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UNITED STATES OF AMERICA  
Before the  
COMMODITY FUTURES TRADING COMMISSION

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Office of  
Product Policy  
Commodity Futures Trading Commission

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In the Matter of: )  
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JPMorgan Chase Bank, N.A., )  
 )  
 ) CFTC Docket No. 14 – 01  
Respondent. )

ORDER INSTITUTING PROCEEDINGS PURSUANT TO  
SECTIONS 6(c) and 6(d) OF THE COMMODITY EXCHANGE ACT, MAKING  
FINDINGS AND IMPOSING REMEDIAL SANCTIONS

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that JPMorgan Chase Bank, N.A. (“JPMorgan”) violated the Commodity Exchange Act (“Act”) and Commission Regulations (“Regulations”). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether JPMorgan has engaged in the violations as set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of this administrative proceeding, JPMorgan has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. JPMorgan admits the findings in parts III-A through III-C herein, and neither admits nor denies the other findings and conclusions herein, and consents to the entry of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.<sup>1</sup>

<sup>1</sup> JPMorgan consents to the entry of this Order and to the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that JPMorgan does not consent to the use of the Offer, or the findings or conclusions in this Order consented to in the Offer, as the sole basis for any other proceeding brought by the Commission, other than a proceeding in bankruptcy, receivership, or to enforce the terms of this Order. Except as admitted in parts III-A through III-C of this Order, JPMorgan also does not consent to the use of the Offer or this Order, or the findings or conclusions in this Order consented to in the Offer, by any other party in any other proceeding.

### III.

The Commission finds the following:

#### A. Summary

The credit default swap (“CDS”) market comprises globally traded credit derivatives used by various market participants to speculate on and hedge against credit defaults, and, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), the market for CDS that reference broad-based credit indices is subject to the Commission’s jurisdiction. Tens of trillions of dollars in notional value of CDS instruments are traded and held by market participants seeking to transfer risk of credit defaults by companies in the United States and around the world. As such, the CDS market is an important aspect of the global economy. Market participants are entitled to rely on the notion that CDS prices are established based on legitimate forces of supply and demand.<sup>2</sup> However, on February 29, 2012, JPMorgan traders acted recklessly with respect to this fundamental precept by employing an aggressive trading strategy concerning a particular type of CDS known as “CDX.”

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 indices. As of the end of 2011, the CIO held a substantial position in CDX and other credit default indices, with a net notional value of more than \$51 billion, including \$217 billion in long risk positions and \$166 billion in short risk positions. At the end of each trading day, traders in the CIO “marked” the positions in this swaps portfolio “to market,” assigning a value to the portfolio’s positions using various measures including market prices for the credit default index positions. The traders’ marks were used to calculate profits and losses (“P&L”).

Although previously quite profitable, as early as late January 2012 the portfolio’s value had taken a serious turn for the worse. In February 2012, daily losses were large and growing, and by February 29 the traders believed the portfolio’s situation was grave. Just ahead of critical February month-end internal portfolio valuations that would be distributed widely within JPMorgan through the P&L statement, the traders in the CIO, who wanted to reduce mark-to-market losses, recklessly employed an aggressive trading strategy on February 29 in connection with one particular CDX, the CDX.NA.IG.9 10 year index (“IG9 10Y”). In particular, 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. The February 29 trading followed sales of

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<sup>2</sup> Prices on CDS and index CDS instruments such as CDX, further described *infra*, are often called spreads, which are the annual payments for the credit protection exchanged, quoted in basis points per year (“bps”). Basis points represent 1/100th of a percent. The annual payments are calculated based on the spread multiplied by the notional amount of the contract. Spreads reflect the riskiness of the underlying reference obligation and “widen” (increase) as credit risk increases, and “tighten” (decrease) as credit risk decreases.

protection of more than \$3 billion of this index in the previous two days. To put the quantity sold by the CIO into perspective, the net volume sold by the CIO over those three days amounted to roughly one-third of the volume traded for the *entire month* of February by all other market participants. During this same period at month-end, the market price on IG9 10Y dropped substantially and the CIO was selling at generally declining prices. The value of the position that the CIO held benefited on a mark-to-market basis from the declining market prices.<sup>3</sup>

JPMorgan's controls and supervision over the CIO did not prevent the CIO from first accumulating the massive portfolio of positions in certain CDX and other credit default indices, and then from taking the steps to conceal the losses. In July 2012, JPMorgan's parent company disclosed that it had lost confidence in the integrity of the traders' marks and acknowledged that it ultimately lost more than \$6 billion in 2012 in connection with the CIO's CDS index trading.

Since the enactment of the Dodd-Frank Act, the Commission has been implementing reforms that Congress mandated to regulate swap dealers. These include internal business conduct rules that require swap dealers to, among other things, establish policies to manage risk and adhere to supervision obligations. JPMorgan's provisional registration with the Commission as a swap dealer took effect on December 31, 2012, which means that these specific internal business conduct rules did not apply to JPMorgan until after the CIO events described in this Order.

