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MANIPULATION UNDER THE CEA AND THE DEFENSE OF SELF-DEFENSE

In a high-profile case now pending, the CFTC has accused a trader of manipulating the S&P E-Mini futures contract, in part, by spoofing. In defense, the accused may argue that he had no intent to create an artificial price, but merely to counteract the price artificiality already created by others. The author discusses this possible defense, finding it consistent with earlier CFTC precedent.

By Chad E. Silverman and David Zornow *

What is manipulation? With regard to its meaning under the Commodity Exchange Act ("CEA"), the question has been asked many times. Answers often are akin to Justice Potter Stewart's famous refrain: "I know it when I see it," such as when one court noted that the bounds of manipulation were limited only by "the ingenuity of man."[1] While an amorphous definition gives prosecutors and enforcement attorneys wide latitude to bring manipulation actions, that is cold comfort for traders who need clear answers as to what conduct is permissible in order to do their jobs effectively without fear of prosecution.

One way to understand the contours of what constitutes manipulation under the CEA is to understand what is not proscribed by the Act. To that end, the Commodity Futures Trading Commission ("CFTC") has provided clear guidance as to what conduct does not, on its own, constitute manipulation. While a layperson may think of manipulation as any and all attempts to affect prices, the Commission has made clear that an attempt to affect price is not enough on its own to constitute manipulation. As the Commission asserted in one of its seminal manipulation cases: "[I]t is not enough to prove simply that the accused intended to influence price."[2]

1 *Cargill v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971).

2 *In re Indiana Farm Bureau Coop. Ass'n*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796 (CFTC Dec. 17, 1982).

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Rather, to prove manipulation, one must show that "the accused acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand influencing futures prices in the particular market at the time of the alleged manipulative activity."[3] Indeed, this is the standard the Commission continues to espouse to this day, as demonstrated by the language it has used in recent benchmark manipulation settlements.[4] Furthermore, the Commission and courts have made clear that this intent requirement applies to both manipulation and attempted manipulation claims.[5]

Under this standard, it is permissible for one to intend to influence the price of something so long as he did not act with the intent to cause an *artificial* price (*viz.* a price that does not reflect the legitimate forces of supply and demand). Although some attempts to influence price will be coterminous with an intent to interfere with the legitimate forces of supply and demand, other attempts to influence price may be done for the opposite purpose: that of ensuring that prices continue to reflect legitimate, as opposed to illegitimate, market forces. In an era where manipulation charges have been levied with increasing frequency, it is reasonable for traders to believe that the markets they trade in may be subject to manipulative attempts by others. Some may even take action to mitigate the effects of other would-be manipulators when such manipulation, if consummated, would cause harm to their own positions. Indeed, this is precisely the defense that may be employed in one of the highest-profile manipulation cases of the year, that of Mr. Navinder Singh Sarao, otherwise known as the alleged "flash-crash" trader.

On April 17, 2015, the CFTC filed a complaint against Mr. Sarao for manipulating the S&P 500 E-Mini futures contract on various days from 2010 through 2014, including May 6, 2010, the day of the so-called "flash crash."[6] The CFTC alleges that Mr. Sarao executed this manipulation, in part, through a practice known as "spoofing," whereby bids and offers are entered with the intent to cancel those orders. The complaint asserts that Mr. Sarao engaged in this activity to move the price of the S&P 500 E-Mini contract to artificial levels, where he could then execute trades at more favorable prices.[7]

Recently, the press reported that Mr. Sarao had previously complained about high-frequency "traders [that] he believed were engaging in manipulative conduct."[8] According to the article, the complaints "underscore[d] the extent to which Mr. Sarao viewed his own trading as a legitimate counter to other high-speed traders." Assuming the facts support the article's reporting, Mr. Sarao may have a defense to the CFTC's manipulation charges based on the theory discussed above. He may argue that even if he intended to affect the price of the E-Mini contract, he had no intent to create an "artificial" price because he was merely trying to counteract the price artificiality already created by other would-be manipulators in the market.

