

ClientAlert

Capital Markets/Derivatives

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CFTC Adopts New Anti-Manipulation and Anti-Fraud Rules

On July 7, 2011, the Commodity Futures Trading Commission ("CFTC") issued final rules under the new anti-manipulation and anti-fraud provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")¹. The CFTC adopted new Rules 180.1 and 180.2 under Section 6(c) of the Commodity Exchange Act ("CEA"), as amended by Dodd-Frank. These rules broaden the scope of the existing prohibition on price manipulation by eliminating the requirement to show an artificial price and lowering scienter to recklessness for the use of a manipulative device to defraud, acts or attempts to defraud, and for false or misleading statements. The prior scienter requirement was specific intent. The rules introduce an expanded prohibition on false reporting and make it unlawful to provide "any false statement of material fact" to the CFTC in any context. Finally, the CFTC preserves its current authority on the prohibition of price manipulation even in the absence of fraud. The final rules became effective on August 15, 2011 with respect to all transactions other than "swaps" (including, but not limited to, futures contracts, options on futures contracts, transactions with retail customers in foreign currency and commodity transactions and most excluded and exempt commodities). The delay in the effective date of Dodd-Frank² will postpone the effectiveness and applicability of the new anti-manipulation and anti-fraud provisions and the rules recently published by the CFTC for many over-the-counter transactions until the effectiveness of the rule that defines the term "swap".

While the CFTC has adopted final rules, we are still awaiting implementing rule 9j-1 to be finalized by the Securities Exchange Commission ("SEC") in respect of its anti-fraud and anti-manipulation enforcement authority. Any finalization of rules by the SEC will face a similar delay in effectiveness until a final definition of "security-based swap" is released.



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¹ See CFTC final Rule, "Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation," issued on July 5, 2011 ("Final Rule"). A copy of the final rule is available [here](#).

² See CFTC Final Order "Effective Date for Swap Regulation," issued on July 13, 2011.

Expanded Authority Under Dodd-Frank

Dodd-Frank expanded the CFTC's authority to combat fraud and manipulation in several ways. New Section 6(c)(1) of the CEA eliminates the requirement to prove an artificial effect on price for fraudulent acts; lowers the standard of scienter for fraudulent and manipulation from "intentional" to "reckless"; prohibits trading on material nonpublic information obtained in breach of a duty not to disclose. Section 6(c)(2) expanded the CFTC's enforcement authority over false or misleading statements. It prohibits false statements of material fact made to the CFTC in any context (where previously such statements were limited to reports and registration statements). Finally, Section 6(c)(3) of the CEA preserved the enforcement authority of the CFTC to prohibit the intentional manipulation or attempt thereof of the price of any swap, commodity or futures contract.

Implementation of "SEC 10b-5 like" Rule on Market Manipulation

New Section 6(c)(1) of the CEA imposes a broad prohibition against market manipulation.³ Modeled after Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), the broad statutory prohibition against the use of any "manipulative or deceptive device or contrivance" in the swaps and derivatives market has expanded the CFTC's authority to prosecute market manipulation and deceptive practices beyond price manipulation: prior to Dodd-Frank, the CFTC's authority to prosecute market manipulation was limited to price manipulation.

Final Rule 180.1 implements rules with respect to the CFTC's new expansive authority under Section 6(c)(1).

Rule 180.1 adopted to implement Section 6(c)(1), is modeled on SEC Rule 10b-5, which implements Section 10(b) of the Exchange Act. SEC Rule 10b-5 has been interpreted by courts to prohibit all practices "that are intended to mislead investors by artificially affecting market activity" and has been interpreted by the Supreme Court as a catchall clause to prevent fraudulent practices. Rule 180.1 generally makes it unlawful for any person,

in connection with any swap, commodity or futures contract, to intentionally or recklessly⁴:

- (1) use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
- (2) 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;
- (3) engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; or,
- (4) deliver or cause to be delivered, or attempt to deliver or cause to be delivered, for transmission through the mails or interstate commerce, by any means of communication whatsoever, 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.

- Nothing in this section shall be construed to require any person to disclose to another person nonpublic information that may be material to the market price, rate or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect.
- Nothing in this section shall affect, or be construed to affect, the applicability of Commodity Exchange Act Section 9(a)(2).

In short, Rule 180.1 implements Section 6(c)(1) by (1) prohibiting fraud-based manipulation in connection with any swap, commodity or futures contract; (2) requiring a scienter of "recklessness" for fraud-based violations; (3) prohibiting attempted fraud; and (4) prohibiting trading on material nonpublic information (i.e., information obtained in breach of a pre-existing duty or information obtained through fraud or deception).

³ Section 6(c)(1) provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, to use or employ or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulation or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate...provided no rule or regulation...shall require any person to disclose to another person, nonpublic information that may be material to the market price, rate or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect.

⁴ The only disparity between the adopted and the proposed regulatory text is the addition of the word "inaccurate" to Section 180.1(a)(4) which previously read "Notwithstanding the foregoing, no violation of this subsection shall exist where the person mistakenly transmit, in good faith, false or misleading information to a price reporting service." The CFTC added the word inaccurate in order to mirror the language of Section 6(c)(1)(C).

