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CFTC ENFORCEMENT

The New Financial Sheriff: CFTC Anti-Fraud Authority After Dodd-Frank



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The Commodity Futures Trading Commission (the “CFTC” or the “Commission”) oversees the nearly \$40 trillion U.S. futures markets as well as the \$300 trillion U.S. swaps markets.¹ But unlike its regulatory counterpart for the securities industry, the Securities and Exchange Commission (the “SEC”), the CFTC historically has lacked the resources, legal authority, and

¹ U.S. Commodity Futures Trading Commission, Budget and Performance Estimate for FY 2013, at 2 (2012).

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perhaps the desire to aggressively pursue fraudulent activities in the futures and swaps markets that it regulates. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) of 2010 attempted to remedy much of this problem by granting the Commission broad antifraud authority to pursue any false or misleading statement of material fact. To support this expanded mandate, the Obama Administration has increased the budget of the CFTC by 40% and the Commission has enlarged its enforcement staff by more than 50%. Statements by the Commission regarding the Dodd-Frank antifraud provisions and the CFTC’s initial use of this power suggest that the Commission will construe its new authority broadly. This expanded regulatory role for the CFTC will have significant implications for individuals and entities involved in the futures and swaps markets.

A. The CFTC’s Enforcement Authority Prior to Dodd-Frank

The Enforcement Division of the CFTC historically has had little success in combating fraudulent activity in the markets that it oversees. The Commission’s most high-profile fraud case, involving an attempt to corner the silver market in the 1970s, was resolved more than twenty years ago.² The Commission has brought many cases alleging manipulation in the energy and swap markets over the past 35 years but has only had a small number of victories in court.³ As a result of this poor track record of fraud enforcement, the CFTC developed a reputation as a weak regulator. As a New York Times article from 2010 explained, the CFTC “has generally been viewed as a regulatory agency with a small bark

² See Peter Henning, *CFTC Is Set to Get Tougher on Fraud*, New York Times Dealbook, November 1, 2010, <http://dealbook.nytimes.com/2010/11/01/c-f-t-c-is-set-to-get-tougher-on-fraud/>.

³ See, e.g., Jerry Dicolo, Dan Strumpf and Jamila Trindle, *Target on Manipulation, but It's Tough to Hit*, Wall Street Journal, April 20, 2012, at C1.

and even less bite” and was considered to be “the scrawny younger brother of the S.E.C.”⁴

The lack of historical enforcement success in CFTC fraud cases was caused by several factors. First, in spite of the vast scope of the derivatives market that it regulates, the CFTC has received only a fraction of the resources that have been provided to the SEC. In fiscal year 2010, for example, the budget of the CFTC’s Enforcement Division was only \$43 million,⁵ whereas the same division at the SEC received more than \$380 million.⁶ Moreover, the enforcement staff at the CFTC is considerably smaller than its securities counterpart, with only 161 individuals in 2010⁷ as opposed to more than 1,200 at the SEC.⁸ This resource disparity is exacerbated by the fact that the CFTC oversees nearly \$340 trillion in the swaps and futures markets whereas the SEC is responsible for regulating less than \$40 trillion in the securities market. Second, the CFTC faced jurisdictional competition from both the SEC and the Federal Energy Regulatory Commission (“FERC”), both of which sought to pursue enforcement matters that overlapped with the CFTC.

Most importantly, the Enforcement Division of the CFTC was constrained by the Commission’s limited legal authority to target fraudulent activity. The SEC, for example, has extensive power to pursue securities fraud through Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In contrast, the CFTC lacked a comparably broad antifraud provision in the Commodity Exchange Act (“CEA”).

The CFTC’s fraud enforcement authority was particularly limited by two requirements of the CEA. In order to bring a successful market manipulation case, the Commission was obligated to demonstrate that the accused had the specific intent to manipulate prices. In addition, the CFTC had to show that the defendant’s actions caused an artificial price in the commodity or derivative at issue. These two requirements created an extremely high bar for fraud cases that the Enforcement Division found difficult to overcome.

B. Expansion of CFTC Enforcement Authority Under Dodd-Frank

The Dodd-Frank Act significantly strengthened the CFTC’s authority to prohibit fraudulent and manipulative behavior by adopting an approach similar to Rule 10b-5. In particular, Section 753 of Dodd-Frank amended section 6(c) of the CEA by creating section 6(c)(1) to prohibit manipulative and deceptive devices and contrivances in connection with any swap or a contract of sale of any commodity in interstate commerce.⁹

⁴ Henning, *supra* note 2.