## **B. Respondent**

JPMorgan is a subsidiary of JPMorgan Chase & Co., a leading global financial services firm that engages in a wide variety of financial services, including banking, mortgage lending, securities, credit card issuance, commodities trading, and asset management. JPMorgan Chase & Co. (including JPMorgan and other subsidiaries) is the largest derivatives dealer in the United States, active in derivatives markets involving

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<sup>3</sup> Two now former JPMorgan traders have been accused of concealing trading losses from others at JPMorgan by using deceptive practices in how they marked the portfolio to market. These two traders' alleged deceptive practices are the subject of criminal charges brought against them by the United States Attorney for the Southern District of New York, as well as civil enforcement charges brought against them by the United States Securities and Exchange Commission ("SEC"). See *U.S. v. Martin-Artajo*, No. 1:13-MJ-1975 (S.D.N.Y., filed Aug. 9, 2013), *U.S. v. Grout*, No. 1:13-MJ-1976 (S.D.N.Y., filed Aug. 9, 2013), and *SEC v. Martin-Artajo, et al.*, No. 1:13-CV-5677-GBD (S.D.N.Y., filed Aug. 14, 2013). The facts alleged in these two sets of fraud charges also provide a basis for the Commission to charge the two traders with violations of Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. §180.1 (2012), which prohibit, among other things, "any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person" "in connection with any swap." Nevertheless, although the Commission at times brings actions in parallel to actions by other authorities, based on the facts and circumstances presented here as well as resource constraints faced by the Commission, the Division of Enforcement has determined not to recommend a third set of virtually identical U.S. fraud charges against these two individuals at this time.

commodities, credit instruments, equities, foreign currencies, and interest rates.<sup>4</sup> As of December 31, 2012, JPMorgan is provisionally registered with the Commission as a swap dealer.

## C. Facts

### 1. The Chief Investment Office (CIO)

According to JPMorgan documents, the CIO's "key mandate" was to "[o]ptimize and protect [the organization]'s balance sheet from potential losses, and create and preserve economic value over the longer-term." JPMorgan's businesses, including those of affiliates—which include financial services, commercial and investment banking, financial transaction processing, and asset management—generated excess cash because deposits received by the businesses exceeded loans they made. CIO, along with JPMorgan's Treasury, was charged with managing JPMorgan's excess deposits. CIO did this by investing the bulk of the cash in an available-for-sale ("AFS") portfolio of fixed-income securities.

Consistent with its mandate to protect JPMorgan against potential losses, the CIO established the "Synthetic Credit Portfolio" ("SCP") in 2007 to protect the firm against adverse credit events affecting the AFS portfolio and other credit exposure in the organization. The SCP included positions in CDX and CDX tranches.<sup>5</sup> The traders and their direct supervisors who were directly responsible for trading in the SCP ("SCP traders") sat together or near one another on a trading floor in JPMorgan's offices in London, and often discussed their business and trading strategies with one another in person orally, over email, on various electronic chat systems, and on the telephone. From its inception in 2007 until late 2011, the SCP generated roughly \$2 billion in gross revenues.

A CDS references an entity whose credit is the subject of protection purchased by one party and sold by the other party. A credit default index, such as CDX, contemplates protection purchased and sold on a group, or "basket," of reference entities' credit. A tranche of a CDX involves protection on a stated subset of the basket. CDS and CDX

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<sup>4</sup> See "OCC's Quarterly Report on Bank Trading and Derivatives Activity Second Quarter 2012," Office of Comptroller of Currency, at Tables 1-5 and Graph 3, <http://www2.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq112.pdf>.

<sup>5</sup> Markit Group Ltd. ("Markit") owns credit default indices that were included in the SCP. Markit performs a variety of services related to credit default indices, including calculating the index values and publishing the daily index prices on its website. The credit default indices, such as CDX, and tranches are generally graded as either investment grade (known as "IG"), which include reference entities with higher credit ratings because they carry a relatively lower risk of default, or high-yield (known as "HY"), which include reference entities with lower credit ratings because they carry a greater risk of default. Each year, Markit issues two new series of each index with an updated listing of reference entities contained in the index (125 names in the IG indices and 100 in the HY indices). For example, in 2007, Markit issued an investment-grade credit default index that referenced North American entities. This particular CDX was the ninth IG CDX that Markit had issued. It is therefore generally referred to as the "CDX.NA.IG9."

have stated durations, or “tenors”, such as 10 years, *i.e.*, the contractual obligations last for a fixed number of years and end on a stated date in the future. Market participants typically buy or sell protection against the default of entities referenced in a CDS, CDX or tranche in an “over the counter” transaction (*i.e.*, not on an exchange), by entering into a standardized swap agreement with a swap dealer or swap participant, many of whom are major financial institutions. Market participants who sell protection against the risk of default of the CDX or tranche reference entities are considered “long” risk and “short” protection and will collect premiums until the CDX reaches maturity. Market participants who buy protection against the risk of default of the CDX or tranche reference entities are considered “short” risk and “long” protection” and must pay premiums until the CDX reaches maturity.

As the end of 2011 approached, the SCP contained sizeable long and short positions in many of the CDX high-yield and CDX investment grade series, among others, including both “on-the-run” series, which are the most-recently issued series, and “off-the-run” (*i.e.*, no longer “on-the-run”) series, and spanning multiple maturities and tranche positions. As of the end of 2011, the SCP held more than \$51 billion net notional of these credit derivatives.

