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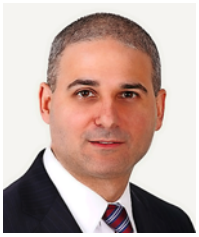
CFTC ENFORCEMENT

The Wheat and the Whale: Reckless Manipulation And the CFTC's Use of the Dodd-Frank Anti-Manipulation Provisions



BY TODD S. FISHMAN

In a recent federal court enforcement action, the Commodity Futures Trading Commission charged Kraft Foods and its former affiliate Mondelez Global with manipulating and attempting to manipulate the price of cash wheat and wheat futures.[1] In a strategy approved by senior management, as alleged, Kraft purchased $90 million of wheat futures — about six months' supply — without intending to take delivery, correctly calculating that this would depress cash wheat prices and increase wheat futures prices. The strategy reportedly earned Kraft approximately $5.4 million in profits. In a press release, Aitan Goelman, the CFTC's director of enforcement, said ''This case goes to the core of the CFTC's mission: protecting market participants and the public from manipulation and abusive practices that undermine the integrity of the derivatives markets.''

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For the CFTC, the Kraft case is clearly an instance where the principle is more prominent than the penalty. The germ of this complaint was planted nearly 18 months earlier, in October 2013, when the CFTC dramatically employed its new authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act to fashion a settlement with JP Morgan Chase Bank regarding the ''London Whale'' trading losses.[2] There, the CFTC first deployed reckless manipulation as a standard to challenge claimed trading abuses in the swap market. With Kraft, the CFTC again employs the recklessness standard to extend the agency's anti-manipulation authority.

The CFTC Complaint Against Kraft

Kraft is one of the largest domestic end users of #2 Soft Red Winter Wheat, the variety of wheat deliverable against the Chicago Board of Trade (''CBOT'') wheat futures contract. According to the complaint, Kraft uses

[1] Complaint, *CFTC v. Kraft Foods Group, Inc. and Modelez Global LLC*, Civil Action No. 15-2881 (N.D. Ill. Apr. 1, 2015).

[2] Order, *In re JPMorgan Chase Bank, N.A.*, CFTC Docket No. 14-01, at 15 (CFTC Oct. 16, 2013) (the ''JP Morgan Order'').

about 30 million bushels of wheat per year in products like Oreo cookies and Triscuit crackers.

Cash wheat prices were high in the late summer of 2011. In October of that year, as alleged, Kraft's wheat procurement staff suggested to senior management that Kraft should buy $90 million of December 2011 wheat futures. In the complaint, the CFTC maintained that, in suggesting this strategy, Kraft ''deviated from its practice of using the futures markets solely to hedge its cash wheat purchases'' and, in addition, ''did not have a bona fide commercial need for $90 million of wheat'' and did not intend to take delivery of it. The CFTC further maintained that Kraft expected that the futures market would react to its substantial long position by increasing the price of the December 2011 futures contract while reducing the differential between the December futures price and the price of the cash market wheat.

According to the complaint, management approved the strategy and staff then executed it. As alleged, Kraft's actions caused cash wheat prices in Toledo to decline and the December 2011/March 2012 wheat futures spread to narrow, which was favorable to Kraft.

An undercurrent flowing through the complaint concerns Kraft's apparent failure to renew its exemption for hedging transactions. In its complaint, the CFTC noted that traders who are ''bona fide hedgers,'' such as producers or end-users of particular commodities, like Kraft, can apply for exemptions to speculative position limits based on a demonstration of bona fide hedging needs. Kraft, evidently, received a hedge exemption to cover its wheat needs effective December 1, 2010, subject to an annual renewal. According to the complaint, ''Kraft did not submit a request for renewal of its hedge exemption until Dec. 28, 2011,'' making it bound by the CBOT's 600 contract speculative position limit for wheat.

