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Derivatives Alert

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Few price manipulation cases brought by the Commodity Futures Trading Commission (CFTC) ever go to trial. The CFTC case filed against the trading firm DRW Investments LLC (and its CEO) was the exception to that rule and would be noteworthy for that reason alone. But there is more. Following a bench trial conducted in December 2016, on November 30, 2018, Judge Richard J. Sullivan dismissed the CFTC's complaint that DRW engaged in price manipulation and attempted price manipulation of interest rate swap futures contracts.[1] Judge Sullivan observed that "[t]here is no disagreement: the Defendants knew that their trading practices … would result in a higher settlement price" inuring to DRW's benefit. Nevertheless, he found that the CFTC failed to prove that the defendants intended to create an artificial price. In so ruling, Judge Sullivan clarified that the intent standard for CFTC's price manipulation or attempted manipulation claims under the Commodity Exchange Act (CEA) requires a specific intent to create an artificial price and not merely an intent to affect price.

This decision is significant because:

- Judge Sullivan rejected the CFTC's legal theory that trading activity that is intended to influence price is *per se* illegitimate and by definition "artificial."
- After finding that the defendants' trading patterns were "supported by a legitimate economic rationale," Judge Sullivan held that such activity cannot be the basis for manipulation or attempted manipulation liability.
- The decision is squarely at odds with several recent CFTC speaking orders in major settlements with financial institutions that concluded that trading conduct constitutes attempted manipulation if the trading activity is intended to affect settlement prices, even if the same trading conduct had another legitimate purpose — *i.e.*, hedging.

Background

In CFTC v. Wilson & DRW Investments,[2] the CFTC alleged that the defendants manipulated and attempted to manipulate the price of the IDEX USD Three-Month Interest Rate Swap Futures Contract (Three-Month Contract) cleared at the International Derivatives Clearinghouse (IDCH). The Three-Month Contract was a cleared derivative contract that largely mirrored the economics of an uncleared, over-the-counter (OTC)

[1] At the time of trial, Judge Sullivan was sitting as a district court judge in the Southern District of New York. Recently, however, Judge Sullivan was confirmed as a circuit judge in the U.S. Court of Appeals for the Second Circuit.

[2] *CFTC v. Wilson & DRW Investments*, No. 1:13-cv-07884, 2018 WL 6322024 (S.D.N.Y. Nov. 30, 2018).

interest rate swap. IDCH calculated settlement prices of the Three-Month Contract according to a formula that was dependent, in part, on electronic bids and offers placed during a daily settlement window, or in the absence of bids and offers, tied to the value of comparable uncleared OTC swaps. But the settlement methodology ignored a key valuation distinction between uncleared swaps and the cleared Three-Month Contract: The margin payments made a long position in the Three-Month contract more valuable than a short position unless an adjustment was applied to the settlement calculation. IDCH's calculation did not include an adjustment. DRW identified this important distinction and speculated that the market had not yet taken into account this pricing disparity. Thus, DRW concluded that it could profit by establishing a long position in the Three-Month Contract.

By September 2010 DRW had established long positions in the Three-Month Contract ($325 million in all). But trading in the Three-Month Contract was illiquid, no electronic bids or offers were made on which to base settlement prices and IDCH followed its rules by looking to uncleared swap rates to calculate the daily settlement price and corresponding margin payments. DRW subsequently began submitting bids electronically on the Three-Month Contract at prices above the prevailing OTC swap rates. Through this bidding strategy, DRW intended that its bids would be included in IDCH's settlement calculation that in turn increased the settlement price of the Three-Month Contract and resulted in higher margin payments to DRW. Judge Sullivan also found that DRW incrementally placed higher bids over time.

From January 2011 through August 2011, DRW submitted more than 2,500 electronic bids (most of them during the settlement window), but none of the bids resulted in a trade. The CFTC characterized the fact that none of DRW's bids were ever hit as evidence of its manipulative intent: "[D]ay after day for seven months DRW's traders were shouting into an empty trading pit devoid of traders and trades." [3] Thus, for the entire period, DRW was the only bidder on the Three-Month Contract, and DRW's bids essentially set the daily settlement price.

