

EXPERT ANALYSIS

CFTC Aims to Lower The Bar on Proving Manipulation in Pending Cases

By Mark D. Young, Esq., Maureen A. Donley, Esq., Gary A. Rubin, Esq., Chad E. Silverman, Esq., and Theodore M. Kneller, Esq.

Skadden, Arps, Slate, Meagher & Flom

In two separate Commodity Futures Trading Commission (CFTC) enforcement actions before district courts in New York and Chicago, the CFTC has asked each court to adopt holdings that would significantly enhance the CFTC's ability to win price-manipulation cases by diminishing the elements it must prove to establish a violation.

Market participants are closely watching *CFTC v. Wilson & DRW Investments*, filed in New York, and *CFTC v. Kraft Foods Group, Inc.*, filed in Illinois.

The parties have fully briefed the issues in *DRW*, and the court is expected to rule in the coming year.¹

On December 18, 2015, the *Kraft* court declined to adopt the CFTC's most expansive interpretation of its price-manipulation authority but also declined to grant the defendant's motion to dismiss.

LOWERING THE TRADITIONAL BAR TO PROVING MANIPULATION

The Commodity Exchange Act (CEA) prohibits manipulation and attempted manipulation of the price of a commodity.

Under precedents stretching back 40 years, in order to prove price manipulation, the CFTC must show the defendant specifically intended to cause an artificial price — that is, a price that does not reflect the legitimate forces of supply and demand.

The CFTC has always chafed at that high bar, and its arguments in *DRW* and *Kraft* seek to lower it. In *DRW* (and in some recent CFTC settlement orders), the CFTC has attempted to lop off the artificial-price component at least for purposes of proving an attempted manipulation.

And in *Kraft*, the CFTC has invoked new Rule 180.1 to try to circumvent both the artificial-price and the specific-intent elements of proof for manipulative trading.

CFTC V. WILSON & DRW INVESTMENTS

In *DRW*, the CFTC charged the defendants with attempting to manipulate and manipulating the settlement price of an interest rate future.

The CFTC moved for summary judgment on its attempted-price-manipulation claim, arguing in its brief that it need only prove that the defendants: (i) intended to affect the price of a commodity (but not to create an artificial price) and (ii) took an overt act in furtherance of that intent.

The CFTC cited numerous statements from DRW's general counsel, who, according to the CFTC, admitted that DRW placed bids intending to move the settlement rate to reflect DRW's view of "fair value."

DRW countered that the CFTC's statement of the law — that it need only prove an intent to affect price — contradicts U.S. Court of Appeals for the Second Circuit precedent and the CFTC's own prior administrative decisions.



The CFTC has asked two district courts to adopt holdings that would significantly enhance the CFTC's ability to win price-manipulation cases by diminishing the elements it must prove to establish a violation.

DRW contended that the CFTC must prove the same intent standard for both attempted and completed manipulation: that a defendant “specifically intended to create an artificial price.”

DRW asserted that attempting to trade at the best available price with the intent to reflect fair value cannot be construed as an intent to create an artificial price and cannot form the basis of a manipulation claim.

In addition to the *DRW* complaint, several recent CFTC administrative orders finding manipulative intent have relied heavily on traders’ statements related to trading to affect price — even if not to an artificial level.

The *DRW* court could follow suit and uphold the CFTC’s recent efforts to lower the manipulation bar or reaffirm that artificial price is a necessary element of a claim for attempted price manipulation.

CFTC V. KRAFT FOODS GROUP, INC.

In *Kraft*, the CFTC charged Kraft with attempting to manipulate and manipulating wheat prices, and with violating new CFTC Rule 180.1.

The Dodd-Frank Act, which authorizes the CFTC to promulgate Rule 180.1, amended the CEA to prohibit “employ[ing] ... any manipulative or deceptive device or contrivance.”

Rule 180.1, which mirrors Securities and Exchange Commission (SEC) Rule 10b-5, prohibits anyone from “intentionally or recklessly” using or employing any manipulative device, scheme or artifice to defraud.

Before *Kraft*, the CFTC had primarily used Rule 180.1 as an anti-fraud tool.

When the CFTC adopted Rule 180.1 in 2011, however, it specifically said that the rule does not require the CFTC to prove specific intent or that an artificial price existed in order to establish a violation.

In other words, the CFTC also views Rule 180.1 as an anti-manipulation enforcement tool that does not require satisfaction of the traditional elements of price manipulation. In *Kraft*, the CFTC is testing that view.