Among other things, the CFTC exercised its Dodd-Frank authority and charged that Kraft ''intended to affect or acted recklessly with regards to affecting the prices of the December 2011 wheat futures contract'' in violation of Section 6(c)(1) of the Commodity Exchange Act (''CEA'') and Regulation 180.1. The CFTC asserted that Kraft employed ''a manipulative or deceptive device'' but failed to detail the nature of the deception or who was deceived. The CFTC also charged separate violations of Sections 6(c)(3) and 9(a)(2) of the CEA and Regulation 180.2, alleging that Kraft manipulated or attempted to manipulate the price of wheat futures and cash wheat.

The CEA and the Dodd-Frank Act

Until 2010, the authority of the CFTC to commence enforcement actions for manipulation rested primarily on Section 6(c) and Section 9(a)(2) of the CEA prohibiting a party from manipulating or attempting to manipulate the price of a commodity.[3] Long-standing CFTC precedent described manipulation as ''any and every operation or transaction or practice, the purpose of which is not primarily to facilitate the movement of the commodity at prices freely responsive to the forces of supply and demand; but, on the contrary, is calculated to produce a price distortion of any kind in any market either in itself or in relation to other markets.''[4] With this standard, any device intentionally employed to distort pricing relationships may be manipulative. The CEA, however, tended to limit the range of enforcement actions filed by the CFTC given the requirement that the agency establish that the alleged manipulator acted with the specific intention of affecting the market price of a commodity.[5]

Under the authority granted to it under the Dodd-Frank Act in Section 6(c)(1) of the CEA, the CFTC adopted anti-fraud Regulation 180.1, effective Aug. 15, 2011. Regulation 180.1 makes it unlawful, in connection with any swap, contract of sale of any commodity or futures contract, to intentionally or recklessly: (i) use manipulative devices or schemes to defraud; (ii) make false or misleading statements and material omissions; (iii) employ practices that operate or would operate as a fraud or deceit; and (iv) deliver misleading or inaccurate reports concerning conditions that tend to affect the price of any commodity.

The amendments to Section 6(c)(1) and Regulation 180.1 freed the CFTC from the pre-Dodd Frank requirement of specific intent.[6] The CFTC has made clear that price-distorting and certain other behavior is barred, even if the offending party acts recklessly rather than intentionally. Applying guidance from the securities law context, the CFTC has 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 or she was doing.' ''[7]

The JP Morgan London Whale Settlement

In October 2013, from the seed of its new Dodd-Frank Act powers, the CFTC issued a settlement Order with JPMorgan resolving charges against the bank for use of a manipulative device with respect to the so-called ''London Whale'' trades. At issue in the Order was whether JPMorgan intentionally or recklessly manipulated the price of a particular type of credit default swap index known as ''CDX.''

According to the JPMorgan Order, from approximately 2007 through 2011, a JPMorgan unit, the Chief Investment Office (''CIO''), operating through a trading desk in a JPMorgan branch in London, purchased and sold default protection in a portfolio of CDX and other credit default swap (''CDS'') indices. The CIO held the positions in CDX and other CDS indices as part of a Synthetic Credit Portfolio, or SCP, which was designed to protect the bank against adverse credit events affecting a portfolio of fixed-income securities and other credit exposure within the organization.

As of the end of 2011, the CIO held a substantial position in CDX and other credit default swap indices, with a net notional value of more than $51 billion, including $217 billion in long risk positions and $166 bil-

[3] 7 U.S.C. § 9 (2006); 7 U.S.C. § 13(a)(2) (2006).

[4] *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] No. 75-14, Comm. Fut. L. Rep. (CCH) ¶ 21,796, 1982 WL 30249, at *4 (CFTC Dec. 17, 1982).

[5] *See In re Commodity Exch., Inc. Silver Futures and Options Trading Litig.*, 560 F. App'x. 84, 87 (2d Cir. 2014).

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

[7] *Id.* (quoting *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1998)).

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lion in short risk positions. According to the CFTC, the traders in the CIO, wanting to reduce mark-to-market losses ahead of month-end internal portfolio valuations in February 2012, employed a trading strategy in connection with one particular CDX, the CDX.NA.IG.9 10 year index (''IG9 10Y''). In particular, the CFTC maintained that ''as the value of the portfolio stood to benefit as the IG9 10Y market price dropped, on February 29, the CIO sold on net more than $7 billion of IG9 10Y, a staggering, record-setting, volume, $4.6 billion of which was sold during a three hour period as that day drew to a close.''[8] The February 29 trading followed sales of protection of more than $3 billion of this index in the previous two days.

