Bloomberg BNA

Securities Regulation & Law Report™

FUTURES TRADING

The CFTC Overreaches in Its Interpretation Of the Anti-Manipulation Provisions Adopted in Dodd-Frank

BY H. PETER HAVELES JR.

In its recent settlement with JPMorgan Chase Bank N.A. regarding its London Whale trading losses, the Commodity Futures Trading Commission (the "CFTC") articulated and seemingly adopted an overly-expansive view of its power to control trading conduct in the futures and derivatives markets. The CFTC's aggressive interpretation of the Dodd-Frank Wall Street Reform and Consumer Protection Act's addition of a new antimanipulative provision to the Commodity Exchange Act (the "CEA") gives rise to substantial risks and unintended consequences, including the chilling of legitimate market activity that is critical to market liquidity. This article examines the validity of the CFTC's expansive view of its authority and concludes with some observations about its implications for market participants.

Background. Until 2010, the authority of the CFTC to commence enforcement actions for manipulation was restricted to the provisions in Section 6(c) of the CEA prohibiting a party from manipulating or attempting to manipulate the price of a commodity. The CFTC for years had chafed under this restriction, and sought to broaden its authority.

H. Peter Haveles Jr. is a partner at Kaye Scholer LLP. Charles Kreafle, an associate of Kaye Scholer LLP, assisted with the research for this article.

With enactment of the Dodd-Frank Act, Congress seemingly granted the CFTC's wish. As a result, the CFTC was freed of the obligation to prove an intent to manipulate. As an alternative, the CFTC may prove that a party engaged in prohibited conduct with an intent to deceive the marketplace.

Congress created Section 6(c)(1) of the CEA to make it "unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance . . . ." In accordance with Congress' charge, a year later, the CFTC adopted Rule 180.1, which states in pertinent part:

> (a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:
>
> (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud . . . .

The JPMorgan London Whale Settlement. The CFTC used this new section of the CEA and Rule 180.1 as the basis for its settlement with JPMorgan regarding the "London Whale" trading losses. In the CFTC's Order, the CFTC found that the traders had "recklessly used or employed manipulative devices and contrivances in connection with swaps in violation of Section 6(c)(1) of the [CEA], 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. § 180.1 (2012)."[1] When the CFTC approved the consent Order with JPMorgan, it was noteworthy that Commissioner Scott D. O'Malia dissented because he observed, among other things:

> since the 'manipulative device' charge has not been tested before, I strongly believe that the courts must decide this

[1] Order, *In re JPMorgan Chase Bank, N.A.*, CFTC Docket No. 14-01, at 15 (CFTC Oct. 16, 2013) ("JPMorgan Order").

case of first impression in order to set precedent and to guide both the Commission and market participants.[2]

Commissioner O'Malia continued:

Because the settlement Order does not allege that JPMorgan engaged in manipulative or fraudulent conduct, I believe the [CFTC] needs to do a better job of explaining why the company's aggressive trading strategy constitutes a ''manipulative device.''

Regrettably, neither the CEA nor [the CFTC] regulations define a 'manipulative device.' This lack of a legal standard makes it even more difficult to determine whether JPMorgan engaged in a reckless behavior that put the company at risk or whether such behavior constitutes a 'manipulative device.'

Although, some case law supports the [CFTC's] conclusion that any device that is intentionally employed to distort a pricing relationship may be manipulative, the [CFTC] has failed to produce data or conduct a more careful evaluation of the actual price to determine whether JPMorgan's conduct distorted the price of certain CDX indices.

This problem is compounded even more by the fact that the allegations in the settlement Order center on bilateral or over-the-counter trading. Given this trading environment, I am not clear how the [CFTC] can distinguish between 'real' and 'distorted' prices if the trades were executed through bilateral negotiations.[3]

That question remains unresolved, and the CFTC's statements in the Order only compound the uncertainty about which Commissioner O'Malia lamented.