Also at the end of 2011, in preparation for implementation of new standards on bank capital adequacy, stress testing, and market liquidity risks known as the Third Basel Accord (or “Basel III”) and due to internal JPMorgan priorities, a decision was made to reduce the amount of risk-weighted assets (“RWA”) held by SCP in order to free up additional capital. Unwinding certain positions in the SCP was one way to achieve the reduction.

## **2. The Valuation Process**

The CIO was required to record an estimate of the “fair value” of each position within the SCP – a process known as marking the book to market. The SCP was marked-to-market each day and at month-end. The month-end marks were far more significant to the CIO than the daily marks because the monthly marks were more widely reported and used within JPMorgan than the daily marks.

On a monthly basis, the SCP’s mark-to-market valuations were reviewed by the Valuation Control Group (“VCG”) within CIO, which price-tested the CIO’s marks and compared them to mid-market prices, namely the mid-point between bid and offer prices. After the close of trading each month, one person from the CIO VCG had approximately three days to complete the VCG process, which included gathering information from dealer quotes and from Markit to determine a mid-market or “independent” price for each of the more than one hundred thirty positions included in the SCP, as well as all other CIO London-based portfolios. For the most part, the CIO VCG used the Markit price as its “independent” price for indices and used information from dealer quotes for tranche prices. The CIO VCG then applied a threshold (or tolerance) based on a multiple of bid-ask spreads observed from dealer quotes around its “independent,” or mid-market, price to develop a “tolerance band” of acceptable prices for each position. SCP prices that were within the tolerance band were accepted without further review. To the extent that

there were discrepancies between the SCP marks and the “independent” prices used by VCG, the traders were given an opportunity to object and provide documentary evidence to support their mark. On a number of occasions, the VCG relented and adjusted its price based on this additional information provided by the SCP traders. For instance, at February 2012 month-end, the VCG’s initial evaluation revealed that trader marks in the aggregate produced a value that was at least \$31 million higher than the “independent” prices. Throughout the day on March 1, SCP traders sent the VCG additional dealer runs, and, by the end of the day, the difference was reduced to \$11 million. The CIO VCG process focused solely on the individual prices of positions and did not consider the notional size of any position or the profit or loss resulting from the variances from the tolerance bands.

### **3. The Trading**

SCP traders were well aware that the marks they applied to their positions would be evaluated by VCG at month-end and that the month-end results for the SCP would be reported widely within JPMorgan. They were also aware that the VCG would compare the traders’ marks to reported market prices and dealers’ bids and offers in testing the accuracy of the marks. The larger the variation between market prices and the traders’ marks, the more the traders’ marks could be called into question.<sup>6</sup> The SCP traders traded large and concentrated volumes of IG9 10Y at the very end of February in the same direction as their existing positions – *i.e.*, they were short protection and they sold more protection. This pattern of trading, which they sometimes referred to as “defending the position” or “fighting” market participants, was most evident on February 29, 2012. Because of the large size of the SCP’s IG9 10Y position, relatively small favorable or adverse movements in the spreads at which the underlying product was traded in the market produced significant mark-to-market profits or losses on the positions.

#### **a. January**

In January 2012, the SCP traders began to buy additional large quantities of protection on HY indices in order to be better positioned for defaults and to balance those purchases by selling additional protection on IG indices. The net result was the addition of positions to the SCP and an increasing notional value – the portfolio was growing.

Because the SCP was short protection on the IG9 10Y, as the price of protection decreased, the value of the SCP position increased. On January 25, the SCP sold its largest daily notional volume of protection in the IG9 10Y up to that point—\$2.777 billion worth—at an average spread of approximately 126.5 basis points (bps). The mark applied by the traders to that position was 123 bps, 3.5 bps points less than the spread at which they traded. The next day, January 26, SCP traders sold on net an additional \$2.169 billion worth of IG9 10Y protection at a lower average spread, approximately

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<sup>6</sup> As noted above at page 3, note 3, two SCP traders have been charged criminally and by the SEC based on allegations that they mis-marked the positions to deceive others at JPMorgan. The violation of the Act described in this Order, among other things, was consistent with a scheme to mis-mark.

120.64 bps. They marked the book on that day at 117.5 bps, which was slightly more than 3 bps lower than the traded spread level. That same day, following a conversation with the CIO manager overseeing the SCP, a junior SCP trader told other SCP traders that he believed the CIO manager wanted the traders “to fight a bit the positions.”

By January 30, the SCP traders were, in the words of one senior trader (“the Senior SCP Trader”), “in full fight here,” referencing the desire to undertake various trading strategies due to the difficult trading environment and adverse price movements. On January 30, the SCP’s traded spread on the IG9 10Y did, in fact, move adversely for the SCP inasmuch as it widened (increased) on that day to roughly 122.35 bps on average. Nevertheless, the traders raised the mark on the IG9 10Y to only 121 bps, which provided a difference between their mark and their trade level of approximately 1.32 bps.

On the last trading day of the month, January 31, the Senior SCP trader explained to CIO management that he “tried to fight it in the last sessions and it was unsuccessful.” As a result of the Senior SCP Trader’s trading in the IG9 10Y during January, the SCP acquired positions that caused the portfolio to be bigger than it ever was. As a result of the SCP’s January sales of protection in the IG 9 10Y, the notional short protection in the portfolio increased to \$56 billion at the end of January, up from \$36 billion at the end of 2011.

