CFTC Expanding Anti-Manipulation Powers to Punish Misrepresentations to Futures Exchanges and FCMs

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Overview

Recent Commodity Futures Trading Commission (CFTC) enforcement actions rely on the anti-manipulation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to punish misstatements made to futures exchanges and futures commission merchants (FCMs) that merely permit a trader to trade futures for his own benefit. These actions rely on a fairly expansive understanding of Section 6(c)(1) of the Commodities Exchange Act (CEA) and CFTC Regulation 180.1, which forbid the use of manipulative or deceptive devices "in connection with any swap, or contract of sale of any commodity . . . or contract for future delivery on or subject to the rules of any registered entity." As a result, futures market participants may face enhanced liability under the CEA for a wider range of misconduct.

Novel Applications of Dodd-Frank Manipulation Provisions in CFTC Enforcement Actions

In March 2021, the CFTC filed a civil complaint against Easterday Farms for (among other misdeeds) making false statements in hedging exemption applications to the Chicago Mercantile Exchange (CME).[1] The enforcement action came on the heels of a parallel criminal indictment against Easterday for falsely invoicing a large agribusiness partner of Easterday.[2] According to the complaint, Easterday allegedly submitted false invoices for "ghost cattle" and used the proceeds to cover margin calls on his futures positions.[3] In addition, Easterday submitted false cattle inventory to the CME in order to exceed speculative trading limits in the feeder cattle and live cattle futures markets.[4] Although the latter misrepresentations likely violated Section 9(a)(4) of the CEA — which already prohibits making false statements to futures exchanges — the CFTC additionally sought relief under Rule 180.1 based on the misstatements to the CME, alleging that they permitted Easterday to exceed speculative position limits and avoid discipline. The CFTC did not allege that the cattle inventory statements misled anyone about the nature of the futures contracts Easterday traded, induced anyone to trade with him, or injected false information into the futures market or the physical cattle markets.[5]

Somewhat similarly, in 2019, the CFTC entered into a settlement with Aaron Seidenfeld for making false representations to FCMs about the true ownership of certain accounts controlled by Seidenfeld.[6] Using funds in a trust, Seidenfeld would open an account under a relative's name to trade futures and options. He

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[1] *CFTC v. Easterday*, No. 4:21-cv-5050, ECF No. 1 (E.D. Wash. Mar. 31, 2021) ("Easterday Compl.").

[2] *United States v. Easterday*, No. 4:21-CR-6012-SAB, 2021 WL 1235491 (E.D. Wash. Mar. 24, 2021).

[3] *See* Easterday Compl. ¶¶ 22-27.

[4] *Id.* ¶¶ 28-41.

[5] *Compare id. with In the Matter of McVean Trading & Investments, LLC*, CFTC Dkt. No. 17 -15 (Jun. 21, 2017) (charging position limit violation under Section 6(c)(1) where market impact alleged) ("[B]y using cattle feedyards as straw purchasers for long live cattle futures positions that . . . exceeded CME spot month position limits by hundreds of contracts, [defendant] created a false appearance of wider interest, participation, and fragmentation on the long side of the live cattle futures market during the delivery period than actually existed.").

[6] *In the Matter of Aron Seidenfeld*, CFTC Dkt. No. 19-51 (Sept. 30, 2019).

sustained significant losses while trading on margin and failed to cover the debt owed to the FCM. He repeated this maneuver twice, incurring losses of over $500,000. Each time, he lied to the FCM about the ownership of the account, misleading the FCM about who was actually conducting trades in the account. Although the misrepresentations allegedly permitted Seidenfeld to open accounts and trade options on futures, they apparently had little to do with the options he traded, did not mislead market participants into trading with him, and injected no false information into the marketplace.

The CFTC's Approach Raises Important Questions About the Proper Scope of Rule 180.1

The emerging trend by the CFTC to pursue Section 6(c)(1) claims arising from misrepresentations to futures market gatekeepers, like exchanges and FCMs, rather than to market participants or the commodities market at large, raises important questions about the proper scope of Rule 180.1 and what constitutes deceptive or manipulative activities made "in connection with any swap, or contract of sale of any commodity . . . or contract for future delivery on or subject to the rules of any registered entity."[7] In other words, is any misstatement, if used to gain access to the futures markets, sufficient to bring the conduct within Rule 180.1?

The answer may turn on the scope of Section 6(c)(1)'s "in connection with" language, which is broad, but has yet to be fully explored by the courts. For its part, the CFTC has maintained that it modeled Rule 180.1 on the Securities and Exchange Commission's (SEC) catchall anti-fraud rule, Rule 10b-5, and would be guided "by the substantial body of judicial precedent" applicable to Rule 10b-5, which similarly forbids manipulative or deceptive devices "in connection with the purchase or sale of any security."[8] Despite the breadth of that language, the CFTC also recognized that "the elasticity of the 'in connection with' language is not limitless,"[9] and pointed to the Supreme Court's reasoning in *Zandford v. SEC*[10] as "instructive."[11] In *Zandford*, the SEC pursued civil penalties against a securities broker for selling securities in an elderly client's account and misappropriating the proceeds.[12] The Supreme Court held that the broker's fraud was "in connection with" the sale of securities because each sale of the client's securities coincided with the brokers' breach of fiduciary — failing to notify the client or obtain authorization for the transactions. As a result of *Zandford*, any time a broker sells securities with the intent to misappropriate the funds or accepts payment for securities the broker never intends to deliver, the fraudulent scheme occurs "in connection with" the sale of securities.