The Meaning of the CFTC's Rule 180.1. In its proposing and promulgating releases regarding Rule 180.1, the CFTC acknowledged that Section 6(c)(1) is modeled on Section 10(b) of the 1934 Securities Exchange Act, which ''has been interpreted as a broad, 'catch-all' prohibition on fraud and manipulation.''[4] Accordingly, the CFTC stated:

Likewise, the [CFTC] proposes to interpret CEA section 6(c)(1) as a broad, catch-all provision reaching fraud in all of its forms — that is, intentional or reckless *conduct that deceives or defrauds market participants*.[5]

Consistent with that objective, the CFTC modified Rule 180.1 on the SEC's Rule 10b-5.[6]

With respect to the phrase ''manipulative or deceptive device or contrivance,'' the CFTC observed, citing to the U.S. Supreme Court's decision in *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462, 494 (1977):

For example, this provision has been interpreted in the SEC Rule 10b-5 context as prohibiting all practices that are *intended* to mislead investors by *artificially* affecting market activity. Consistent with judicial interpretations of the scope of SEC Rule 10b-5, the [CFTC] proposes that subsection (c)(i) be given a broad, remedial reading, embracing the use or employment, or attempted use or employment, of any manipulative or deceptive contrivance for the purpose of impairing, obstructing, or defeating the integrity of the markets subject to the jurisdiction of the [CFTC].[7]

When it promulgated the rule, the CFTC stated:

To account for the differences between the securities markets and the derivative markets, the [CFTC] will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5. Such extensive judicial review serves as an important benefit to the [CFTC] and provides the public with increased certainty because the terms of Exchange Act Section 10(b) and SEC Rule 10b-5 have withstood challenges to their constitutionality in both civil and criminal matters.[8]

The CFTC declared that it intended to interpret and apply both Section 6(c)(1) and Rule 180.1 ''not technically and restrictively, but flexibly to effectuate its remedial purposes.''[9]

Those comments are the totality of the CFTC's formal guidance concerning Rule 180.1 and the meaning of a ''manipulative or deceptive device.'' According to the CFTC's statements in its 2010 proposing release, the device must be ''intended to mislead investors by artificially affecting market activity'' and the rule is directed at misconduct that ''deceives or defrauds'' the market.[10]

Yet, in the JPMorgan Order, as Commissioner O'Malia suggested, the CFTC did not adhere to those limitations, and took a very broad, if not unprecedented, view that the buying of substantial volumes of a swap in a short period of time was a reckless use of a manipulative device because the size of the trades had the potential to affect market prices and because the volume of the trades was calculated to defend the position.[11] The CFTC observed:

Such activity designed to 'defend' the position or 'fight' other market participants, whether through contemplated month-end trading or otherwise, falls squarely within the prohibitions of Section 6(c)(1) of the [CEA] and [CFTC] Regulation 180.1(a).[12]

In other words, the CFTC appears to have adopted the position that, whenever an entity with a large position trades large volumes to ''defend'' that position, it is employing a manipulative device in violation of Section 6(c)(1) and Rule 180.1. Yet, absent from the CFTC's findings and conclusions is a discussion as to whether there was an intent to mislead investors by artificially affecting market activity or whether the market was deceived.

The Courts' Interpretation of 'Manipulative and Deceptive Devices' Term. Despite the CFTC's declaration, the case law, including the decisions from the United States Supreme Court, regarding manipulative and deceptive devices does not appear to support such a broad reading of Section 6(c)(1) of the CEA. Starting with the two seminal decisions from the U.S. Supreme Court, to which the CFTC pointed in its releases, more is required.

In *Santa Fe*, the Supreme Court stated:

'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The *term refers generally to practices*, such as wash sales, matched orders, or rigged

[2] Statement of Commissioner Scott D. O'Malia, dated Oct. 15, 2013.
[3] *Id.* (footnote omitted).
[4] Prohibition of Market Manipulation, 75 Fed. Reg. 67657, 67658 (CFTC Nov. 3, 2010).
[5] *Id.* (emphasis added).
[6] *Id.*
[7] 75 Fed. Reg. at 67659 (emphasis added).
[8] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41399 (CFTC July 14, 2011) (footnotes omitted).
[9] *Id.* at 41401.
[10] *See* 75 Fed. Reg. at 67658-59.
[11] JP Morgan Order, *supra* note 1, at 14-15.
[12] *Id.* at 15.