CFTC Rule 180.1 models SEC Rule 10b-5 in several ways. It establishes a broad “catch-all” anti-fraud and anti-manipulation provision; the CFTC states in the release for final Rule 180.1 that while proof of a market or price effect could be used to establish a violation under Section 6(c)(1) and Rule 180.1, a violation may exist irrespective of any such effect.⁵ The CFTC will now be able to prosecute manipulation without having to establish price manipulation. This was not the case prior to Dodd-Frank. Rule 180.1 incorporates SEC Rule 10b-5’s standards of materiality and scienter. The standard of scienter has been lowered to that of “recklessness.” In response to the industry’s request for clarification on the definition of “recklessness,” the CFTC has stated in the release for the rule 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.”⁶ With respect to the term “in connection with” under Rule 180.1(a) and (b), CFTC asserts in the release to the final rule that it interprets the term broadly and not restrictively or technically and will “reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency or termination” of any swap, or commodity or futures contract. Further, the CFTC states in the release that it will look to the Supreme Court’s broad interpretation of the term in the context of SEC Rule 10b-5 for clarification and guidance on the limits of its applicability. Under the final rule, the plaintiff will bear the burden of proving a violation based upon a preponderance of the evidence. In short, the similarities to Rule 10b-5 will likely influence the CFTC’s interpretation and application of Rule 180.1.

In addition, the CFTC has provided important clarifications in response to comments received from the industry. It has noted that the new Rule 180.1 would not impose new disclosure obligations or affirmative duties of inquiry or diligence. Further, it is not a violation of Rule 180.1 to withhold information that a market participant lawfully possesses about market conditions. The CFTC notes that “[t]he failure to disclose such market information prior to entering into a transaction, either in an anonymous market setting or in bilateral negotiations, will not, by itself constitute a violation of final Rule 180.1...silence, absent a pre-existing duty to disclose is not deceptive within the meaning of final Rule 180.1.”⁷ Market participants may still trade on the basis of material nonpublic information so long as they obtained the information lawfully and not through fraud or deception and do not otherwise owe a pre-existing duty of disclosure (i.e., a duty to disclose so

that the statement made to the other person in connection with the transaction is not misleading in any material respect or a duty imposed by another law or regulation). The approach to determine whether a violation exists under Section 6(c)(1) will be a facts and circumstances analysis. The CFTC believes this is consistent with the broad catch-all provision to prohibit fraud and manipulation.

With respect to the new provision prohibiting material misstatements and omissions (Rule 180.1(a)(4)), the CFTC declined to limit the final rule by either excluding partial omissions or requiring that material misstatements or omissions distort (or, with respect to attempted violations, are likely to distort) market conditions. Half-truths could suffice for a finding of a violation depending on the facts and circumstances of a specific case and, as mentioned above, market or price effects are not required for a finding of a violation. The CFTC further clarified that (1) the good faith exception was limited to the mistaken transmission of false or misleading or inaccurate information to a price reporting service in order to mirror the language of the new Section 6(c)(1) of the CEA, which is similarly limited in scope and (2) the scienter requirements of Rule 180.1 and Rule 180.2 will further ensure that good faith mistakes and negligence will not result in a violation of the final rules.

In clarifying the reasoning for including the language “or attempt to make” in final Rule 180.1(a)(2), the CFTC provided an example of a supervisor instructing a subordinate to make a material misstatement or omission and being rebuffed by the subordinate. The supervisor would still violate the final rule in such a situation because of the “or attempt to make” language.

The maximum penalty for each violation will be the greater of US\$1 million or triple the monetary gain to the violator.

Implementation of Broadened Rule on Prohibition of Price Manipulation

New Section 6(c)(3) and amended Section 9(a)(2) of the CEA expands the prohibition of manipulative practices in connection with price manipulation or attempted price manipulation to swaps. Section 6(c)(3) and Section 9(a)(2) establish civil and criminal enforcement authority for the CFTC, respectively. In keeping with the stated purpose to deter or prevent price manipulation, the CFTC clarified in the final rule release that the CFTC’s criminal enforcement authority under Section 9(a)(2) remained a valid

⁵ “A market or price effect may well be indicia of the use or employment of a manipulative or deceptive device or contrivance; nonetheless, a violation of final Rule 180.1 may exist in the absence of any market or price effect.” (Final Rule §IV.B.2)

⁶ See Final Rule, §IV.F.2.

⁷ See Final Rule, §IV.C.S.

and enforceable statutory provision against price manipulation.⁸ Implementing Rule 180.2 mirrors Section 6(c)(3) by making it:

Unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.

In responding to comments to Rule 180.2, the CFTC clarified that it would be guided by the traditional four-part test for manipulation that had been developed under CEA case law in the context of price manipulation actions involving futures. The four-part test requires that:

- (5) The accused had the ability to influence market prices;
- (6) The accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand;
- (7) Artificial prices existed; and
- (8) The accused caused the artificial prices.

The CFTC clarified that it has retained the original scienter requirement of specific intent under original Section 6(a) (and now new Section 6(a)(3)) for establishing price manipulation. Unlike new Section 6(a)(1) and implementing Rule 180.1, recklessness will not suffice to establish a violation under Section 6(a)(3) and implementing Rule 180.2.⁹ The CFTC further noted that it will continue to interpret the prohibition on price manipulation broadly. This will include any influence on the price of a swap, commodity or commodity futures contract that is intended to interfere with the supply and demand in the market. The CFTC stresses that determination of manipulation is fact-intensive and that for purposes of the traditional framework, demonstrating an “artificial price” through economic analysis may not be necessary as it may be evident without the need for economic analysis. The CFTC also clarifies that requirements (3) and (4) of the four-part test remain separate and distinct tests. Finally, the CFTC notes that Section 6(c)(3) and Rule 180.2 will include “indirect” levels of manipulation (i.e., a broker executing a trade on a person’s behalf, which trade is designed to manipulate a price in the market) and further notes that in keeping with existing jurisprudence, the conduct giving rise to such manipulation need not be fraudulent or illegal.

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⁸ Dodd-Frank did not require any further rulemaking in respect of Section 9(a)(2).

⁹ Note that specific intent is required to establish a criminal violation under Section 9(a)(2) of the CEA. Dodd-Frank only amended Section 9(a)(2) and did not issue any further rules in respect thereof.