In the JPMorgan Order, the CFTC found that the traders had ''recklessly used or employed manipulative devices and contrivances in connection with swaps in violation of Section 6(c)(1) of the [Commodity Exchange Act], 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. § 180.1 (2012).''[9] In particular, the CFTC determined that JPMorgan traders ''developed a resolve'' to ''defend the position'' of the SCP, that is to ''protect its value that was predicated, at least in part, on the market price.''[10] According the CFTC, the JPMorgan traders ''[r]ecogniz[ed] that the sheer size'' of their position in a credit default swap index tranche ''had the potential to affect or influence the market'' and thereby ''recklessly sold massive amounts of protection'' ''during a concentrated period.''[11] The CFTC added that ''[s]uch activity designed to 'defend' the position or 'fight' other market participants, whether through concentrated month-end trading or otherwise, falls squarely within the prohibitions of Section 6(c)(1) of the Act and Commission Regulation Rule 180.1(a).''[12]

In the JPMorgan Order, the CFTC seemed to have adopted the stance that, at least in illiquid markets and potentially otherwise, a manipulation occurs under the commodity laws when a firm with a large position trades large and concentrated volumes to ''defend'' that position. In an apparent attempt to clarify its findings, the CFTC offered the following point in a footnote:

> The Commission's imposition of liability for use of manipulative devices based on a recklessness standard is an important safeguard for international derivatives markets. Regardless of whether the conduct in question was intended to create or did create an artificial price, it interfered with the free and open markets to which every participant is entitled.[13]

Accompanying the JPMorgan Order was a noteworthy dissent by Commissioner Scott O'Malia.[14] Commission O'Malia observed that although ''the Order discusses the Commission's broad manipulation authority at length,'' the CFTC ''still does not conclude whether JPMorgan's aggressive trading strategy resulted in price manipulation.'' He added that while ''some case law supports the Commission's conclusion that any device that is intentionally employed to distort a pricing relationship may be manipulative, the Commission has failed to produce data or conduct a more careful evaluation of the actual price to determine whether JPMorgan's conduct distorted the price of certain CDX indices.'' Commissioner O'Malia then stated: ''This problem is compounded even more by the fact that the allegations in the settlement Order center on bilateral or over-the-counter trading. Given this trading environment, I am not clear how the Commission can distinguish between 'real' and 'distorted' prices if the trades were executed through bilateral negotiations.'' Indeed, as Commission O'Malia explained, the CFTC alluded to the issue of ''real'' versus ''distorted'' pricing in over-the-counter trading in its interpretative release for Regulation 180.1, commenting that ''the failure to disclose [] 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.''[15]

Tipping Point ?

In February 2015, a CFTC official authored a study questioning the legality of a common practice by high-frequency trading firms.[16] In his discussion of CEA Section 6(c)(1) and Regulation 180.1, the official suggested if courts adopt the reasoning of manipulation-as-fraud decisions made under SEC Rule 10b-5, then ''the CFTC should be able to characterize any scheme involving market manipulation . . . as a violation of Rule 180.1, provided that the scheme was not disclosed to market participants.''[17] Seen in this light, Kraft may augur an important tipping point where reckless behavior replaces market manipulation as the standard for punishing misconduct in the commodities markets.

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[8] JP Morgan Order at 2.
[9] *Id.* at 15.
[10] *Id.* at 14.
[11] *Id.*
[12] *Id.* at 15.
[13] *Id.* at 14 n.17.
[14] Statement of Commissioner Scott D. O'Malia Regarding JPMorgan's Use of Manipulative Device dated Oct. 15, 2013.
[15] 76 Fed. Reg. 41398, at 41402.
[16] Gregory Scopino, *The (Questionable) Legality of High-Speed ''Pinging'' and ''Front Running'' in the Futures Markets*, Conn. L. Review (Feb. 2015).
[17] *Id.* at 674.