> prices, that are *intended to mislead investors by artificially affecting market activity*.[13]

In its decision issued one year earlier, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court stated:

> Section 10(b) makes unlawful the use or employment of ''any manipulative or deceptive device or contrivance'' in contravention of Commission rules. The word ''manipulative or deceptive'' used in conjunction with ''device or contrivance'' *strongly suggests that § 10(b) was intended to proscribe knowing or intentional conduct*.[14]

The Supreme Court explicitly rejected the argument made by the SEC in its *amicus curiae* brief that the language was not limited to knowing or intentional practices, stating that:

> The [SEC's] argument simply ignores the use of the words ''manipulative,'' ''device,'' and ''contrivance'' – terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word ''manipulative'' is especially significant. It is and was virtually a term of art when used in connection with securities markets. *It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities*.[15]

Three SEC enforcement cases underscore the burden of proof that an agency must meet. In all of them, there was a course of conduct intended to deceive the market.

In *Markowski v. SEC*, 274 F.3d 525 (D.C. Cir. 2001), the court sustained an enforcement proceeding determination that Michael J. Markowski had violated Section 10b-5 by engaging in manipulative, deceptive and fraudulent conduct. For a period of six months after an initial public offering, Markowski and his firm supported the price of the issuer's securities by maintaining high bid prices and absorbing all unwanted securities into inventory in order to prevent sales from depressing market prices. Markowski argued that there could not be a manipulation because the trades were real. The court acknowledged the difficulty that that situation creates, observing:

> It may be hard to separate a 'manipulative' investor from one who is simply overenthusiastic, a true believer in the object of investment. Both may amass huge inventories and place high bids, even though there are scant objective data supporting the implicit estimate of the stock's value. Legality would thus depend entirely on whether the investor's intent was 'an investment purpose' or solely to affect the price of the security.[16]

The court then concluded that it could not ''find the [SEC's] interpretation to be unreasonable in light of what appears to be Congress's determination that 'manipulation' can be illegal solely because of the actor's purpose.''[17]

In the *United States v. Mulheren* decision on which the D.C. Circuit relies, the U.S. Court of Appeals for the Second Circuit reversed a criminal mail and wire fraud conviction predicated on violation of Rule 10b-5. The government based its criminal charge on the contention that, when an investor ''engages in securities transactions in the open market with the sole intent to affect the price of the security, the transaction is manipulative and violates Rule 10b-5.''[18] The Second Circuit observed that it had ''misgivings'' about the government's view of the law, but assumed without deciding on the appeal ''that an investor may lawfully be convicted under Rule 10b-5 where the purpose of his transaction is solely to affect the price of the security.''[19] In response to one of the government's arguments, the court stated:

> While we agree, as a general proposition, that market domination is a factor that supports a manipulation charge, the extent to which an investor controls or dominates the market at any given period of time cannot be viewed in a vacuum. For example, if only ten shares of stock are bought or sold in a given hour only by one investor, that investor has created 100 percent of the activity in that stock in that hour. This alone, however, does not make the investor a manipulator. The percent of domination must be viewed in light of the time period involved and other indicia of manipulation.[20]

With respect to the decisions on which the government relied, the court stated that those instances involved the defendant exercising domination for a prolonged period of time (*e.g.*, one year of engaging in more than 50 percent of the overall trading, and four months of accounting for approximately 29 percent of the daily volume). Consequently, the Second Circuit observed:

> When domination is sustained over such an extended period of time, evidence of manipulation is strong. But, if the percentage of control be measured in terms of minutes or hours, anyone could find himself labeled as a manipulator.[21]

In *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107 (2d Cir. 1998), the Second Circuit reversed the dismissal of the SEC's complaint brought by the SEC against a party participating in and assisting a manipulation. The SEC's complaint alleged that the manipulation consisted of a stock promoter, with the assistance of other parties, engaging in a course of conduct of:

(a) effecting offers, purchases, and sales of [the company's] securities in return for promises of risk-free profit for engaging in such trades;

(b) effecting directed and controlled trades of [the company's] securities;

(c) effecting ''wash sales'' and ''matched orders''; and

(d) effecting trades involving undisclosed nominees.[22]