⁵ U.S. Commodity Futures Trading Commission, President’s Budget and Performance Plan for FY 2011, at 77 (2011).

⁶ See Securities and Exchange Commission, FY 2011 Congressional Justification, at 11 (February 2010).

⁷ CFTC Budget and Performance Plan for FY 2011, *supra* note 5, at 77.

⁸ See SEC FY 2011 Congressional Justification, *supra* note 6, at 8.

⁹ Section 753 of Dodd-Frank also created section 6(c)(2) of the CEA to prohibit the provision of false information to the Commission and created section 6(c)(3) to make it unlawful to manipulate or attempt to manipulate the price of any swap or commodity. These provisions are not discussed in this article

Section 753 required the CFTC to promulgate rules implementing this antifraud provision within a year of the Act’s passage; pursuant to this authority, the CFTC adopted Rule 180.1 on July 14, 2011.¹⁰

Interestingly, the CFTC’s antifraud rule goes well beyond the similar SEC provision. Rule 180.1 broadly prohibits fraud by any person acting intentionally or recklessly in connection with any swap or cash or futures contract.¹¹ Specifically, the relevant portion of Rule 180.1 makes it unlawful to:

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.

There are several important features of this new rule. First, Rule 180.1 is not limited to actual transactions but extends to all activities that have a *relationship* to the swap or futures contract at issue. As the CFTC explained, the “in connection with” requirement of the rule is intended to be read “broadly, not technically or restrictively” and explained that Rule 180.1 is meant to “reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap, or contract of sale of any commodity in interstate commerce. . . .”¹² This represents a significant departure from Rule 10b-5, which requires the prohibited activity to be in connection with an actual transaction involving the purchase or sale of a security.

Second, Rule 180.1 covers not just fraudulent actions but also extends to any *attempt* to engage in fraudulent activity. As a result, even failed efforts to manipulate the market may still be deemed a violation of this provision.

Third, the rule lowers the scienter threshold for the CFTC’s fraud cases to include reckless actions. As noted above, the requirement of a specific intent to defraud or manipulate the market served as a significant impediment to bringing CFTC enforcement cases. By eliminating this constraint, Rule 180.1 makes it much easier for the Commission to charge individuals and entities with fraud. As Commissioner of the CFTC Gary

but should be carefully reviewed by legal and compliance professionals and market participants.

¹⁰ In addition to the expansion of antifraud authority, Title VII of the Dodd-Frank Act also clarified some of the jurisdictional concerns for the CFTC by empowering the Commission to oversee the swaps market.

¹¹ The CFTC has stated that Section 6(c) was modeled on Exchange Act Rule 10b-5. Indeed, the Adopting Release specifically embraced language from 10b-5 case law in noting that the Commission intends to interpret and apply Rule 180.1 “not technically and restrictively, but flexibly to effectuate its remedial purposes.” See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41401 (Jul. 14, 2011) (“Adopting Release”). However, the Commission also made clear that in order to “account for the differences between the securities markets and the derivatives markets, the Commission will be guided, but not controlled by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5.” *Id.*, 76 Fed. Reg. at 41399.

¹² *Id.*, 76 Fed. Reg. at 41405.

Gensler explained, this rule “closes a significant gap, as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.”¹³

The Obama Administration has supported this expansion of legal authority for the Commission by increasing funding for the CFTC. Appropriations for the Commission have risen from roughly \$146 million for fiscal year 2009¹⁴ to more than \$205 million for fiscal year 2012,¹⁵ and the Administration has proposed a budget of \$308 million for fiscal year 2013.¹⁶ The enforcement staff of the CFTC has also increased from 113 employees in fiscal year 2008¹⁷ to 175 in fiscal year 2012; the request for fiscal year 2013 would add an additional 50 employees.¹⁸ In short, the CFTC now appears to have all of the tools necessary to vigorously pursue wrongdoing in the swaps and futures markets.