By the end of January, the SCP had suffered year-to-date mark-to-market losses of \$100 million, and SCP traders anticipated a further potential \$300 million in losses for the year.<sup>7</sup> A member of CIO management in London acknowledged at the time that its strategies were not working and that the performance was “worrisome.”

#### **b. February**

As February began, despite efforts to “defend the position” in the IG9 10Y, the SCP continued to suffer mark-to-market losses. The SCP traders were aware that the SCP had an outside position: the Senior SCP trader had advised that “the notionals” were “becom[ing] scary,” and the CIO should take losses (“full pain”) now; he further stated that these increased notionals would expose JPMorgan to “larger and larger drawdown pressure versus the risk due to notional increases.” On a February 16 telephone call, a junior trader told the Senior SCP Trader to “look at the huge influence we have in credit . . .” As month-end approached, the SCP’s IG9 10Y position grew to a mammoth \$65 billion in notional short protection from \$56 billion at the end of January.

On February 27, 2012, the SCP sold on net roughly \$1.08 billion notional value of protection in IG9 10Y at an average spread level of approximately 119 bps. The SCP marked this position at 115 bps, which differed from the trade level by 4 bps. On February 28, the SCP nearly doubled its previous day’s sales, selling on net more than \$2 billion of protection in IG9 10Y, which was among the five largest daily amounts ever sold by the SCP up to that point. The average trade price was close to 117 bps, but the

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<sup>7</sup> SCP was initially budgeted to make \$30 million in profits for 2012.

SCP marked the position at 113.25 bps, *i.e.*, roughly 3.5 bps less.

**c. February 29**

The next day, February 29, the last day of trading for the month, the SCP sold on net an unprecedented \$7.17 billion in protection in IG9 10Y in outright trades, far and away the largest amount the CIO ever traded in one day, at an average trade spread of approximately 113.83 bps. Approximately \$4.6 billion of the \$7.17 billion in protection sold by the SCP on February 29 was sold during a three-hour period at the end of the trading day. The final position was marked at 112.5 bps that day, which provided the lowest difference in the month between traded spread levels and marks, at 1.3 bps.

The SCP's volume of IG9 10Y protection sold on February 29 made up greater than 90% of the net market volume for the day, and accounted for approximately 15% of the net volume traded by the entire market for the entire month of February and approximately three times the average daily market volume. Measured another way, the amount of protection the SCP sold on February 29 was nearly 11 times the SCP's own average daily volume for the rest of February.

On the evening of February 29, the Senior SCP trader explained to the manager who oversaw SCP trading that the day's sale of this large amount of protection in the IG9 10Y was related to "month end price moves that were all adverse, although we could limit the damage."

**D. The Commission's New Supervision and Control Rules**

The Dodd-Frank Act amended the Act to provide the Commission with authority to regulate swap dealers like JPMorgan and the swap transactions that are the subject of this Order. Specifically, Section 4s was added to the Act to require swap dealers and major swap participants to register. Section 4s also imposed specific regulatory requirements for effective risk management, supervision, and transparency in swap dealing activities. Those new requirements authorized the Commission to adopt regulations to implement the requirements of Section 4s. To that end, the Commission has adopted numerous swap transaction and swap dealer regulations that became effective subsequent to the events that are the subject of this Order. JPMorgan's practices during early 2012 would have been covered by the requirements that are now applicable to registered swap dealers like JPMorgan, who registered as a swap dealer effective December 31, 2012.

Of particular relevance to JPMorgan's conduct here are Regulations 23.600 through 23.607, 17 C.F.R. §§ 23.600-23.607 (2013), which impose a range of duties on swap dealers and major swap participants with regard to, among other things: (1) risk management procedures; (2) monitoring of trading to prevent violations of applicable position limits; (3) diligent supervision; and (4) conflicts of interest policies and procedures. In addition, the Commission promulgated Regulations 23.200 through 23.205, 17 C.F.R. §§23.200-23.205 (2013), which set forth reporting and recordkeeping

requirements and daily trading records requirements for swap dealers and major swap participants.<sup>8</sup>

If the new regulations had been in effect during early 2012, JPMorgan would have been in a better position to detect the risks in the SCP sooner and manage them effectively. For example, Regulation 23.602(a) requires swap dealers and major swap participants to develop and implement a system to diligently supervise all activities related to their business, and to do so in a manner reasonably designed to achieve compliance with the Act and the Regulations promulgated thereunder. JPMorgan's supervision of the SCP was inadequate as demonstrated by the fact that the trading limits imposed were routinely breached with little repercussion and without adequate analysis of the causes of the breaches. JPMorgan has acknowledged in filings with the SEC that as of March 31, 2012, it had a material weakness in its internal controls over financial reporting with respect to the effectiveness of the CIO's internal controls over valuation of the SCP. In addition, the persons responsible for overseeing the CIO were disconnected from the day-to-day activities of the CIO in London.

