



## Fraud, Manipulation and Deception: CFTC/SEC Proposed Rules

On November 3, 2010, both the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) proposed rules under the new anti-manipulation and anti-fraud provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”).<sup>1</sup>

The CFTC proposed rules broaden the scope of existing prohibitions on price manipulation. The SEC Proposed Rule 9j-1 expands the language of 10b-5 as specifically applied to security-based swaps<sup>2</sup> to capture instances of fraud and manipulation in connection with on-going obligations arising under security-based swaps, such as cash flow payments. The anti-fraud and anti-manipulation provisions of the Dodd-Frank Act will be effective, in the case of the CFTC’s rules, on the date on which the related implementing rules take effect and, in the case of those provisions in the Securities Exchange Act of 1934 (the “Exchange Act”), not less than 60 days after publication of the final related rules. The comment period for the proposed CFTC rules is open until January 3, 2011,<sup>3</sup> and the comment period for the proposed SEC rule is open until December 23, 2010.<sup>4</sup>

### CFTC Proposes Rules to Expand Prohibition on Market Manipulation

Historically, the CFTC relied on a number of provisions of the Commodity Exchange Act (the “CEA”) to deter manipulative conduct, including pre-Dodd-Frank Act Sections 6(c) and 9(a)(2). The Dodd-Frank Act preserves this authority but also expands the CFTC’s authority. Specifically, the Dodd-Frank Act amends Section 6(c) of the Commodity Exchange Act (the “CEA”) to expand the CFTC’s authority to prohibit the use of any “manipulative or deceptive device or contrivance” in the swaps and derivatives market. New subsection 6(c)(1) of the CEA provides that:

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 manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate not later than 1 year after the date of enactment of the Dodd-Frank Act, provided no rule or regulation promulgated by the Commission shall require any person to disclose to another person non-public information that may be material to the market price, rate or level of the commodity transaction, except

<sup>1</sup> §753 and §763(g) of the Dodd-Frank Act grant the CFTC and SEC, respectively, broad rulemaking authority to prevent market manipulation and fraud.

<sup>2</sup> §761(a) of the Dodd-Frank Act adds new §3(a)(68) of the Exchange Act to define “security-based swap” as any agreement, contract, or transaction that is a swap...that is based on a narrow-based security index, or a single security or loan, or any interest therein or on the value thereof, or the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligation of the issuer.

<sup>3</sup> A copy of the proposed rule can be found [here](#).

<sup>4</sup> A copy of the proposed rule can be found [here](#).

as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect.

Proposed Rule 180.1 is promulgated pursuant to this Section 6(c)(1) and it is modelled, in part, on Section 10(b) of the Exchange Act.

Proposed Rule 180.1 provides in pertinent part that:

- 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:
  - 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, 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 information to a price reporting service.
- Nothing in Rule 180.1 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.

The CFTC proposes that the same requirements of materiality and scienter applied in the context of Rule 10b-5 be applied in the context of Proposed Rule 180.1, and proposes similar treatment of the term “in connection with” as that which has been construed by the Supreme Court to be applicable in the context of Rule 10b-5, stating that the requirement would be satisfied “whenever misstatements or other relevant conduct are made in a manner reasonably calculated to influence market participants.” Scienter is required to prove a violation of the CFTC’s proposed rule; however, scienter would be understood to include “recklessness.”

#### *Prohibition of Price Manipulation*

As amended by the Dodd-Frank Act, Section 6(c)(3) of the CEA prohibits manipulative practices in connection with price manipulation or attempted price manipulation. Section 6(c)(3) of the CEA reinforces and preserves one of the CEA’s stated purposes, which is to deter or prevent price manipulation. Proposed Rule 180.2 mirrors the statute, 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 the any registered entity.

The CFTC states that it proposes to continue to interpret the prohibition on price manipulation broadly, including 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 a determination of manipulation is fact-intensive and that, for purposes of the traditional four-part framework for liability, demonstrating an “artificial price” through economic analysis may not be necessary, and further notes that in keeping with existing jurisprudence, the conduct giving rise to such manipulation need not be fraudulent or illegal.

### SEC Proposes Rule 9j-1 under the Exchange Act for Security-based Swaps

The Dodd-Frank Act amended the definition of “security” under the Exchange Act to include “security-based swaps.” As a general matter, this means that security-based swaps, given that they are securities, will be subject to all of the anti-fraud and anti-manipulation provisions of the federal securities laws, including Section 10 of the Exchange Act (and Rule 10b-5 thereunder) and Section 17 of the Securities Act.

