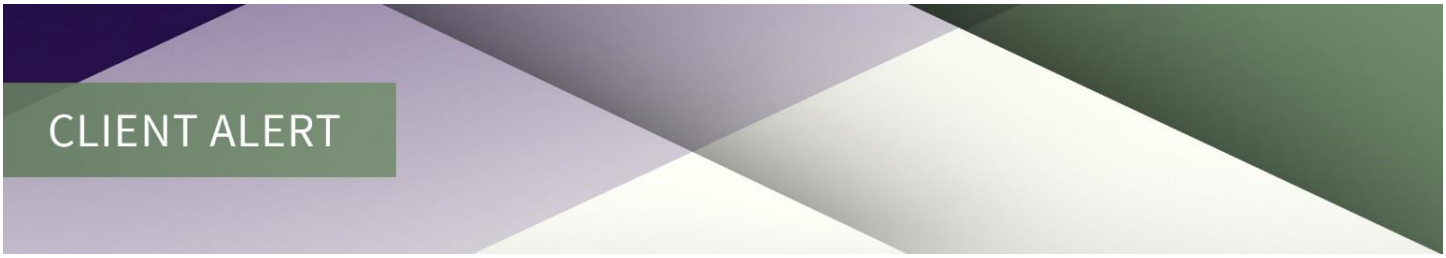

Recent Decision Permits CFTC to Bring Enforcement Actions Involving Fraud Without Also Alleging Manipulation, and May Open the Door for a Stand-Alone Manipulation Claim

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In an important decision from the Ninth Circuit Court of Appeals, the court held that the CFTC has authority to bring a stand-alone enforcement action alleging fraud without any allegation of manipulative conduct. Although not expressly addressed, the decision may open the door for the CFTC to allege a stand-alone action alleging manipulation without any allegation of a fraudulent act. This decision differs from a prior federal court decision, and likely will bolster the CFTC's already expansive view of its enforcement authority.

On July 25, 2019, the 9th Circuit reversed a Central District Court of California decision to dismiss a complaint by the Commodity Futures Trading Commission ("**CFTC**") against Monex Credit Company ("**Monex**") (among others) for failure to state a claim.[1] In reinstating the CFTC's complaint, the 9th Circuit held that the CFTC is authorized to pursue stand-alone fraud claims under Section 6(c)(1) of the Commodity Exchange Act, as amended ("**CEA**"), without also alleging manipulative activity. In addition to authorizing a stand-alone claim for fraud, the 9th Circuit Decision may provide a basis for the CFTC to rely upon CEA Section 6(c)(1) to pursue a stand-alone claim for manipulation without also alleging fraudulent conduct.

[1] *CFTC v. Monex Credit Co.*, Case No. 18-55814 (July 25, 2019) ("**9th Circuit Decision**"). The 9th Circuit Decision overturned *CFTC v. Monex*, Case No. SACV 17-01868 JVS (DFMx) (May 1, 2018).

Congress added CEA Section 6(c)(1) as part of the Dodd-Frank Act of 2010. The CFTC has maintained that this provision authorizes it to pursue claims based upon fraud and/or manipulation, and supports claims alleging intentional *or reckless* conduct. The ability to pursue reckless conduct represents a significant expansion to the CFTC's anti-manipulation authority because prior to CEA Section 6(c)(1), the CFTC's anti-manipulation authority required proof of specific intent. As discussed further below, the 9th Circuit's interpretation in *Monex* differs from a 2015 district court decision in *CFTC v. Kraft*, one of the first federal court decisions to interpret the scope of the CFTC's authority to pursue claims under CEA Section 6(c)(1).[2]

Separate from its ruling on the scope of the CFTC's anti-fraud and anti-manipulation authority, the 9th Circuit also opined that as alleged in the CFTC's complaint, Monex's retail precious metals transactions did not involve "actual delivery" of precious metals and, therefore, were not eligible for an exception from certain provisions of the CEA for qualifying retail transactions.

The CFTC's Allegations Against Monex

The CFTC's fraud allegations relate to Monex's "Atlas" program. Through the Atlas program, customers can purchase precious metals on margin with the remaining amount financed by Monex. As part of buying and selling precious metals on the Monex platform, a customer must sign an Atlas account agreement that provides that Monex will store the metals in depositories with which Monex has contractual relationships. Furthermore, Monex retains exclusive authority to direct the depository on how to handle the metals.