Artificial Price and Manipulative Intent

The CFTC alleged that DRW violated Sections 6(c) and 9(a)(2) of the CEA by manipulating or attempting to manipulate the settlement price of the Three-Month Contract. In particular, the CFTC alleged that DRW unlawfully placed manipulative bids that "DRW knew would never be accepted" to move the Three-Month Contract's settlement price in its favor and ultimately to benefit its existing positions at the expense of those holding short positions.[4] The CFTC argued that DRW committed attempted and completed price manipulation because it submitted bids to influence the settlement price in its favor — conduct that the CFTC asserted was inherently manipulative regardless of whether the bids were placed for another legitimate purpose. DRW presented evidence at trial that the bids were below DRW's assessment of fair market value (in the absence of other market participants' bids or offers), and even though the bids were in part designed to increase the margin payments DRW would receive on its existing positions, the bids had a dual purpose — potentially attracting counterparties for new transactions.

Judge Sullivan rejected the CFTC's position, holding that for both attempted and completed manipulation claims, the CFTC must prove that a defendant intended to create an artificial price, not just that the defendant intended to affect a price. Judge Sullivan followed Second Circuit precedent establishing four elements for completed price manipulation: (1) defendants were able to influence market prices; (2) an artificial price existed; (3) defendants caused the artificial price; and (4) defendants specifically intended to cause the artificial price. Finding that the CFTC had not presented evidence at trial that could establish the second element (that DRW's bids were in fact at artificial prices), the district court brushed aside what it termed to be the CFTC's "fallback argument" that would "conflate artificial prices with the mere intent to affect prices."

Judge Sullivan summarized the CFTC's argument as asserting that "any price influenced by [DRW's] bids was 'illegitimate,' and by definition 'artificial,'" because DRW understood and intended that the bids would have an effect on the settlement prices. In other words, because DRW understood and intended that its bids would affect the Three-Month Contract settlement price — and by consequence, affect the margin payments to DRW on its open position — those bids were *inherently* manipulative, even if the bids reflected DRW's view of fair market value and were designed to attract other market participants to execute a trade. Judge Sullivan rejected the CFTC's argument, concluding that "it would [] lower the bar for proving market manipulation" and was "simply an attempt to read out the artificial price element of the [Second Circuit's] test by collapsing it into the subjective intent requirement." In contrast, Judge Sullivan sided with another district court's assessment that "the laws that forbid market manipulation should not encroach on legitimate economic decisions lest they discourage the very activity that underlies the integrity of the markets they seek to protect."[5]

[3] Judge Sullivan pointed out, however, that another financial institution had verbally agreed to an additional trade at one point, but it backed out and eventually settled a lawsuit with DRW over the busted trade.

[4] *Complaint for Injunctive and Other Equitable Relief and for Civil Monetary Penalties Under the Commodity Exchange Act* at ¶ 4, *CFTC v. Wilson & DRW Investments*, No. 1:13-cv-07884-RJS-KNF (S.D.N.Y. Nov. 6, 2013), ECF No. 1.

[5] *In re Amaranth Nat. Gas Commodities Litig.*, 587 F. Supp. 2d 513, 534-35 (S.D.N.Y. 2008), *aff'd*, 730 F.3d at 170.

Noting that both completed and attempted market manipulation require the same specific intent to cause an artificial price, Judge Sullivan similarly addressed the CFTC's attempted manipulation claim. According to Judge Sullivan, DRW "made bids with an honest desire to transact at those posted prices, and that [DRW] fully believed the resulting settlement prices to be reflective of the forces of supply and demand." In light of these findings, Judge Sullivan entered judgement for DRW on the attempted manipulation claim observing that "[a]ny other conclusion would be akin to finding manipulation by hindsight."

DRW's Impact

The court's decision — that manipulation or attempted manipulation claims under the CEA require a showing of a specific intent to create an artificial price and not merely an intent to affect price — has significant implications for CFTC's enforcement actions and private actions under the CEA.