Nonetheless, Section 763(g) of the Dodd-Frank Act (which added Section 9(j) of the Exchange Act) directs the SEC to issue rules that are designed to prevent fraudulent, deceptive or manipulative conduct in connection with the purchase and sale of, or transaction in, a security-based swap. New Section 9(j) of the Exchange Act makes it unlawful “for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange, to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security-based swap, in connection with which such person engages in any fraudulent, deceptive, or manipulative act or practice, makes any fictitious quotation, or engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person.”

The proposed rule under Section 9(j) of the Exchange Act specifically addresses activities related to security-based swaps. In its release relating to the proposed rule, the SEC notes that given that security-based swaps are different from securities in that they involve ongoing payments, the proposed rule addresses fraudulent or deceptive acts that occur during the term of a security-based swap.

Proposed Rule 9j-1 provides as follows:

It shall be unlawful for any person, directly or indirectly, in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance,

- (a) To employ any device, scheme, or artifice to defraud or manipulate;
- (b) To knowingly or recklessly make any untrue statement of a material fact, or to knowingly or recklessly omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;
- (c) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (d) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

The proposed rule prohibits the same misconduct as Section 10(b) and Rule 10b-5 but expands the anti-fraud and anti-manipulation rules with respect to security-based swaps.

The SEC notes that unlike the sale and purchase of traditional securities, security-based swaps (like other derivatives) may be characterized by ordinary course payments or deliveries. Rule 10b-5 prohibits fraud, manipulation, and deception in connection with the “purchase or sale of any security.” Even with the expanded

definition of “purchase or sale” under the Dodd-Frank Act, out of concern that liability under 10b-5 would be avoided by wrongdoers where their acts were not directly linked to the “purchase or sale” of the security-based swap, Proposed Rule 9j-1 expressly prohibits fraud, deception, and manipulation against “the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance.” The proposed rule would, as a result, directly apply to fraudulent or manipulative acts in connection with cash flows, payments, deliveries, and other ongoing swap obligations.

The SEC clarifies that the prohibition on fraudulent activities addresses deceptive or manipulative acts “in connection with...a security-based swap,” which could potentially capture manipulative or fraudulent activity with respect to the underlying security. The SEC notes in its release that “[t]he exercise of rights or performance of obligations under a security-based swap can present opportunities and incentives for fraudulent, deceptive or manipulative conduct.” For example, the SEC notes that, “a party faced with significant risk exposure may attempt to engage in manipulative or deceptive conduct that increases or decreases the value of payments or cash flow under a security-based swap relative to the value of the reference underlying.”

The SEC expressly requires scienter with respect to the making of untrue statements of material fact by requiring that any material misstatement or omission be made “knowingly or recklessly” in clause (b) of the proposed rule. Such a requirement is in line with the current interpretation of Rule 10b-5. Notably, the CFTC’s proposal did not require misstatements to be made “knowingly or recklessly” but rather “intentionally or recklessly.” Clause (a) of the proposed rule also is understood to require scienter. However, clause (c) of Proposed Rule 9j-1, an analogue of which is not present in Rule 10b-5, does not require scienter. The SEC has proposed that such a prohibition on fraudulent conduct would extend to negligent conduct such as “where a party to a security-based swap knows or reasonably should know that a statement was false or misleading and directly or indirectly obtains money or property from such statement.” In keeping with Rule 10b-5, engaging in fraudulent conduct under clause (d) of Proposed Rule 9j-1 also does not require scienter.

Clause (a) of Proposed Rule 9j-1 follows the wording of Rule 10b-5, but adds the word “manipulate.” The SEC states that this addition is in keeping with the interpretations of Rule 10b-5 in prohibiting the employment of schemes, devices, or any artifice that acts to defraud or manipulate.

Security-based swaps, as securities, will still be subject to the general anti-fraud and anti-manipulation provisions of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and Section 17(a) of the Securities Act of 1933. One should also note that the Dodd-Frank Act further amended the definitions of “purchase” and “sale” to include with respect to security-based swaps the “execution, termination, assignment, exchange, transfer or extinguishment of rights.”

Arguably, the new rules and regulations, as proposed, cast a particularly wide net for security-based swaps with respect to the prevention of fraud and manipulative practices.

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