The parties and their nominees traded the company's shares among themselves '' 'for the purpose of creating the appearance of an actual market for trading [the company's] shares' and thus raising [the company's] stock price.''[23]

The difficulty of determining whether there has been a use of a manipulative or deceptive device when dealing with real as opposed to contrived trading (such as wash trades) is illustrated by decisions from the North-

---

[13] 430 U.S. 462, 475 (emphasis added; citations omitted).
[14] 425 U.S. 185, 197 (1976) (emphasis added; citations omitted).
[15] *Id.* at 199 (emphasis added; footnotes omitted).
[16] 274 F.3d 525, 528 (D.C. Cir. 2001) (quoting *United States v. Mulheren*, 938 F.2d 364, 368 (2d Cir. 1991)).
[17] *Id.* at 529 (citations omitted).
[18] 938 F.2d at 368 (footnote omitted).
[19] *Id.*
[20] *Id.* at 371.
[21] *Id.*
[22] 155 F.3d 107, 109 (2d Cir. 1998)
[23] *Id.*

ern District of Illinois and the Southern District of New York.

In *SEC v. Kimmes*, 799 F. Supp. 852 (N.D. Ill. 1992), the court held that the defendant had engaged in manipulation in violation of Section 10(b) and Rule 10b-5, and issued a permanent injunction. The legal predicate of the court's decision was:

> Securities manipulation, the final component or step of the scheme of [defendant] in his confederates, is conduct 'designed to deceive or defraud investors by controlling or artificially affecting the price of securities.' Among the fundamental purposes of the federal securities laws is the assurance of free and open securities markets in which prices are fixed by the interaction of supply and demand, uninfluenced by manipulative activities that would cause prices to be inflated or depressed artificially.
>
> That being so, any activities that falsely persuade the public that activity in an over-the-counter security is 'the reflection of a genuine demand instead of a mirage' are outlawed by 1933 Act § 17(a) and 1934 Act § 10(b). Such activities may include (1) fraudulent promises of quick profits made by salesman to friends and customers; (2) directed and controlled trading in a security; (3) the use of wash sales and matched orders; (4) the use of undisclosed nominees; and (5) the use of material misrepresentations in newsletters and otherwise.[24]

The court held that the defendant had engaged in a series of ''sham public offerings,'' the prices for which he artificially maintained by virtue of using captive brokerage companies, nominee accounts, false public filings and news releases, false price quotes and sham after-market transactions.[25]

In *SEC v. Masri*, 523 F. Supp. 2d 361 (S.D.N.Y. 2007), the court declined to grant the defendants' motion for summary judgment, after concluding (albeit reluctantly) that there were issues of fact requiring a trial. In doing so, the court held:

> [T]he Court must decide the related question of whether an open-market transaction unaccompanied by deceptive or fraudulent conduct can support liability for market manipulation where the defendant has both a manipulative and non-manipulative intent, whether it requires that the sole intent be to artificially affect the price of the stock, or whether some other standard is appropriate.
>
> The Court holds that in order to impose liability for an open market transaction, the SEC must prove that *but for* the manipulative intent, the defendant would not have conducted the transaction. The Court reaches this conclusion based on three considerations. First, in *Mulheren*, the Second Circuit accepted, with ''misgivings,'' the government's theory that an open-market transaction could violate Section 10(b) where it was done with the ''sole intent'' to affect the price of securities, and not for any ''investment purpose.''
>
> Because the Second Circuit accepted the government's theory only with ''misgivings,'' then *a fortiori*, it would find problematic a theory under which an investor could be found liable for market manipulation when only one of the investor's purposes was to alter the price. Second, if a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is ''artificially'' affecting the price of the security or injecting inaccurate information into the market, which is the principal concern about manipulative conduct. Finally, given the inherent ambiguity in determining intent, the concerns about imposing liability for otherwise legal activities based solely on intent, and the potential for chilling such legal activity, the Court finds it wise to err on the side of caution.[26]

The court concluded that there were factual issues regarding the SEC's claim and assertion regarding intent:

