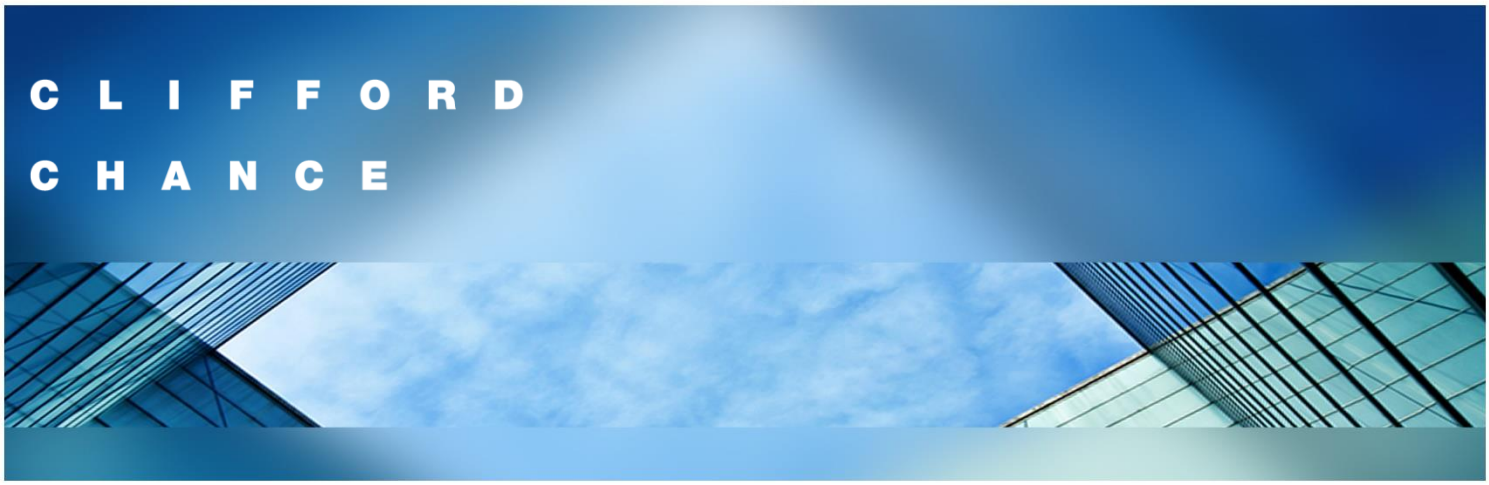

U.S. COURT AFFIRMS ECONOMIC REALISM AND REJECTS CFTC BID TO EXPAND THE OFFENSE OF PRICE MANIPULATION

In a sharply worded decision released last week, a New York federal court provided some much-needed clarity for commodities and derivatives market participants by making clear that the U.S. Commodity Futures Trading Commission ("CFTC") must show that a trader intends to create an artificial price in order to be guilty of attempting to manipulate or manipulating a commodity price and that an intent to merely influence the price is insufficient. The Court's decision, dismissing all of the CFTC's price manipulation related charges against DRW Investments, LLC and its CEO, has dealt the CFTC a serious blow in its attempt to expand the definition of what constitutes unlawful price manipulation. The decision is based on certain findings that likely have broad application for large traders whose market conduct influences price in centralized or bilateral commodities and derivatives markets. Finding that DRW believed that its bids were in line with market value and were placed with a desire to transact, the Court concluded that where a trading pattern is supported by a legitimate economic rationale, it cannot be the basis for liability under the CEA. Although this decision remains subject to possible appeal by the CFTC, it offers some much needed guidance, as we wrote about in July 2016.[1]

The Court's decision in *CFTC v. Wilson and DRW Investments, LLC*,[2] was issued on November 30, 2018 approximately two years after a 2-week trial and resulted in the dismissal of all charges against the proprietary trading firm DRW Investments and its founder and CEO Donald R. Wilson (collectively, "DRW").