JPMorgan's management of the SCP's risk during the first quarter of 2012 was wholly inconsistent with principles of sound risk management—principles that have been incorporated into many of the risk management provisions of Regulations 23.600 through 23.607. Indeed, had the regulations been in place, much of the offending conduct at issue (and the significant losses it caused) may well have been detected and remedied internally much more quickly, thereby potentially reducing losses.

For example, Regulation 23.600(b)(5) requires that a firm's risk management unit have sufficient authority, personnel and resources to carry out a risk management program. The risk management unit must also be independent from the business trading unit. During the first quarter of 2012, the CIO risk function was understaffed, and risk managers were not expected, encouraged or supported sufficiently by CIO management to vigorously question and challenge SCP trading strategies.

Furthermore, Regulation 23.600(b)(1) requires swap dealers to establish, document, maintain, and enforce a system of risk management policies and procedures that complies with the prescriptive requirements of the Act and the Commission's Regulations. Although JPMorgan had a system of risk management policies and procedures for the CIO's swaps trading in the SCP, the system had ineffective controls, which resulted in a failure to maintain and enforce the risk management system adequately. For example, the CIO Risk Management Committee did not meet regularly during the first quarter of 2012, and did not devote adequate attention to the risks in the SCP.

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<sup>8</sup> These Commission regulations became effective on June 2, 2012, and JPMorgan provisionally registered as a swap dealer on December 31, 2012. Upon registration, JPMorgan became subject to the Commission's swap-dealer rules. Because the offending conduct occurred in the first two quarters of 2012, prior to JPMorgan's registration, the Commission does not make a finding as to whether JPMorgan violated any of such rules.

Also included in the Commission's risk-management program requirements are Regulations 23.600(c)(1)-(2), which establish a swap dealer's obligation to (1) identify risks and risk tolerance limits, (2) provide its senior management, governing body, and the Commission with regular risk exposure reports, and (3) immediately notify its senior management and governing body upon detection of any material change in risk exposure. The CIO frequently violated the established risk limits with no repercussions and inadequate analysis. When limit breaches did occur, the CIO attempted to change the methodology used to calculate the variables included in the limit or simply increased the limit, without informed approval. In short, when the CIO's conduct failed to conform to JPMorgan's risk management policies, the institutional response was not to inform senior management or the firm's governing body, but rather to change the policies and procedures without consulting senior management.

Regulations 23.600(d)(3) and (4) require that swap dealers and major swap participants establish specific quantitative and qualitative limits for traders and monitor each trader throughout the day to prevent the trader from exceeding those limits. Prior to the effective date of the regulations, JPMorgan imposed no limits on the notional size of trades for the SCP and had no system for monitoring limits on an intraday basis during the first quarter of 2012.

Another way that senior management can be kept informed of changes in risk as it occurs is by establishing appropriate risk parameters. Ensuring that those parameters are followed can be accomplished by procedures requiring regular and frequent calculation of those parameters. Regulation 23.600(c)(4)(i)(A) requires that a registrant's market risk policies explicitly take into account daily measurement of market exposure, including position concentration. CIO management lacked a full understanding of the SCP's position concentration in the IG9 10Y in 2012. During the first quarter of 2012, the CIO's risk managers failed to adequately measure the risk in CIO's market position. Similarly, Regulation 23.600(c)(2) now requires that risk exposure reports be generated and provided to the governing body immediately upon detection of any material changes to risk exposure. JPMorgan's governing body did not receive a single notification regarding the size of or the risks imposed by the SCP during the first quarter of 2012—and it only received a notification as to certain of the risks thereafter because the press began calling the firm in preparation for publication of a new report of the JPMorgan "London Whale." This was far too late for effective intervention.

The foregoing is not an exhaustive analysis of all of the ways in which the Commission's new swap dealer rules, if in effect and fully implemented during the first quarter of 2012, could have detected and/or prevented the deficiencies and reduced the losses suffered by JPMorgan. However, even this summary makes apparent the need for such swap dealer rules and regulations.

## IV. LEGAL DISCUSSION

### A. Jurisdiction

The Act, as modified by the Dodd-Frank Act, provides the Commission with exclusive jurisdiction over accounts, agreements and transactions involving swaps, except to the extent otherwise provided by the Dodd-Frank Act (including an amendment made thereby) as set forth in Sections 2(a)(1)(C), 2(a)(1)(D), & 2(a)(1)(I), as well as 2(c) and 2(f) of the Act.<sup>9</sup> In Section 1a(47)(A), the term “swap” is defined as, *inter alia*, a credit default swap and certain “security-based swap agreement[s].”<sup>10</sup> The term “swap,” however, excludes from its scope, *inter alia*, any “security-based swap,” other than a mixed swap.<sup>11</sup> A security-based swap is defined as a swap based on (1) a single security or (2) a loan or (3) a narrow-based group or index of securities or (4) events relating to a single issuer or issuers of securities in a narrow-based security index.<sup>12</sup> Because the instruments at issue in this Order involve swaps based on a broad-based index of issuers of corporate debt, they are not security-based swaps, and this matter falls within the Commission’s jurisdiction. *See* 17 C.F.R. §1.3(zzz) (2012), *and* Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,207, 48,273 & 48,294 at n. 966<sup>13</sup> (Aug. 13, 2012).<sup>14</sup>

### B. The Commission’s New Authority Prohibiting Manipulative Devices Pursuant to Section 6(c)(1) of the Act and Regulation 180.1

Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), provides, among other things, that it is unlawful for any person “to employ, or attempt to use or employ, in connection with any swap . . . any manipulative or deceptive device or contrivance, in contravention of [Commission rules and regulations].” Commission Regulation 180.1(a), 17 C.F.R. §180.1 (2012), which became effective on August 15, 2011, in relevant part, makes it unlawful for any person:

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<sup>9</sup> *See* Section 2(a)(1)(A) of the Act, 7 U.S.C. §2(a)(1)(A) (2012).

