D.N.Y. Apr. 16, 2018); Complaint, *CFTC v. Gelfman Blueprint, Inc.*, No. 1:17-cv-07181 (S.D.N.Y. Sept. 21, 2017).

<sup>13</sup> See *CFTC v. McDonnell*, No. 18-CV-361, 2018 WL 3435047, at \*2 (E.D.N.Y. July 16, 2018), denying reconsideration in *CFTC v. McDonnell*, 287 F. Supp. 3d 213 (E.D.N.Y. 2018).

<sup>14</sup> See *McDonnell*, 287 F. Supp. 3d at 216.

<sup>15</sup> See *id.* at 229; see also *McDonnell*, 2018 WL 3435047, at \*1-2 (ruling that Section 6(c)(1) and Rule 180.1 “extend[] to fraud in derivatives markets and underlying spot markets”).

<sup>16</sup> No. 1:18-cv-10077-RWZ, 2018 WL 4621727 (D. Mass. Sept. 26, 2018).

<sup>17</sup> The CEA’s definition of “commodity” covers a range of specifically enumerated agricultural products, as well as “all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.” CEA Section 1a(9). The *My Big Coin Pay, Inc.* court ruled that the CEA “only requires the existence of futures trading within a certain class” of items “in order for all items within that class . . . to be considered commodities.” *My Big Coin Pay, Inc.*, 2018 WL 4621727, at \*4. Because the CFTC alleged that both the virtual currency at issue in the case and bitcoin are virtual currencies, and bitcoin futures are currently traded, the court ruled that the defendants’ virtual currency fit within the CEA’s commodity definition, subjecting the defendants to the CFTC’s anti-fraud enforcement authority. See *id.* at \*3 n.5, \*5 & n.8.

# Derivatives Alert

The Eleventh Circuit also found fraud liability in the absence of market manipulation under Section 6(c)(1) and Rule 180.1(a) in *CFTC v. Southern Trust Metals, Inc.*<sup>18</sup> The CFTC alleged that the defendants had defrauded customers in violation of CEA Sections 4b and 6(c)(1) and Rule 180.1. The defendants had allegedly promised to invest customers' money in precious metals, but instead invested funds in metals derivatives without informing customers and charged them fictitious storage fees. The Eleventh Circuit affirmed the district court's ruling that the defendants committed fraud, without expressly addressing whether the CFTC also needed to allege and prove manipulation.<sup>19</sup>

The *Monex* decision — which is in the minority with respect to the scope of the CFTC's anti-fraud authority — is currently on appeal to the Ninth Circuit.<sup>20</sup> The outcome of the case could have a significant effect on the CFTC's efforts to pursue fraud actions on theories that do not involve market manipulation, such as the alleged frauds involving virtual currency discussed here and fraudulent misappropriation of material, nonpublic information.<sup>21</sup> And, applying Section 6(c)(1) to cash commodity fraud absent manipulation allegations, when combined with the potentially elastic definition of "commodity" that the *My Big Coin* court endorsed, could represent a significant expansion of the CFTC's anti-fraud enforcement authority to specific "goods" or "articles" for which there is no directly related futures market.

Beyond the CFTC's anti-fraud enforcement efforts, the outcome of the *Monex* appeal could also affect the CFTC's anti-manipulation authority under Section 6(c)(1) and Rule 180.1. For

example, if the Ninth Circuit upholds the district court's decision in *Monex*, it will help cement another district court's decision in *CFTC v. Kraft Foods Group, Inc.*<sup>22</sup> In *Kraft*, the CFTC charged manipulation, not fraud, under CEA Section 6(c)(1) and Rule 180.1. In a decision that thus presents a set of allegations that are the converse of *Monex*, the *Kraft* court rejected the CFTC's position that Section 6(c)(1) prohibits manipulation in the absence of fraud. The *Kraft* court ruled that because Section 6(c)(1) prohibits manipulative or deceptive devices or contrivances "in contravention of" the CFTC regulations, the statute and regulations (Rule 180.1) must be interpreted together.<sup>23</sup> The court further stated that the "only reasonable understanding" of Rule 180.1's phrase "any manipulative device, scheme, or artifice to defraud" is that "the [CEA] prohibits (1) the use of manipulative devices to defraud; (2) the use of schemes to defraud; and (3) the use of artifices to defraud."<sup>24</sup>

If the Ninth Circuit were to affirm the *Monex* court's conclusion that Section 6(c)(1) and Rule 180.1 require proof of both fraud and manipulation, that decision would likely influence how the CFTC uses those provisions not only in future fraud enforcement actions but also in future manipulation cases, as well as where it chooses to pursue those actions.<sup>25</sup> The CFTC's recent enforcement actions demonstrate that the agency seeks to be able to use Section 6(c)(1) and Rule 180.1 for pure fraud cases and pure manipulation cases, as well as combined fraud and manipulation cases. But it is unclear today whether courts will agree with the CFTC's interpretation of its post-Dodd-Frank authority.

<sup>18</sup>894 F.3d 1313 (11th Cir. 2018).

<sup>19</sup>See *id.* at 1325-27. The Eleventh Circuit treated CEA Sections 4b and 6(c)(1) and Rule 180.1 as identical for the purpose of finding fraud liability, noting that "[t]he CFTC must prove the same three elements to establish liability under each of the . . . provisions: '(1) the making of a misrepresentation, misleading statement, or a deceptive omission; (2) scienter; and (3) materiality.'" *Id.* at 1325 (citation omitted).

<sup>20</sup>The CFTC filed a motion for expedited review in *Monex* (it was granted in part), arguing that the case presents "issues of unusual public importance concerning the CFTC's authority to police commodity markets for fraud." See *CFTC v. Monex Credit Co.*, No. 18-55815 (9th Cir. June 21, 2018), ECF No. 2.

<sup>21</sup>See, e.g., *In re Ruggles*, CFTC No. 16-34 (Sept. 29, 2016); *In re Arya Motazedj*, CFTC No. 16-02 (Dec. 2, 2015).

<sup>22</sup>153 F. Supp. 3d 996, 1010 (N.D. Ill. 2015).

<sup>23</sup>*Id.* at 1008.

<sup>24</sup>*Id.*

<sup>25</sup>For example, the CFTC has been pursuing alleged spoofing activity not only under CEA Section 4c(a)(5), but also under Section 6(c)(1) and Rule 180.1. See, e.g., *In re Victory Asset, Inc.*, CFTC No. 18-36 (Sept. 19, 2018); *In re Michael D. Franko*, CFTC No. 18-35 (Sept. 19, 2018). CEA Section 4c(a)(5), which makes it unlawful for "any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that . . . is, is of the character of, or is commonly known to the trade, as 'spoofing,'" characterizes "spoofing" as "bidding or offering with the intent to cancel the bid or offer before execution."

# Derivatives Alert

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