Subsequent rulings, however, have been less generous than *Zandford* and have sought to rein in the "in connection with" language. In *Chadburne & Parke LLP v. Troice*,[13] a case decided after Rule 180.1 became effective, the Supreme Court held that "[a] fraudulent misrepresentation or omission is not made 'in connection with' such a 'purchase or sale of a covered security' unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'"[14] If *Troice* were applied faithfully, it may have precluded the Rule 180.1 charges in *Easterday* or *Seidenfeld*.

Within the context of the CEA, however, there remains a dearth of case law interpreting the "in connection with" language or fully addressing the differences between the language of Regulation 180.1 ("in connection with any swap, or contract of sale of any commodity . . . or contract for future delivery on or subject to the rules of any registered entity") and Rule 10b-5 ("in connection with the purchase or sale of any [covered] security"). If challenged, the CFTC would likely argue that *Troice* and its progeny are based on a "purchase or sale" limitation

[7] 17 C.F.R. § 180.1(a).

[8] 17 C.F.R. § 240.10b-5.

[9] 76 Fed. Reg. 135, 41405 (2011).

[10] 535 U.S. 813 (2002).

[11] 76 Fed. Reg. at 41405.

[12] 535 U.S. at 816.

[13] 571 U.S. 377 (2014).

[14] *Id.* at 387.

in the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 that is arguably absent from the CEA. At least one court, however, has read Section 6(c)(1) of the CEA consistent with the Exchange Act, suggesting that the inquiry is whether the fraudulent statements were made "in connection with the *purchase or sale of commodities*."[15]

At a minimum, the materiality standard courts have adopted in this area would likely need to be revisited if the CFTC continues to pursue Rule 180.1 charges based on misstatements to futures exchanges or FCMs. Borrowing from securities law, courts are currently asking whether "a reasonable investor would consider [the fact] important in deciding to make an investment,"[16] which makes for a poor fit in cases where the misstatement is made only to the exchange or has little to do with the futures product being traded.

Although the CFTC has yet to be challenged on this new enforcement strategy, the *Seidenfeld* order provides some insight into what the CFTC sees as its support for its approach. There, the CFTC cites *R&W Technical Services Ltd. v. CFTC*, a case predating the enactment of Section 6(c)(a) or Rule 180.1 that interpreted somewhat similar language in another section of the CEA.[17] The *R&W Technical* court ultimately deferred to the CFTC's interpretation that fraud in the sale of investment advice "will be 'in connection with' the sale of a commodities futures contract if the fraud relates to the risk of the trading and the primary purpose of purchasing the advice is to execute trades."[18] The *R&W Technical* approach, however, may not fully support the CFTC's charge against Seidenfeld or Easterday.[19] Although the alleged misrepresentation to FCMs and the CME by Seidenfeld and Easterday were clearly intended to allow them to execute futures trades they might not otherwise have been able to, it is less clear how those misrepresentations were actually related to the risks of their futures trading. The other cases cited by the CFTC are examples of the classic *Zandford*-like fraud, where the defendant induced customers into fraudulent commodities schemes that misappropriated funds.[20] Such cases offer little support for the position that misrepresentations to futures exchanges or FCMs that merely allowed the trader to trade futures for *its own benefit*, absent market distortion or market participant deception, should be charged similarly.

Conclusion

The novel enforcement strategy at issue in the *Easterday* and *Seidenfeld* actions arguably casts too wide of a net by capturing conduct that bears little resemblance to market manipulation or commodities fraud. In neither case did the defendant induce an unsuspecting investor or customer into futures trading. Nor did the defendants harm the integrity of the underlying futures markets by introducing false information about supply or demand. Instead, it appears the only entities misled by the particular misrepresentations were the CME and FCMs, which are sophisticated entities and non-market participants that arguably do not require additional protection from the CFTC under Section 6(c)(1) and Rule 180.1, or, in the CME's case, are already fully protected elsewhere in the CEA.

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[15] *See CFTC v. Hunter Wise Commodities, LLC*, 21 F.Supp.3d 1317, 1347 (S.D. Fla. 2014) (emphasis added); *see also CFTC v. Southern Tr. Metals, Inc.*, 894 F.3d 1313, 1325¬–27 (11th Cir. 2018) (requiring a connection to investment to satisfy materiality).

[16] *Southern Tr. Metals*, 894 F.3d at 1327.

[17] 205 F.3d 165 (5th Cir. 2000).

[18] *Id*. at 173.

[19] In *R&W Technical*, a software company made misstatements to potential investors about the success of its analysis software, which they would only buy to enter into the commodities futures market. *See id*. ("[N]o one spends several thousand dollars on a sophisticated software package without seriously intending to execute trades.").

[20] *See Seidenfeld* at 4; *see also CFTC v. Gibraltar Monetary Corp.*, 2006 WL 1789018 (S.D. Fla. May, 30, 2006); *CFTC v. Heffernan*, 2006 WL 2434015 (D.S.C. Aug., 21, 2006). *In Gibraltar Monetary Corp.*, the firm advertised risk-free investments in foreign exchange markets to investors, when in fact prior investments by the firm had lost money. Similarly, in *Heffernan*, the investor made false statements to customers regarding past profits from trading futures to induce investments.

CONTACTS

For more information, please contact your Katten attorney or any of the following members of Katten's Financial Markets Litigation and Enforcement or Financial Markets and Funds practices.

J Matthew W. Haws
+1.312.902.5319
matthew.haws@katten.com

Gary DeWaal
+1.212.940.6558
gary.dewaal@katten.com

Christian T. Kemnitz
+1.312.902.5379
christian.kemnitz@katten.com

Carl E. Kennedy
+1.212.940.8544
carl.kennedy@katten.com

Katten katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

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