C. CFTC’s Aggressive Use of New Enforcement Powers

The CFTC’s public statements and actions since the enactment of these antifraud provisions have made clear that the Commission intends to employ the powers granted under Dodd-Frank to the fullest extent possible. In a speech in December, for example, CFTC Director of Enforcement David Meister labeled the Dodd-Frank Act a “game changer” for the Commission and stated that he “intends to use the new Dodd-Frank authority aggressively.”¹⁹ In describing these new powers, Director Meister has suggested that section 6(c) is “one of the most important provisions of Dodd-Frank”²⁰ and it “allows us to, I would say, be creative in our use of anti-fraud authority.”²¹ The enormous

breadth of this antifraud power even prompted the SEC’s Director of Enforcement, Robert Khuzami, to lament the fact that his agency lacked the same authority: as he explained at a conference in March 2012, “[f]rankly, I wish we had the power the CFTC has.”²²

The CFTC has already previewed several areas in which these new enforcement powers might be employed. For example, Director Meister has suggested that cases involving a failure to adequately supervise activity that is fraudulent will be considered as violations of section 6(c).²³ In addition, he noted that so-called “gatekeeper” cases - in which auditors of CFTC registrants fail to perform proper audits of firms that have engaged in fraud - will also fall within this section and will be increased as a result of the CFTC’s new authority.²⁴ Finally, a recent article suggested that the new antifraud power could even be used by the CFTC to take action against lawyers for advice given to clients that involved a false or misleading statement of material fact or for fraudulent representations made by the attorney to the Commission.²⁵ The extension of this antifraud provision to these types of activities highlights the robust approach that the CFTC intends to take with respect to section 6(c).

The Commission’s first use of Rule 180.1 provides additional insight into the CFTC’s antifraud approach after the enactment of Dodd-Frank. On May 10, 2012, J.P. Morgan disclosed losses of more than \$2 billion dollars from a derivatives trade that it had entered. Numerous government agencies immediately began investigating the company, including the Treasury Department, the Federal Reserve Board, and the SEC.

In late May, the CFTC announced that it had opened its own investigation of J.P. Morgan using the authority granted under Dodd-Frank. News articles explained that the CFTC probe was focused in part on the disclosures that J.P. Morgan traders had made to their supervisors and risk-management staff as their trade began to show signs of distress.²⁶ Significantly, the reports suggested that their actions would constitute fraud if these traders had made *internal* statements to their superiors that were considered to be deceptive.

D. Conclusion

While it is too early to determine the full extent of the CFTC’s enforcement strategy under its new antifraud authority, statements by the Commission and the J.P. Morgan investigation make clear that the Commission will do everything it can to end its reputation as the “scrawny younger brother” of the SEC and to begin asserting itself as the new financial sheriff for the 21st century.

<http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/programs/sechistorical-09132011-transcript.pdf>.

²² Jean Eaglesham, *Legal Eagles In Cross Hairs*, Wall Street Journal, May 1, 2012, at C1.

²³ Meister, Comments at SIFMA Monthly Meeting, *supra* note 19.

²⁴ *Id.*

²⁵ See Eaglesham, *supra* note 18.

²⁶ Jean Eaglesham and Dan Fitzpatrick, *U.S. Probe of J.P. Morgan Widens*, Wall Street Journal, June 1, 2012 at C1.

¹³ *Id.*, 76 Fed. Reg. at 41410.

¹⁴ U.S. Commodity Futures Trading Commission, President’s Budget and Performance Plan for FY 2010, at 57 (2009).

¹⁵ CFTC Budget and Performance Plan for FY 2013, *supra* note 1, at 5.

¹⁶ Christopher Doering, *Obama seeks \$308 million budget for CFTC*, Reuters, February 10, 2012, available at <http://www.reuters.com/article/2012/02/10/us-usa-budget-cftc-idUSTRE8191IR20120210>. However, Republicans in Congress recently announced that they are attempting to reduce the Commission’s budget for fiscal year 2013 to \$180 million. See Silla Brush, *House Republicans Seek Cuts in Financial Regulators*, Bloomberg, June 5, 2012, available at <http://www.bloomberg.com/news/2012-06-05/house-republicans-seek-cuts-in-dodd-frank-regulatory-agencies.html>.

¹⁷ CFTC Budget and Performance Plan for FY 2010, *supra* note 14, at 57.

¹⁸ CFTC Budget and Performance Plan for FY 2013, *supra* note 1, at 5.

¹⁹ David Meister, Director of Enforcement, CFTC, Comments at the Securities Industry and Financial Markets Association’s Monthly Meeting (December 20, 2012), summarized at <http://www.leclairryan.com/pubs/xprPubDetail.aspx?xpST=PubDetail&pub=676>.

²⁰ David Meister, Director of Enforcement, CFTC, Open Meeting on Five Final Rule Proposals Under the Dodd-Frank Act (July 7, 2011), transcript available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmissionmult_070711-trans.pdf

²¹ David Meister, Director of Enforcement, CFTC, Panel Discussion at the SEC Historical Society on Enforcement After Dodd-Frank (September 13, 2011), transcript available at