<sup>10</sup> *See* Section 1a(47)(A)(iii)(XV) and 1a(47)(A)(v) of the Act, respectively, 7 U.S.C. §1a(47)(A)(iii)(XV) and §1a(47)(A)(v) (2012), respectively.

<sup>11</sup> *See* Section 1a(47)(B)(x) of the Act, 7 U.S.C. §1a(47)(B)(x) (2012).

<sup>12</sup> *See* Section 1a(42) of the Act, 7 U.S.C. §1a(42) (2012), which defines a security-based swap by reference to 15 U.S.C. §78c(a)(68) (2012).

<sup>13</sup> “Swaps based on indexes that are not narrow-based security indexes are not included within the definition of the term security-based swap under the Dodd-Frank Act.”

<sup>14</sup> In addition to the fact that JPMorgan is a U.S. bank and that some of the trades in question were with U.S. counterparties, the facts found herein provide the Commission with jurisdiction over JPMorgan’s swaps trading activity described in this Order for a variety of independent reasons including but not limited to that (i) the CDX products in question are swaps that were traded during the relevant period by market participants in the United States; and (ii) pursuant to Section 2(i)(1) of the Act, the Commission’s swaps jurisdiction extends to any activity “outside” the United States that has “a direct and significant connection with activities in, or effect on, commerce of the United States.”

in connection with any swap . . . to intentionally or recklessly: (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; (2) 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; (3) 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 . . . .<sup>15</sup>

“Section 6(c)(1) and [] Rule 180.1 augment the Commission’s existing authority to prohibit fraud and manipulation.” Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation (“Prohibition on Manipulative and Deceptive Devices”), 76 Fed. Reg. 41,398, 41,401 (July 14, 2011).

### 1. The Commission’s Traditional Manipulation Authority

By way of background, under long-standing Commission precedent, manipulation was historically described 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 its relation to other markets. If a firm is engaged in manipulation it will be found using devices by which the prices of contracts for some one month in some one market may be higher than they would be if only the forces of supply and demand were operative . . . . Any and every operation, transaction, device, employed to produce those abnormalities of price relationship in the futures markets, is manipulation.

*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), citing *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962) (quoting testimony before a Senate subcommittee of Arthur R. Marsh, a former president of the New York Cotton Exchange). Under this standard, any device intentionally employed to distort pricing relationships may be manipulative.<sup>16</sup> Under Section 6(c)(1) of the Act and

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<sup>15</sup> “The Commission interprets the words ‘in connection with’ broadly, not technically or restrictively. Section 6(c)(1) and Commission Regulation 180.1 reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap . . . .” Prohibition on Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,406. See *R & W Tech. Servs. Ltd. v. CFTC*, 205 F.3d 165, 171-173 (5th Cir. 2000) (“in connection with” requirement interpreted broadly); see also *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) (“Section 10(b) must be read flexibly, not technically and restrictively.”).

<sup>16</sup> See, e.g., *DiPlacido v. CFTC*, 364 F. App’x 657, 661(2d Cir. 2009) (noting the traditional standards of proof under Commission case law including intent “to influence market prices”).

Commission Regulation 180.1, price-distorting and certain other behavior is barred, even if the offending party acts recklessly rather than intentionally.

## 2. Section 6(c)(1) of the Act and Regulation 180.1

While the bounds of manipulative conduct under the Act have long been construed by *Indiana Farm Bureau* and other authority, Section 6(c)(1) and Commission Regulation 180.1, because of their relatively recent enactment, have not been interpreted in this context by any court. Precedent applying very similar provisions in the SEC regime, however, provides guidance: “The language of CEA section 6(c)(1), particularly the operative phrase ‘manipulative or deceptive device or contrivance,’ is virtually identical to the terms used in section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”).” Prohibition on Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,399. Indeed, when the Commission promulgated Rule 180.1, the Commission observed that “[g]iven the similarities between CEA section 6(c)(1) and Exchange Act section 10(b), the Commission deems it appropriate and in the public interest to model final Rule 180.1 on SEC Rule 10b-5.” *Id.* “To account for the differences between the securities markets and the derivatives markets, the Commission will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5.” *Id.* Accordingly, case law developed under Section 10(b) of the Exchange Act and SEC Rule 10b-5 is instructive in construing CEA Section 6(c)(1) and Commission Regulation 180.1(a). *Cf. Northcross v. Bd. of Ed. of Memphis City Schs.*, 412 U.S. 427, 428 (1973) (“The similarity of language in § 718 [of the Emergency School Aid Act of 1972] and § 204(b) [of the Civil Rights Act of 1964] is, of course, a strong indication that the two statutes should be interpreted *pari passu*.”).