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1 For further information on this topic, please review *CFTC Presses Its Case to Expand Conduct Punishable As Manipulation* (July 26, 2016), *available at* https:/www.cliffordchance.com/briefings/2016/07/cftc_presses_its casetoexpandconduc.html

2 *U.S. Commodity Futures Trading Comm'n v. Donald R. Wilson, Jr. and DRW Invs., LLC,* No. 13-7884 (S.D.N.Y. filed Nov. 5, 2013).

This decision was foreshadowed by the Court's September 2016 decision on summary judgment, which held that the CFTC must prove that a trader intended to create an artificial price rather than merely intending to influence price in order to successfully bring charges for manipulation or attempted manipulation.[3] It reaffirms over 30 years of CFTC and judicial precedent, which has held that the specific intent to create an "artificial price," rather than the intent to merely influence price is the *sine qua non* of unlawful price manipulation. Although the Court was construing a particular anti-manipulation provision found in CFTC Rule 180.2 (the CFTC's long-standing anti-manipulation provision), the rationale of this decision has likely applicability to other provisions prohibiting price manipulation, particularly the CFTC's Rule 180.1 (which was added as part of the Dodd-Frank Act reforms).

Background

In November 2013, the CFTC filed its civil action against DRW in Manhattan federal court, alleging that DRW had attempted to manipulate and manipulated an exchange-traded interest rate swap futures contract by placing bids to influence the price of the contract. DRW has not denied that its bids were intended to influence the price of the contract. Instead, DRW admitted that after studying the contract, its management believed that the methodology used to price the contract undervalued it and traded in a manner intended to bring price in line with DRW's view of fair value.[4] The CFTC did not allege that DRW's conduct involved fraud or deceit, but instead alleged that DRW placing bids in the open market for the purpose of merely influencing a price was proof of specific intent to manipulate prices and ultimately that any influence on price was automatically an artificial price.

From the beginning, DRW argued that its trading was not manipulative because it was intended to move the price to its fair market value, an argument that courts have not been asked to address since the CFTC's landmark 1982 *Indiana Farm Bureau* decision, where the Commission established the four-part test for manipulation. Pursuant to that test, to prove illegal price manipulation the CFTC must show "(1) [t]hat the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices."[5]

Based on the four-part test, DRW initially moved to dismiss the enforcement action, but the court rejected DRW's motion, holding that it was inappropriate at that early stage to rule on DRW's factually-disputable argument.[6] In so deciding,

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3 *Court Rejects CFTC's Expansive Definition of Price Manipulation* (October 1, 2016), *available at:* https://www.cliffordchance.com/briefings/2016/10/court_rejects_cftcsexpansivedefinitiono.html

4 The enforcement action relates to the IDEX Interest Rate Swap Futures Contract ("IDEX Contract"), which is an exchange-traded Interest Rate Swap contract. The IDEX Contract is designed to mimic Over the Counter Interest Rate Swap Futures ("OTC Contract"), but it does not have a Price Adjustment Interest ("PAI") that would account for the contract's natural convexity bias. As a result, the long-side of the IDEX Contract is economically more valuable than the long-side of the OTC Contract. However, despite the difference in the value of the contracts, the method of calculating the settlement price for the IDEX Contract could result in the contract being treated as economically equivalent to the OTC Contract. This would occur because the settlement price would be based on the swap curve for OTC Contracts if there were no electronic trades during the settlement period, or if there were no bids or offers, or the clearinghouse decided not to consider bids and offers in calculating the settlement price.

5 *In re Ind. Farm Bureau Coop. Ass'n, Inc*., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 21,796, 1982 WL 30249 at *6, (CFTC Dec. 17, 1982).

6 *U.S. Commodity Futures Trading Comm'n v. Wilson*, 27 F. Supp. 3d 517, 533 (S.D.N.Y. 2014).

the Court used a short-hand version of the four-part test, which originated in a 1987 Commission decision dismissing an enforcement action.[7]

The CFTC argued on summary judgment that the short-hand test, rather than the full test was the law of the case and that it need only show that DRW intended to influence price to prove manipulation. In other words, the CFTC claimed that it did not need to show that an "artificial" price existed.[8] Consequently, since it was undisputed that DRW acted to influence price, the CFTC argued that it had satisfied the intent requirement for price manipulation.