If Mr. Sarao asserts such a defense, it would not be the first time a defense of this variety was attempted. Indeed, in another case being handled by Mr. Sarao's

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[3] *Id.*

[4] *See, e.g.,* Settlement Order regarding LIBOR Manipulation at 27, *In re Barclays PLC, et. al*., CFTC Docket 12-25 (June 27, 2012) (citing *Indiana Farm Bureau*); Settlement Order regarding FX Manipulation at 9, *In re Citibank, N.A.,* CFTC Docket No. 15-03 (November 11, 2014).

[5] *CFTC v. Parnon Energy Inc.*, 875 F. Supp. 2d. 233, 250 (S.D.N.Y. 2012). Although the Commission often formulates the intent element of attempted manipulation as "an intent to affect market price," it has clarified that, even under this formulation, it must prove that, "the respondent . . . 'acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand.'" *See, e.g.*, Barclays' Settlement Order regarding LIBOR Manipulation at 15.

[6] Complaint, *CFTC v. NAV Sarao Futures Limited PLC and Navinder Singh Sarao*, 15-cv-03398 (S.D.N.Y. April 17, 2015).

[7] *Id.* ¶7.

[8] Aruna Viswanatha, "Accused Trader Accused His Rivals," *The Wall Street Journal*, C1 (May 14, 2015).

current attorneys, the defendant put forth a similar argument. In *CFTC v. Wilson and DRW Investments LLC*, the CFTC charged the defendants with manipulating the settlement price of an exchange-traded interest rate futures contract by submitting bids during the contract's settlement period that they had no intention of consummating and then withdrawing those bids.[9] In their motion to dismiss, the defendants argued that their bids during the settlement pricing process were attempts to "bring market prices into line with what defendants believed was their true economic value" and were therefore not attempts to cause "artificial" prices, the hallmark of manipulation.[10] In *Wilson*, the court denied the defendants' motion to dismiss because it found it was not appropriate at that stage for it to make determinations as to the contract's "intrinsic value."[11] However, the court left open the possibility that such a defense could be successful at a later stage in the litigation.

There seems to be some daylight between Wilson's argument and the one Sarao may make. Wilson said his trading was innocent because he was just trying to ensure that the price of the contracts he traded reflected their intrinsic value, or at least his view of that value. Sarao's potential defense is somewhat different: he may say that he placed orders to counter manipulative forces in the market that created an artificial price.

That distinction may be important. Rather than seek to ensure that a product's price reflects its intrinsic value, the CEA seeks to ensure that the market price of a product is not the result of illegitimate forces. As the Commission said in *Indiana Farm Bureau*: "[T]o determine whether an artificial price has occurred, one must . . . search for those factors which are extraneous to the pricing system. . . . [T]he focus should not be as much on the ultimate price, as on the nature of the factors causing it."[12]

In this sense, Sarao's potential defense arguably fits more squarely within the CEA's statutory objective than Wilson's did. It would be a defense premised on his conclusion that the predicate price was a result of artificial forces caused by other market participants. He would assert that, consistent with the Commission's precedent in *Indiana Farm Bureau*, he was justified in having engaged in conduct to counteract that perceived artificiality because his own trading efforts were intended to cause a "normal" price rather than an "artificial" one.

Although much grey remains around the definition of manipulation, the case law has made clear that certain types of conduct do not meet that definition. One such category is conduct that is not intended to cause artificial prices, which may well exist when traders try to combat the effects of self-perceived third-party manipulation of their markets. It remains to be seen whether Sarao employs such a defense — and if so, whether it works — but surely it will not be long before someone does. ■

[9] Complaint, *CFTC v. Wilson, et al.,* 13-cv-07884 (S.D.N.Y. Nov. 6, 2013).

[10] Motion to Dismiss at 11-14, *CFTC v. Wilson, et al.,* 13-cv-07884 (S.D.N.Y. Jan. 17, 2014).

[11] *CFTC v. Wilson*, 27 F. Supp. 3d 517, 535 (S.D.N.Y. 2014).

[12] *In re Indiana Farm Bureau Coop. Ass'n*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796 (CFTC Dec. 17, 1982).