It is well-settled that prohibitions on manipulative devices are designed to protect the market from devices that could interfere with legitimate pricing forces. Thus, Exchange Act Section 10(b) seeks a market where “‘competing judgments of buyers and sellers as to the fair price of the security brings about a situation where the market price reflects as nearly as possible a just price.’” *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1466 (2d Cir.1996) (quoting H.R. Rep. No. 73-1383, at 11 (1934)). “The basic aim of the antifraud provisions is to ‘prevent rigging of the market and to permit operation of the natural law of supply and demand.’” *Id.* (quoting *United States v. Stein*, 456 F.2d 844, 850 (2d Cir. 1972)). While the CDS index market was historically opaque and lacked the transparency prevalent in the securities markets, the same concepts hold true in that “[t]he gravamen of manipulation is deception of [market participants] into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.” *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999); *see also Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 12 (1985) (using Section 10(b) precedent to analyze meaning of “manipulative” in Section 14(e) of Securities Exchange Act); *Pagel, Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir.1986) (agreeing with the SEC that “[w]hen individuals occupying a dominant market position engage in a scheme to distort the price of a security for their own benefit, they violate the securities laws . . . .” (quoting *In re Pagel, Inc.*, Exchange Act Release No. 22,280, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,909, at 87,752 (Aug. 1, 1985))).

**C. Respondent's SCP Traders Recklessly Employed Manipulative Devices In Connection With Swaps Trading on February 29, 2012**

**1. Manipulative Device**

In a properly functioning market, prices reflect the competing judgments of buyers and sellers as to the fair price of a commodity or, in this instance, swaps. Here, acting on behalf of JPMorgan, the SCP traders' activities on February 29, 2012 constituted a manipulative device in connection with swaps because they sold enormous volumes of the IG9 10Y in a very short period of time at month-end. *See SEC v. Kimmes*, 799 F.Supp. 852, 858-59 (N.D. Ill. 1992), *aff'd sub.nom.*, *SEC v. Quinn*, 997 F.2d 287 (7th Cir. 1993); *see also, In re Pia*, ¶ 32,014, CFTC No. 11-17, 2011 WL 3228315, at \*2 (CFTC July 25, 2011) (describing scheme in which a trader executed large volumes in the final ten seconds before the end of trading day); *SEC v. Ficeto*, 839 F. Supp. 2d 1101, 1104 (S.D.N.Y. 2011) (describing similar scheme in securities context).

**2. Recklessness**

Consistent with long-standing precedent under the commodities and securities laws, the Commission defines 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." *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988); *see also First Commodity Corp. v. CFTC*, 676 F.2d 1, 7 (1st Cir. 1982); Prohibition on Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,404, & n. 87 (quoting *Drexel Burnham Lambert*, 850 F.2d at 748). Under this standard, the Commission need not prove that the defendant's motive or primary motive was to interfere with the forces of supply and demand. *See SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) (finding that "complaint's claim that [the defendant] recklessly participated in the manipulation" alleged "sufficient scienter"). For example, even if a trader were motivated by a desire to obtain compensation rather than by a desire to affect a market price, if the trader recklessly effected the manipulative trades, he will be held liable. *Id.* at 112-13.<sup>17</sup>

The SCP traders here acted recklessly. Operating out of desperation to avoid further losses, they developed a resolve to "defend the position" of the SCP, *i.e.*, protect its value that was predicated, at least in part, on the market price. Recognizing that the sheer size of the SCP position in IG9 10Y had the potential to affect or influence the market, they recklessly sold massive amounts of protection on the IG9 10Y during a concentrated period on February 29, 2012. The size and timing of SCP traders' transactions during this concentrated period was calculated to defend the position of the

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<sup>17</sup> 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. This standard will help promote the integrity of the markets and protect market participants. Prohibition on Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,398.

SCP just prior to the month-end review by the VCG. Such 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 180.1(a). *Cf. Pension Comm. of Univ. of Montreal Pension Plan v. Bank of Am. Secs., Inc.*, 652 F. Supp. 2d 495, 498 (S.D.N.Y. 2009) (describing concentrated trading in an otherwise infrequently traded stock as a manipulative device in securities context).

“[I]t is very difficult to believe [the SCP traders] were not aware” of the possible consequence of selling enormous volumes of IG9 10Y in a concentrated period at month-end. *See Drexel Burnham Lambert*, 850 F.2d at 748. The traders recklessly disregarded the possible consequences of selling an unprecedented \$7.17 billion in protection in the IG9 10Y on February 29, including \$4.6 billion in the last three hours of the trading day. In increasing the sale of IG9 10Y protection during a concentrated period of time on February 29 - amounting to nearly 11 times the SCP’s average daily volume for the rest of February - the traders demonstrated a reckless disregard to obvious dangers to legitimate market forces from their trading. *See id.*<sup>18</sup>

## V. FINDINGS OF VIOLATION

Based on the foregoing, the Commission finds that on February 29, 2012, JPMorgan, through its SCP traders, recklessly used or employed manipulative devices and contrivances in connection with swaps in violation of Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. §180.1 (2012).