According to the CFTC's complaint, although Monex informs customers that leveraged precious metals trading is "a safe, secure and profitable way for retail customers to invest," the Atlas program is in fact designed for customers to *lose* money because Monex is the counterparty for each Atlas transaction.[3] In addition, approximately 90 percent of customer accounts lose money. These facts led the CFTC to allege that Monex engaged in fraudulent activity in violation of CEA Section 6(c)(1), which provides:

> 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 (emphasis added).[4]

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2 *CFTC v. Kraft Foods Group Inc. and Mondelez Global LLC*, Case No. 15 C 2881 (Dec. 18, 2018) (U.S. District Court E.D.Il).

3 9th Circuit Decision at 8.

4 Pursuant to CEA Section 6(c)(1), the CFTC promulgated 17 C.F.R. 180.1.

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9th Circuit Reverses District Court's Interpretation of CFTC's Authority to Pursue Fraud Absent Manipulation

When the district court dismissed the CFTC's complaint against Monex in 2018, it interpreted the language in CEA Section 6(c)(1) prohibiting "any manipulative or deceptive device" as requiring proof both of manipulative *and* fraudulent conduct. Because the CFTC's complaint alleged only fraudulent conduct against Monex, the district court dismissed the CFTC's complaint.

"Or" Means Or, Not "And"

The 9th Circuit disagreed with the district court's interpretation of CEA Section 6(c)(1), and reinstated the CFTC's complaint. According to the 9th Circuit, CEA Section 6(c)(1) unambiguously authorizes claims against manipulative *or* deceptive conduct, so that the "CFTC may sue for fraudulently deceptive activity, regardless of whether it was also manipulative."[5] In other words, the prohibition against using a "manipulative or deceptive device" authorizes a claim against a "manipulative or deceptive device" and does not require proof of both fraud and manipulation. As the court explained, "When the word 'or' joins two terms, we apply a disjunctive reading. While there are exceptions, this is not an instance where a disjunctive meaning would produce absurd results and statutory context compels us to treat 'or' as if it were 'and.'"[6]

The 9th Circuit bolstered its conclusion that CEA Section 6(c)(1) authorizes a claim for purely fraudulent activity by noting that it "is a mirror image of Section 10(b) of the Securities Exchange Act, which the Supreme Court has interpreted as a 'catch-all clause to prevent fraudulent practices.'"[7] The 9th Circuit presumed that "by copying § 10(b)'s language and pasting it in the CEA, Congress adopted § 10(b)'s judicial interpretations as well."[8]

The 9th Circuit in *Monex* Interpretation of CEA Section 6(c)(1) Differs from the District Court Decision in *Kraft*

In December of 2015, the District Court for the Eastern District of Illinois upheld a CFTC complaint against *Kraft*. In upholding the complaint, the district court in *Kraft* interpreted CEA Section 6(c)(1) to require proof of fraudulent conduct. In other words, manipulative activity, absent fraud, was not sufficient to state a claim under CEA Section 6(c)(1). The District Court in Kraft reasoned that CEA Section 6(c)(1) prohibited "any manipulative or deceptive device [. . .] *in contravention of the regulations promulgated by the CFTC*."[9] Therefore, the scope of prohibited conduct in CEA Section 6(c)(1) was defined with reference to the scope of prohibited conduct under the CFTC's implementing regulation — CFTC Rule 180.1. After reviewing the text of CFTC Rule 180.1 and the preamble to the adopting release, the district court

5 9th Circuit Decision at 18.

6 *Id.*

7 *Id*.

8 *Id.*

9 *Kraft* Decision at 16.

concluded that Rule 180.1 prohibits only fraudulent conduct, not stand-alone manipulative conduct. In particular, the district court in *Kraft* read the prohibition in CFTC Rule 180.1(a)(1) against "any manipulative device, scheme, or artifice to defraud" as prohibiting only any manipulative device *to defraud*, any scheme *to defraud*, or any artifice *to defraud*.