The CFTC alleged that Kraft violated Rule 180.1 through a scheme to use the futures market to affect prices in the cash wheat market to Kraft’s benefit.

According to the CFTC, Kraft established an “enormous” wheat futures position and appeared to stand for delivery on its futures contracts, even though it never intended to take delivery because the grade of wheat was unsuitable for Kraft’s purposes.

The CFTC alleged that Kraft instead established its futures position to cause wheat spot prices to decline, intending that, as other market participants perceived that Kraft would satisfy its significant demand for wheat in the futures market, the apparent reduction in demand in the cash market would cause spot prices to fall.

Kraft moved to dismiss the CFTC’s complaint, arguing that the CFTC’s adopting release interprets Rule 180.1 only to “prohibit fraud and fraud-based manipulations” consistent with the jurisprudence under SEC Rule 10b-5.

Kraft argued that the CFTC did not allege a scheme to defraud but merely alleged an open market transaction to purchase wheat at the best available price.

According to Kraft, to state a claim for a CEA violation, the CFTC must allege either: (i) fraud (as under Rule 10b-5) or (ii) a specific intent to create an artificial price (as under traditional price manipulation), but the CFTC cannot shoehorn a price-manipulation claim into Rule 180.1 without a fraud allegation.

In its answering brief, the CFTC argued that the phrase in Rule 180.1 prohibiting “any manipulative device, scheme, or artifice to defraud” separately prohibits (i) manipulative devices and (ii) deceptive devices (artifices to defraud), but that only claims for the latter sound in fraud.

The CFTC argued that its manipulation claim against Kraft is “premised on [its] abuse of its market power” — establishing an “enormous” futures position and standing for delivery.

In ruling on the motion to dismiss, the court agreed with Kraft that Rule 180.1 “prohibit[s] only fraudulent conduct.”

The court rejected the CFTC’s assertion that the statutory authority for Rule 180.1 — prohibiting “manipulative or deceptive devices” — should be read to prohibit manipulative conduct in the absence of fraud.

Instead, the court held the CFTC is required to meet the heightened pleading standard for fraud claims.

Nevertheless, the court denied the defendant’s motion to dismiss after finding that the CFTC’s complaint, when construed in the light most favorable to the CFTC, adequately alleged a plausible violation of Rule 180.1 under the heightened pleading standards.

Despite rejecting the CFTC’s argument that would have permitted the CFTC to use Rule 180.1 to establish manipulative trading in the absence of fraud without having to prove either specific intent or creation of an artificial price, the court broadly construed the types of schemes that may be considered fraudulent.

It observed that fraud-based manipulation could include traditional fraud by misrepresentation or omission or, alternatively, by fraudulent manipulation (*i.e.*, deceiving market participants by artificially affecting prices through open-market transactions).

The court found the CFTC’s pleading sufficiently alleged fraudulent manipulation, as Kraft established a “huge” futures position intended to signal the company’s demand in a way that would “mislead” other market participants into thinking that Kraft would take delivery in the futures market, causing cash wheat prices to fall.

As the *Kraft* case proceeds, the CFTC may attempt to construe the court’s articulation of fraudulent manipulations as another way to avoid the traditional elements of proof for manipulative trading.

NOTES

¹ Since the original publication of this article, Skadden Arps was retained to represent the CME Group, Commodity Markets Council, Futures Industry Association, Intercontinental Exchange (ICE), and the Managed Funds Association as amici curiae in *CFTC v. Wilson & DRW Investments*. A copy of the amici brief is available here: <http://www.commoditymkt.com/wp-content/uploads/2016/01/DRW-Amicus-Brief.pdf>.



(L-R, top) **Mark D. Young** is a partner and co-head of Skadden, Arps, Slate, Meagher & Flom’s derivatives group and is based in Washington. Of counsel **Maureen A. Donley**, counsel **Gary A. Rubin** and associate (L-R, bottom) **Theodore M. Kneller** are also members of Skadden’s derivatives group and are based in Washington. **Chad Silverman** is a counsel in Skadden’s government enforcement and white collar crime practice and is based in New York. A version of this expert analysis article previously appeared in the firm’s 2016 Insights compendium of attorney-authored articles. Republished with permission.

In ruling on the motion to dismiss, the court agreed with Kraft that CFTC Rule 180.1 “prohibit[s] only fraudulent conduct.”

©2016 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit www.West.Thomson.com.