Five key participants in the futures market, including futures exchanges, clearinghouses, and trade associations filed an *amicus curiae* brief opposing the CFTC's position. The *amici* believed that under the CFTC's looser interpretation of the requisite intent, there would be no way "to ensure that innocent trading activity not be regarded with the advantage of hindsight as unlawful manipulation." The *amici* shared concerns first expressed by the Commission in *Indiana Farm Bureau* that a lesser standard could "wreak havoc with the market place" by blurring the line between lawful and unlawful activity, leaving traders without adequate guidance on what constitutes manipulation. Because the CFTC sought to punish *all* attempted price influences, even ones that would result in more accurate prices, the *amici* feared that traders would "abstain from legitimate trading to avoid the risk of being branded an attempted manipulator." The court agreed with the defendant and the *amici*, holding that the "CFTC's interpretation is incorrect," and that the CFTC must prove that there is an intent to cause artificial prices.[9]

After the summary judgment decision, Judge Analisa Torres, who had been handling the case since November 2013, was replaced by Judge Richard Sullivan, who presided over the bench trial. During the trial, Judge Sullivan challenged the arguments put forward by both sides but seemed particularly skeptical of the Commission's evidence regarding price artificiality. Peppering the CFTC attorneys with questions during their closing arguments, he asked them to explain the evidence that the price was artificial and suggested that the logical inference from the lack of other bidders for the contract was that DRW's bidding prices were too low, rather than high.

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7 This shorthand version requires that the CFTC "allege '(1) that the accused had the ability to influence market prices; (2) that [he] specifically intended to do so; (3) that artificial prices existed; and (4) that the accused caused the artificial prices'" to support a price manipulation claim. In that case, *In re Cox*, the Commission ultimately "did not find it necessary" to examine the defendant's intent, but noted that the Administrative Law Judge ("ALJ") may have "used the same flawed methodology that we rejected in *Indiana Farm Bureau*" in ruling on specific intent. *In re Cox* [1986–1987 Transfer Binder] No. 75–16, Comm. Fut. L. Rep. (CCH) ¶ 23,786, 1987 WL 106879, at *4 (CFTC July 15, 1987). Similarly, *DiPlacido v. CFTC*, a Second Circuit decision which was also cited by the court, did not turn on the intent of the trader. Instead, the ALJ who initially decided the case found that DiPlacido had an intent to manipulate the contract because it "had no apparent business or economic rationale except to influence market prices." *In re Anthony J. DiPlacido*, CFTC No. 01-23, 2008 WL 4831204, at *10 (Nov. 5, 2008). The Second Circuit, in reviewing the decision, similarly held that the ALJ's intent decision was supported by DiPlacido "having violated bids and offers," as well as "taped conversations signaling manipulative intent and the ALJ's finding that DiPlacido's denial of intent lacked credibility." *DiPlacido v. CFTC*, 364 F. App'x 657, 661 (2d Cir. 2009).

8 Pl. Response in Opp. to Defs. Mot. For Summary Judgment, at 29, *U.S. Commodity Futures Trading Comm'n v. Wilson*, No. 13-7884, (S.D.N.Y. Dec. 22, 2015), ECF No. 119 (*citing* Wilson, 27 F. Supp. 3d at 531-32).

9 Memorandum and Order, *Commodity Futures Trading Comm'n v. Donald R. Wilson*, No. 13-cv-7884 (S.D.N.Y. Sept. 30, 2016), ECF No. 139 at 26.