> concerned that his August 5 puts would expire ''in the money,'' forcing him to purchase over 800,000 TZA shares, [the defendant] placed a large TZA order in the closing minutes on the day before expiration in order to artificially drive the price over $5 per share, thereby insuring that the options would expire worthless.[27]

Conclusion. The CFTC's position regarding trading intended to ''defend'' a position fails to take into account the case law addressing the meaning of a manipulative and deceptive device under the securities laws. Instead, the CFTC rests its view solely on the fact that any reasonable trader ought to know that such a volume of trades ''may'' affect prices. Yet, given the economics of a trading market, whether the market is liquid or illiquid, it is axiomatic that a large order to buy or sell a commodity or a swap may influence prices. That inherent possibility should not be enough to trigger liability. More is required, specifically, the intent to engage in conduct that is designed to deceive the market and market deceit.

Indeed, the factual context of the ''London Whale'' situation underscores the CFTC's overbroad interpretation of Section 6(c)(1). Throughout the fourth quarter of 2011 and the first quarter of 2012, there was substantial speculation in the industry regarding an extremely large swap position held by one trader, later learned to be JPMorgan, and some hedge funds began a concerted pattern of trading, taking substantial positions in the CDX swap in order to put pressure on prices and to obtain a profit at JPMorgan's expense.[28] Thus, when JPMorgan responded to the conduct of traders taking that counter-position, there was nothing deceptive or misleading about ''defending'' its position in a trading environment that consciously targeted JPMorgan's position. Indeed, if the decision to ''defend'' this position was enough to trigger liability under Section 6(c)(1), then logically the hedge funds that put on a position in order to attack the JPMorgan position could have likewise been exposed to the same charges.

All this goes to show that the CFTC's position is a dangerous and troubling one that triggers the very concerns expressed by the district court in *Masri*, namely improperly chilling legitimate activity in the marketplace. In order to sustain enforcement claims under Section 6(c)(1) of the CEA, the CFTC should be required to demonstrate an actual intent to deceive or to cause artificial prices. Absent such boundaries, there will be unnecessary uncertainty and risk, and market participants will be denied the clear guidance to which they are entitled, just as Commissioner O'Malia feared in his dissent.

Any fund or trader that builds a large speculative position, whether or not in a very liquid market, must confront this risk. Likewise, this risk is present for large traders that are driven by technical market strategies.

---

[24] 799 F. Supp. 852, 858-59 (N.D. Ill. 1992) (citations omitted).
[25] *Id.* 857-59.

[26] 523 F. Supp. 2d 361, 372-73 (S.D.N.Y. 2007) (original emphasis; citations and footnote omitted).
[27] *Id.* at 373.
[28] *See* Azam Ahmed, *The Hunch, the Pounce and the Kill*, N.Y. Times, May 26, 2012, at B1.

In essence, any such trader is at risk of being accused of trying wrongly to affect market prices by virtue of trading that is legitimately intended to protect or further a position's profitability. Unless the new leadership at the CFTC takes a more moderate view consistent with the long-standing legal development of the term ''deceptive and manipulative conduct,'' large speculative traders, who are critical to ensuring that there is liquidity in the futures and derivatives markets, run the risk of enforcement action for pursuing historically acceptable trading practices, especially if their trading activity acquires any notoriety.

To protect against that risk, traders are confronted with several courses of action, none of which is ideal:

1. Do not change trading practices and be prepared to incur substantial legal expenses to defend against and oppose any enforcement activity by the CFTC and to oppose the CFTC's aggressive interpretation of the statutory provision.

2. Adopt substantial compliance systems to monitor the establishment and maintenance of large speculative positions and to vet trading strategies to protect those positions prior to the strategies being implemented.

3. Impose internal limits on the size of speculative positions or prohibitions against such trading altogether, in order to prevent such positions from becoming sufficiently large to draw attention and ultimately to attract enforcement inquiries and/or actions.

These alternative courses of conduct compelled by the CFTC's position will lead to the very market chilling effect that has concerned the courts. Absent self-reflection by the CFTC, either large speculative positions will be repressed for no legitimate reason or the cost of maintaining such positions will be substantially increased. In either circumstance, market liquidity and thus price determination will be unnecessarily damaged.