E-ALERT | Dodd-Frank Act

July 11, 2011

CFTC Issues Final Rules Prohibiting Market Manipulation

On July 7, the Commodity Futures Trading Commission ("CFTC") voted 5-0 to issue two final rules prohibiting market manipulation. These rules, which will be codified at Sections 180.1 and 180.2 of the CFTC's regulations, implement new authority to prohibit fraud-based manipulation and deceptive schemes given to the CFTC by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Although the final rules are almost identical to the rules that the CFTC proposed last fall, the CFTC responded to public comments and concerns and, in doing so, explained how it will interpret the scope of these new provisions. The new rules will become effective 30 days after publication in the *Federal Register*, which has not yet occurred. During the CFTC's open meeting on July 7, Enforcement Director David Meister stated that the new anti-manipulation provisions will be a priority for the CFTC's Enforcement Division in conducting investigations.

Dodd-Frank's New Manipulation Authority

Title VII of Dodd-Frank establishes a comprehensive new regulatory framework for derivatives. As part of this new framework, Dodd-Frank prohibits fraud and manipulation in connection with trading swaps, commodities, and futures and expands the CFTC's enforcement authority. Specifically, Section 753 of Dodd-Frank, which is patterned after Section 10(b) of the Securities Exchange Act of 1934, amends existing Section 6(c) of the Commodity Exchange Act ("CEA") as follows:

- New Section 6(c)(1) prohibits the direct or indirect use of any "manipulative or deceptive device or contrivance" in connection with any swap, commodity, or futures transaction. This section requires the CFTC to issue implementing rules.
- New Section 6(c)(1)(A) adds a special provision extending the definition of manipulation to include knowing or reckless false reporting of market or price information. This provision also includes an exception for mistakenly transmitting false reports in good faith.
- New Section 6(c)(2) prohibits making any false or misleading statement or omission of material fact to the CFTC.
- New Section 6(c)(3) prohibits direct or indirect swap or commodity price manipulation and attempted manipulation.

New Section 6(c) is broader than the existing prohibition of manipulation in Section 9(a)(2) of the CEA, because new Section 6(c) reaches beyond intentional price manipulation. For example, the CFTC will be able to take enforcement action against fraud-based manipulative schemes generally and will no longer have to prove specific intent or an effect on prices.

The CFTC's New Manipulation Rules

On November 3, 2010, the CFTC issued proposed rules implementing its new authority to prohibit fraud and manipulation. Thereafter, the CFTC received comments from 27 parties, including a member of Congress, a law professor, economists, industry members, trade associations, energy news and price reporting organizations, designated contract markets, a government-sponsored enterprise, and members of the public. After reviewing these comments, the CFTC determined that it was appropriate and in the public interest to issue final rules that were identical to the proposed rules but for one change discussed below.

Rule 180.1

Rule 180.1 broadly prohibits fraud in connection with any swap, commodity contract, or futures contract. Specifically, Rule 180.1 makes it unlawful for any person, intentionally or recklessly, to:

- Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
- 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;
- 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
- Deliver or cause to be delivered (or attempt to deliver or cause to be delivered) 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, knowing, or acting in reckless disregard of the fact that such report is false, misleading or inaccurate.
  - But a person will not violate this provision if he mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service.
  - The only difference in language between the final rules and the proposed rules is the insertion of the word "inaccurate" in this exception, which as proposed stated only "false or misleading information." With this change, the CFTC updated the proposed rule to mirror the language in Section 6(c)(1)(A).

The CFTC explained the scope of the new rule in responding to public comments:

- Potential Disclosure Implications. The CFTC modeled this rule after the Securities and Exchange Commission's Rule 10b-5, which is designed as a "catchall" to prevent fraud in connection with the purchase or sale of securities. In response to public comments expressing concern about applying securities precedent (especially with respect to insider trading) to commodities markets, the CFTC clarified that it is not a violation of Rule 180.1 to withhold information that a market participant lawfully possesses about market conditions. In other words, silence, absent a pre-existing duty to disclose, will not be considered "deceptive" within the meaning of Rule 180.1. While the final rule does not prohibit trading on the basis of material nonpublic information, the CFTC has clarified that it may be deceptive or manipulative, and therefore a violation of Rule 180.1, for a person to trade on information in breach of a pre-existing duty, established by law or rule, agreement, understanding, or otherwise.
- Attempt and Half-Truths. The CFTC declined to adopt comments recommending deletion of the phrase "attempt to make" an untrue statement that operates as a fraud or deceit. The CFTC also declined to modify the provision prohibiting "partial omissions" (that is, the omission of a material fact necessary to make the statement not untrue or misleading).
- Scienter. The CFTC clarified that a showing of recklessness is, at a minimum, necessary to prove the scienter element of Rule 180.1. In the preamble, the CFTC defined recklessness as 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 was doing. In interpreting the scienter requirement further

for particular provisions of Rule 180.1, the CFTC will be guided, but not controlled, by judicial precedent interpreting and applying the scienter requirement under Rule 10b-5.

- **In Connection With.** The CFTC will interpret the nexus requirement that the fraud be "in connection with" a swap, commodity contract, or futures contract broadly, not technically or restrictively. In doing so, the CFTC will be guided by judicial precedent interpreting Rule 10b-5.
- **Penalty.** The CFTC may assess in any case of manipulation or attempted manipulation a civil penalty of not more than $1 million or triple the monetary gain to the person for each violation. This penalty structure will apply to any type of manipulation, including attempted manipulation and manipulation by false reporting, prohibited by Section 6(c)(1)(A).

Rule 180.2

Rule 180.2 codifies the CFTC's authority to prohibit price manipulation. This rule makes it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, commodity, or futures contract.

Responding to public comments, the CFTC stated that, in applying Rule 180.2, it will be guided by the following four-part test for manipulation that has developed in case law under the CEA:

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

Because the rule requires the specific intent to affect prices, a showing of recklessness will not suffice to prove a violation.

The CFTC's final manipulation rules are available here.

If you have any questions about the new manipulation rules and how they will affect your business, please contact the following members of the firm:

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