The holding in *DRW* is at odds with the CFTC's position in several recent administrative speaking orders in benchmark rates cases in which the CFTC has found manipulative intent and therefore attempted manipulation based on traders' statements related to trading to affect price — even if not to an artificial level.[6] In these orders, the CFTC rejected the defense that trading activity undertaken to affect a settlement price that may benefit existing positions was not impermissibly manipulative if done within the context of current market prices and simultaneously undertaken for the legitimate purpose of risk management and hedging.[7] The Commission's reasoning does not hold up under the analysis in *DRW*, which reaffirmed that specific intent to create an artificial price is required for attempted price manipulation.

The *DRW* decision, however, does leave a significant question unanswered regarding manipulative activity under the CEA and CFTC rules. Notably, the conduct at issue in *DRW* ended just before the Dodd-Frank Act amendments and the CFTC's expanded enforcement authority under Rule 180.1 became effective, and it remains unclear how a court would apply the CFTC's current enforcement authority to facts similar to the *DRW* case.[8] The CFTC's rulemaking is clear that the Commission does not interpret Section 6(c)(1) to require the CFTC to prove an artificial price when pursuing "fraud and fraud-based manipulative schemes" under Rule 180.1.

New insights on the question of Rule 180.1's role in market manipulation may soon come to light. Two other federal district courts have addressed the scope of the CFTC's enforcement authority under Rule 180.1, from very different perspectives. In *CFTC v. Kraft Foods Group, Inc.*,[9] the District Court for the Northern District of Illinois rejected the CFTC's position that CEA Section 6(c)(1) and Rule 180.1 prohibit manipulation in the absence of fraud, holding that a violation under Rule 180.1 for market manipulation must sound in fraud. In a bit of a twist, a District Court for the Central District of California decision in *CFTC v. Monex Credit Co.*[10] rejected the CFTC's argument that CEA Section 6(c)(1) and Rule 180.1 prohibit fraudulent conduct outside the context of a market manipulation. In other words, *Kraft* says you cannot have a 180.1 violation for market manipulation in the absence of fraud, and *Monex* says there the reverse is also true — you cannot have a 180.1 violation for fraud in the absence of a market manipulation. How these cases are ultimately resolved is likely to shape the CFTC's pursuit of market misconduct cases. The parties continue to litigate the *Kraft* case in district court, and the *Monex* decision is currently on appeal before the Ninth Circuit.

Finally, the *DRW* decision further reinforces the intent requirement applied in many cases in which private litigants have sought damages for price manipulation under the CEA. Under a *DRW* analysis, private plaintiffs' allegations that a defendant's trading activity was intended to affect a market price for the purpose of benefiting the defendant's existing positions would likely be insufficient to survive a motion to dismiss. Instead, the plaintiffs would need to allege not only that the defendant's conduct caused artificial prices, but also that the defendant specifically intended to cause the prices to be artificial.

[6] *See* "CFTC Aims to Lower the Bar on Proving Manipulation in Pending Cases," Skadden client alert, Jan. 2016.

[7] *See, e.g.*, *In re Barclays PLC*, CFTC No. 15-25 (May 20, 2015), at 9 n.9 ("Irrespective of whether the NY Options Desk and NY Swaps Desk traders had an interest in hedging, they engaged in attempted manipulation when they placed bids and offers or executed trades around 11:00 a.m. with the improper intent to move the USD ISDAFIX rate in Barclays' favor."); *In re JPMorgan Chase Bank, N.A.*, CFTC No. 18-15 (June 18, 2018), at 8 n.6; *In re BNP Paribas Securities Corp.*, CFTC No. 18-19 (Aug. 29, 2018), at 8 n.12; *In re Bank of America, N.A.*, CFTC No. 18-34 (Sept. 19, 2018), at 8 n.8.

[8] *See* Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398 (July 14, 2011) ("Rule 180.1 prohibits, among other things, fraud and fraud-based manipulative schemes … regardless of whether the conduct in question was intended to or did create an artificial price").

[9] 153 F. Supp. 3d 996 (N.D. Ill. 2015).

[10] 311 F. Supp. 3d 1173 (C.D. Cal. 2018), *appeal docketed*, No. 18-55815 (9th Cir. June 20, 2018).