## VI. OFFER OF SETTLEMENT

JPMorgan has submitted the Offer in which it:

- A. Admits the findings of fact in parts III-A through III-C herein, and neither admits nor denies the other findings of fact and conclusions herein;
- B. Acknowledges receipt of service of this Order;
- C. Admits the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;

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<sup>18</sup> As the Commission has observed, “[a] market or price effect may well be indicia of the use or employment of a manipulative or deceptive device or contrivance; nonetheless, a violation of final Rule 180.1 may exist in the absence of any market or price effect.” Prohibition on Manipulative and Deceptive Devices, 76 Fed. Reg. at 41,401.

D. Waives:

1. the filing and service of a complaint and notice of hearing;
2. a hearing;
3. all post-hearing procedures;
4. judicial review by any court;
5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
6. any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. §504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1-30 (2012), relating to, or arising from, this proceeding;
7. any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and
8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;

E. Stipulates that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which JPMorgan has consented in the Offer;

F. Consents, solely on the basis of the Offer, to the Commission's entry of this Order that:

1. makes findings by the Commission that JPMorgan violated Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. §180.1 (2012), when it recklessly used or employed manipulative devices and contrivances in connection with swaps;
2. orders JPMorgan to cease and desist from violating Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. §180.1 (2012);
3. orders JPMorgan to pay a civil monetary penalty in the amount of one hundred million dollars (\$100,000,000) within ten (10) days of the date of entry of this Order, plus post-judgment interest; and

4. orders JPMorgan, and its successors and assigns, to comply with the conditions and undertakings consented to in the Offer and as set forth in Part VII of this Order.

Upon consideration, the Commission has determined to accept the Offer.

## VII. ORDER

### Accordingly, IT IS HEREBY ORDERED THAT:

A. JPMorgan shall cease and desist from violating Section 6(c)(1) of the Act, 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. §180.1 (2012);

B. JPMorgan shall pay a civil monetary penalty in the amount of one hundred million dollars (\$100,000,000) within ten (10) business days of the date of the entry of this Order (the "CMP Obligation"). If the CMP Obligation is not paid in full within ten (10) business days of the date of entry of this Order, then post-judgment interest shall accrue on the CMP beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2012). JPMorgan shall pay the CMP Obligation by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made by other than electronic funds transfer, the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission  
Division of Enforcement  
Attn: Accounts Receivables – AMZ 340  
E-mail Box: 9-AMC-AMZ-AR-CFTC  
DOT/FAA/MMAC  
6500 S. MacArthur Blvd.  
Oklahoma City, OK 73169  
Telephone: (405) 954-5644

If payment by electronic funds transfer is chosen, JPMorgan shall contact Linda Zurhorst or her successor at the above address to receive payment instructions and shall fully comply with those instructions. JPMorgan shall accompany payment of the CMP Obligation with a cover letter that identifies JPMorgan and the name and docket number of this proceeding. JPMorgan shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581.

C. JPMorgan and its successors and assigns shall comply with the following conditions and undertakings set forth in the Offer:

JPMorgan undertakes to continue to implement written enhancements to its supervision and control system in connection with swaps trading activity, including trading and risk management controls reasonably designed to prevent and promptly detect mis-marking of its books, enhanced communications among risk, control and supervisory functions, and the development of additional surveillance tools designed to assist supervisors with monitoring trading activity in connection with swaps.

**D. Public Statements:** JPMorgan and its successors and assigns, agents or employees under its authority or control shall not take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis, nor take any action or make, directly or indirectly any public statement to the effect or creating or tending to create the impression that that JPMorgan does not admit the findings in Part IIIA through IIIC of this Order; provided, however, that nothing in this provision shall affect JPMorgan's: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. JPMorgan and its successors and assigns shall undertake all steps necessary to ensure that all of its agents and/or employees under its authority or control understand and comply with this agreement.

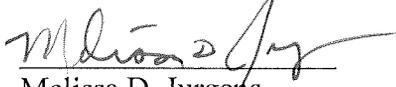
**E.** Pursuant to Rule 506(d)(1)(iii)(B), 17 C.F.R. § 230.506(d)(1)(iii)(B), of the Securities & Exchange Commission's Regulation D, this Order constitutes a Commission final order based on a violation of law and regulation that prohibits manipulative conduct. Nevertheless, under the specific and unique facts and circumstances presented here, pursuant to Rule 506(d)(2)(iii), disqualification under Rule 506(d)(1) of the Regulation D exemption should not arise as a consequence of this Order.

**F. Partial Satisfaction:** JPMorgan understands and agrees that any acceptance by the Commission of partial payment of JPMorgan's CMP Obligation shall not be deemed a waiver of its obligation to make further payments pursuant to this Order, and shall not be deemed a waiver of the Commission's right to seek to compel payment of any remaining balance.

**G. Change of Address/Phone:** Until such time as JPMorgan satisfies in full its CMP Obligation as set forth in this Order, JPMorgan shall provide written notice to the Commission by certified mail of any change to its telephone number and mailing address within ten (10) calendar days of the change.

The provisions of this Order shall be effective on this date.

**By the Commission**



Melissa D. Jurgens  
Secretary of the Commission  
Commodity Futures Trading Commission

Dated: October 16, 2013