Unlike the court in *Kraft*, the 9th Circuit in *Monex* interpreted CEA Section 6(c)(1) without reference to the CFTC's implementing regulation. Although the 9th Circuit in *Monex* did not address whether a CFTC complaint under CEA Section 6(c)(1) must allege fraud, most likely because the parties in *Monex* acknowledged that the CFTC's complaint alleged fraud, the 9th Circuit's interpretation of CEA Section 6(c)(1) may provide a basis for the CFTC to pursue a stand-alone claim for manipulation without fraud. This interpretation likely emboldens the CFTC to pursue claims against a wider range of manipulative conduct because, as noted above, CEA Section 6(c)(1) lowers the bar for the CFTC to prove intent compared to the CFTC's traditional anti-manipulation authority. That is, the CFTC maintains that it is not required to prove that a person acted with specific intent under CEA Section 6(c)(1). Rather, proof of reckless conduct is sufficient.[10]

9th Circuit Reinstates CFTC Complaint Alleging that Monex Platform Does Not Provide for "Actual" Delivery

Under CEA Section 2(c)(2)(D), transactions that involve retail customers and that are entered into on a leveraged or margined basis are considered futures contracts for purposes of the CEA. As a result, these transactions must be traded on or pursuant to the rules of a designated contract market ("**DCM**"), and must comply with other provisions of the CEA and CFTC regulations applicable to futures. However, there is an exclusion from treating retail leveraged/margined transactions as futures contracts if the transactions result "in actual delivery within 28 days."[11]

According to the CFTC's complaint, the retail transactions on the Atlas platform were retail leveraged/margined transactions and, thus, Monex violated various provisions of the CEA because the transactions were not executed on or pursuant to the rules of a DCM. Monex had argued that it was eligible for the exception from treating these transactions as futures contracts because "actual" delivery occurred within 28 days. Although the District Court had agreed with Monex that actual delivery occurred, the 9th Circuit disagreed and reversed the District Court decision.

The 9th Circuit ruled that the exception is an affirmative defense for which the defendant bears the burden of proof, citing a general rule that a defendant claiming the benefit of an exception to a prohibition of a statute bears the burden of proof.[12] According to the 9th Circuit, the facts alleged in the CFTC's complaint were sufficient to allege that "actual" delivery did not occur. In particular, the 9th Circuit determined that the facts alleged in the CFTC's complaint demonstrated that delivery under the Atlas program was a "sham" delivery as opposed to actual delivery:

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[10] *See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41398, 41404 (July 14, 2011).

[11] *See* CEA Section 2(c)(2)(D)(ii)(III)(aa).

[12] 9th Circuit Decision at 11.

> [T]he plain language tells us that *actual delivery requires at least some meaningful degree of possession or control by the customer*. It is possible for this exception to be satisfied when the commodity sits in a third-party depository, but not when, as here, metals are in the broker's chosen depository, never exchange hands, and are subject to the broker's exclusive control, and customers have no substantial, non-contingent interests[. . .]
>
> [T]he entire transaction is merely a book entry. This amounts to sham delivery, not actual delivery.[13]

Because a court presumes the factual allegations in a complaint to be true when evaluating a motion to dismiss a complaint, the 9th Circuit overturned the District Court's decision to grant Monex's motion to dismiss the CFTC's complaint. The 9th Circuit noted that "[a]lthough Monex challenges the CFTC's characterization of the delivery scheme, we ignore such factual disputes and accept as true the allegations in the complaint [for purposes of ruling on a motion to dismiss]."[14]

Key Takeaways from the Decision

The 9th Circuit Decision highlights the fact that the CFTC's authority to pursue fraud and/or manipulation under CEA Section 6(c)(1) remains unsettled. The 9th Circuit took the position that this provision of the CEA authorizes separate claims for fraud or manipulation, so the CFTC is not required to allege both. However, the district court in *Kraft* took a different approach, stating that the CFTC must allege fraud. Given that Congress adopted CEA Section 6(c)(1) recently as part of the Dodd-Frank Act, we expect more judicial scrutiny interpreting the scope of this provision in the near future.

Fraud cases can yield interpretations of "actual delivery" that may be overly narrow if applied to commercial as opposed to leveraged/margined retail transactions. The CFTC survived Monex's motion to dismiss because the 9th Circuit deferred to the facts alleged in the CFTC's complaint. Those facts identified a number of areas where the delivery mechanisms appeared to be inconsistent with "actual" delivery, mainly an apparent lack of customer possession or access to metals held in a third-party depository. In many commercial transactions, delivery of a commodity is made through a transfer of title as documented in a confirmation, a contract or by a transfer of a warehouse receipt. Market participants should watch these developments to make sure that interpretations of what constitutes delivery in CFTC fraud cases are not applied to commercial transactions without more careful analysis and thought.

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13 9th Circuit Decision at 14, 16.

14 9th Circuit Decision at 16-17.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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