Analysis of Decision

Judge Sullivan, who was elevated to the Second Circuit Court of Appeals in October 2018, rejected the CFTC's manipulation and attempted manipulation claims in short order, describing them as "little more than an 'earth is flat'-style conviction."[10] In the judge's view, DRW committed no offence because "[i]t is not illegal to be smarter than your counterparties in a swap transaction, nor is it improper to understand a financial product better than the people who invented that product."[11]

Ruling on the CFTC's manipulation claim, the Court rejected as "absurd" the CFTC's expert's opinion that DRW's bids were necessarily illegitimate because DRW was the only participant placing bids on the contract, which necessarily "created artificial settlement prices."[12] Instead, the Court found that DRW placed bids based on its understanding of the contract, which "actually contributed to price discovery."[13] The Court went on to describe the CFTC's argument that any price that was influenced by DRW's conduct was necessarily artificial as a "tautological fallback" before rejecting it for effectively eliminating the artificial price requirement and "collapsing it into the subjective intent requirement."[14] According to the Court, such a rule would "effectively bar market participants with open positions from ever making additional bids."[15]

The Court also made short-shrift of the CFTC's attempted manipulation allegations. According to Judge Sullivan, "trial testimony and exhibits prove[d] beyond the shadow of a doubt that Defendants sincerely believed the value of the [exchange traded-contract] was higher than the bids they submitted."[16] Based on this belief, the Court concluded that DRW "made bids with an honest desire to transact at those prices, and that they fully believed the resulting settlement prices to be reflective of the forces of supply and demand."[17] As Judge Sullivan put it, because the "trading pattern is supported by a legitimate economic rationale, it 'cannot be the basis for liability under the CEA.'"[18] "Any other conclusion would be akin to finding manipulation by hindsight."[19]

Key Takeaways

The Court's rejection of the CFTC's new stance on intent should provide some comfort to market participants concerned with the CFTC's more aggressive recent approach to price manipulation, as the CFTC must now provide evidence that there was an intent to create an artificial price rather than merely an intent to influence price. This will undoubtedly also make it more difficult for the CFTC to successfully prosecute Rule 180.2 price manipulation cases, which are likely to turn on expert evidence. As a result, we expect that the CFTC will appeal this

10 *U.S. Commodity Futures Trading Comm'n v. Wilson*, 2018 WL 6322024, *21 (S.D.N.Y. Nov. 30, 2018).
11 *Id*. at *21.
12 *Id.* at *13.
13 *Id.* at *14.
14 *Id.* at *14.
15 *Id.* at *14-15.
16 *Id*. at *15.
17 *Id.* at *20.
18 *Id.* at *20 (quoting *In re Amaranth*, 587 F. Supp. 2d 523, 527 (S.D.N.Y. 2008).
19 *Wilson*, 2018 WL 6322024 at *20.

ruling, as well as the Court's earlier summary judgment ruling, to reassert its authority to bring Rule 180.2 cases based on this theory.

Aside from a possible appeal, the CFTC may attempt to limit any benefit to market participants by continuing in its recent attempts to pursue similar theories of liability under its Rule 180.1 authority, which was added pursuant to certain Dodd-Frank Act-related statutory amendments. In particular, the CFTC's pending case against Kraft Foods in Chicago federal court suggests that the CFTC will seek to prosecute market participants when it can be established that the purpose of their conduct was to influence price or even that the market participant was reckless in regard to price impact, irrespective of whether any fraudulent or deceptive statement was made.[20] Nevertheless, while we expect that the CFTC may try to allege a Rule 180.1 violation when bringing future cases, rather than relying upon the now-limited Rule 180.2, the Court's rationale in requiring both the existence of an artificial price and the trader's intent to create an artificial price is likely to be persuasive in such cases, given the well-established requirement that the specific intent to create an artificial or distorted price is essential for finding price manipulation in cases premised on open market transactions.[21]

[20] For further discussion of this topic, please review *Freedom to Trade in the Age of Heightened Market Protection* (April 3, 2016), *available at* https://corpgov.law.harvard.edu/2016/04/03/freedom-to-trade-in-the-age-of-heightened-market-protection/

[21] For further information on this topic, please review *U.S. Market Manipulation: Has Congress Given the CFTC Greater Latitude than the SEC to Prosecute Open Market Trading as Unlawful Manipulation? It's Doubtful* (June 2018), *available at* https:/www.cliffordchance.com/content/dam/cliffordchance/PDFDocuments/FDLR_6_Art_1.pdf

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