Correcting CFTC Course On Manipulative Intent

By **Chad Silverman** (January 10, 2019, 11:21 AM EST)


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Intent is the sine qua non of manipulation. Whether a particular trade is unlawful or proper can depend solely on the trader's intent at the time he makes the trade. For 30 years, the U.S. Commodity Futures Trading Commission followed a relatively straight course when bringing and resolving trading-based manipulation cases, applying the same standard of intent — an intent to create an artificial price. However, in CFTC v. Donald R. Wilson & DRW Investments LLC,[1] the CFTC appeared to diverge from its well-trodden path when it pushed an intent theory it had not previously publicly pursued. The commission alleged that trading for the purpose of "affecting price" was sufficient to render the trading unlawful. The court in DRW rejected the CFTC's theory, concluding that it was a bridge too far.

In DRW, the firm accumulated a $300 million long position in certain cleared interest rate swap futures because the firm believed these futures were underpriced and that the value of its position would rise over time.[2] The value of the position depended on a daily settlement price, which was calculated by the relevant exchange using a formula based in part on electronically submitted bids and offers that were open during a specified settlement period each afternoon.[3] After acquiring the long position, the firm placed bids during the settlement period on a regular basis, understanding and intending that "such bids would affect the settlement price."[4] The court also found the firm believed that the value of the contract it was bidding on was higher than the prices at which it was bidding, wanted to find counterparties for its bids so it could profit on that valuation discrepancy and raised its bids over time to attract such participants.[5] In the end, none of the firm's more than 2,500 bids resulted in a transaction.[6] The CFTC charged DRW and its CEO with manipulation and attempted manipulation, alleging that they "intended that their bids would affect the settlement price," which made the bids "inherently manipulative."[7]

The court disagreed, apparently concluding that the CFTC's theory proved too much. According to the court, the CFTC's theory — intending to affect price is always manipulative —would "effectively bar market participants with open positions from ever making additional bids to pursue future transactions," because those bids could be viewed as evidencing manipulative intent.[8] Recognizing that the "mere intent to affect prices is not enough," the court ordered that the CFTC would be held to its well-known and long-standing burden: It must prove that a trader intended to cause "artificial" prices, as in "prices that [he] understood to be unreflective of the forces of supply and demand."[9]

The court's holding is supported by two of the CFTC's seminal manipulation precedents. In Indiana Farm Bureau Cooperative Association,[10] cited in DRW, the CFTC's Division of Enforcement contended that respondents had manipulated the price of corn futures by standing for delivery on corn contracts, when there was a supply shortage, to force their counterparties "into paying artificial[ly] [high] prices" to exit the contracts.[11] The commission acknowledged that the respondents may have been standing for delivery solely to extract a higher price, but found that "self-interest" plays a "legitimate part in the price setting process."[12] "[I]t is not enough to prove simply that the accused intended to influence price."[13] Rather, it must be shown that the defendant acted with the purpose of causing a price that "did not reflect the legitimate forces of supply and demand" influencing the price of that product.[14]

The court's decision in DRW also finds support in Henner,[15] another "landmark manipulation case," which sheds light on the question of when market forces are "legitimate."[16] When sellers and buyers act "rationally," namely when "buyers [are] trying to buy as cheaply as they can and ... sellers [are] trying to sell as high as they can," they are applying legitimate forces of supply and demand to the market.[17] "[W]henever a buyer ... intentionally pays more than he has to for the purpose of causing the quoted price to be higher than it would otherwise have been [], the resultant price is an artificial price not determined by the free forces of supply and demand."[18] Under that principle, the respondent in Henner was found to have engaged in manipulation because he "paid more than he had to ... for the purpose of causing the closing price to be at that high level."[19]

Although the court in DRW did not refer to Henner, its rationale for rejecting the CFTC's manipulation theory comports with the rule of Henner. In DRW, the defendants bid at increasing prices over time, but the court found they raised their bids in response to being unable to find counterparties at the levels at which they had been bidding. The defendants were not attempting to "pay more than they had to" like the defendant in Henner, but rather they increased their bids "to attract new counterparties in a nascent market."[20] Even when increasing bids, DRW's "goal was still to bid at the lowest price necessary to attract a new counterparty," which legitimized the bidding in DRW.[21] (Emphasis added.)

In the end, the DRW opinion comes as no surprise, as it simply reaffirms decades of CFTC precedent and puts the CFTC back on course. Intending to affect price is not sufficient to establish manipulative intent. Bidding prices necessary to attract sellers and offering prices necessary to attract buyers, remain legitimate market activity, just like always.

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[1] CFTC v. Donald R. Wilson & DRW Investments LLC , No. 13-CV-7884, 2018 WL 6322024 (S.D.N.Y. Nov. 30, 2018).

[2] Id. at *6.

[3] Id. at *5–6.

[4] Id. at *17.

[5] Id. at *10.

[6] Id. at *7.

[7] Id. at *14. Based on the timing of the conduct, the Commission charged manipulation and attempted manipulation under Sections 6(c) and 9(a)(2) of the Commodity Exchange Act as those sections existed prior to their amendments under the Dodd-Frank Wall Street Reform Act, and thus, not under the Commission's newer anti-manipulation authority, 17 C.F.R. 180.1. See 2018 WL 6322024, at *1 n.1.

[8] Id. at *15.

[9] Id.

[10] Indiana Farm Bureau Coop. Ass’n., C.F.T.C., 1982 WL 30249 (Dec. 17, 1982).

[11] Id. at *3.

[12] Id. at *6.

[13] Id.

[14] Id. at *7.

[15] Henner, 30 Agric. Dec. 1151 (1971).

[16] See Prohibition of Market Manipulation, 75 Fed. Reg. 67657, 67660 (Nov 3, 2010).

[17] Henner, 30 Agric. Dec. at 1198.

[18] Id.

[19] Id. at 1194.

[20] 2018 WL 6322024, at *10.

[21] Id.