PUBLICATIONS

Court Delimits CFTC's Enforcement Reach

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The Dodd-Frank Wall Street Reform Act strengthened the jurisdiction and enforcement capabilities of the CFTC in a number of respects. Once key provision concerned Retail Commodity Contracts, under CEA section 2(c)(2)(D). It provides that the CFTC shall have jurisdiction over commodity transactions "entered into, or offered (even if not entered into), on a leveraged or margined basis, or financed by the offeror, the counter-party, or a person acting in concert with the offeror or counter-party on a similar basis." An exception is where there is delivery within 28 days.

A second key addition is section 6(c)(1), an anti-fraud provision which 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, any manipulative or deceptive device or contrivance, in contravention of such rule and regulations as the Commission shall promulgate." The CFTC adopted Rule 180.1 which generally tracks the language of the statute.

Each of these provisions was critical to the recent decision in *CFTC v. Monex Credit Company*, Civil Action No. 8:17-CV-01868 (C.D.Cal. May 1, 2018). There the court rejected the position of the CFTC as to each provision. The court's interpretation of anti-fraud section 6 (c)(1) is also at odds with a recent decision of another district court, according to the decision.

Monex

The CFTC brought an enforcement action against Monex and others based in part on the two provisions cited above. The case was before the court on the defendants' motion to dismiss under Rule 12(b)(6), F. R Civ. and the agency's motion for a preliminary

injunction. The former was granted, the latter denied.

Monex offered retail customers two types of transactions, according to the complaint. The first are retail transactions in which the customer pays full price for precious metals. This type of transaction is not at issue here.

The second offer is what the firm called its Atlas program. There Monex offers precious metals on a leveraged, margined, or financed basis. Retail customers can purchase precious metals by paying a portion of the purchase price and financing the balance under the program. Customers with trading accounts can open positions with Monex acting as the counter-party and setting the price in each transaction. If the transaction is "on leverage" or "on margin," Monex provides the financing and a deposit is required as margin. In this situation Monex retains complete control – it sets the margin and can liquidate the account for failure to meet the requirements of the program.

Under the terms of the customer agreement Monex retains control of the metals traded in the Atlas program. The customer does not take actual physical delivery. Rather, the metal is maintained in a depository subject to an agreement Monex has with the depository. The customer only obtains physical possession of the metal on full payment or if they ask for actual delivery. Otherwise, the customer holds a long position. The CFTC complaint claims that the customers do not have an actual position, but just a book entry that is a sham. The agency alleged prohibited off-exchange transactions and fraud.

In resolving the motion to dismiss the court first turned to section 2(c)(2)(D). The parties disagreed regarding the impact of the delivery exception on the provision. The CFTC argued that since it is an exception, the Defendants had the burden of establishing it applies here. The Defendants disagreed, claiming that it is an exclusion requiring the CFTC to prove that it does not apply here. The court declined to resolve the question.

Rather, the court focused on the meaning of the term delivery. The decision in *CFTC v. Hunter Wise Commodities, LLC*, 749 F. 3d 967 (11th Cir. 2014) is the only case to have focused on the meaning of that term. There the court defined delivery in terms of a transfer of possession and control. The court's holding did not require, however, that the buyers take actual physical control of the commodity. The court also found that the defendant in the action did not have sufficient supplies available to cover its margin accounts. Since it could not deliver, there was no delivery.

In this case Defendants claimed that there was delivery within the meaning of prior CFTC interpretations which have not required actual physical delivery to meet the requirement. Rather, a number of factors have been considered such as ownership, possession, title and the physical location of the commodity purchased or sold. Here Monex claimed its agreements fall within these requirements.

The CFTC rejected this claim, contending that the arrangement here is a sham. That contention was based primarily on the fact that the customer positions can be liquidated at any time without notice. The agency also cited to provisions in the agreements which give Monex complete control.

The court rejected the CFTC's interpretation based largely on its reading of the statutes. The points cited by the CFTC focus on the Monex business model, the court noted. The statutory provisions involved "apply to covered retail commodity transactions, which must be entered into or offered on a leveraged or margin basis, or financed by the offeror. If this conduct alone negated "actual delivery," every financed transaction would violate Dodd-Frank. The Court can conceive of no plausible leveraged retail transaction of fungible commodities that would not involve at least some of the same alleged practices. Thus, if the Court were to adopt the CFTC's construction, the result would be to eliminate the Actual Delivery Exception from the CEA." (internal citations omitted).

Second, the court turned to the application of the anti-fraud section, 6(c)(1). Initially, the court rejected Defendants' claim that the actual delivery exception negated the application of the statute here. To the contrary, the plain language of the sections provides the CFTC with jurisdiction over covered retail commodity transactions to enforce the anti-fraud sections.

The court then turned to the construction of the statute. Monex argued that the section only applies to particular commodity transactions that are manipulative in the derivatives market. In contrast, the CFTC claimed that section 6(c)(1) applies to retail commodities transactions with or without market manipulation.

Initially, the court focused on the language of the section which it acknowledged is broad. That language prohibits "manipulation" and makes it unlawful in connection with any swap, or a contract of sale of any commodity -- "any manipulative or deceptive device or contrivance. . ." is prohibited. The legislative history is consistent with this reading of the statute. That history reveals that the section was designed to ease the burned of proving manipulation for the CFTC by reducing the "specific intent" element to one of recklessness. This followed the approach used by the SEC in manipulation cases. Viewed in this context, the court concluded that "the CEA unambiguously forecloses the application of section 6(c)(1) in the absence of actual or potential market manipulation. While this conclusion appears to be inconsistent with *CFTC v. McDonnell*, 287 F. Supp. 3d 213, 226-27, 229-30 (E.D.N.Y. 2018) "the main focus of that decision was whether the CFTC could regulate virtual currencies as a commodity," the court stated.

Comment.

The decision is significant. Section 2(c)(2)(D) regarding Retail Commodity Transactions broadened the jurisdiction of the CFTC. Under this section the agency argued here that arrangements such as those used by Monex are in fact trades that should be on a regulated exchange. Yet, if in fact delivery is made within the time limit, there is an exception, which the court noted.

The court's construction of CEA section 6(c)(1) clearly delimits its reach. While the court focused on the language of the section, the result seems driven more by its reading of the legislative history. The language of the section, which is also the predicate for the ruling in *McDonnell*, and the Supreme Court's focus on statutory language to the exclusion of history should be considered when evaluating this determination. Nevertheless, the decision represents two significant losses for the CFTC. *See, e.g.*, Digital Realty Trust Inc. v. Somers, No. 1276 (S.Ct. Feb. 21, 2018) (Three Justices object to citing legislative history to interpret text of statute).