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Screaming into a Pit: CFTC Gets Empty Response to Market Manipulation Claims

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In an opinion released on November 30, 2018, federal Circuit Judge Richard Sullivan dismissed a lawsuit brought by the U.S. Commodity Futures Trading Commission (the "CFTC") seeking to hold a prominent Chicago trader and his investment firm liable for manipulation and attempted market manipulation of a highly illiquid segment of the interest rate swaps market. The decision—which followed a four-day bench trial conducted in 2016—is noteworthy not only for the setback dealt to the CFTC in its first market manipulation trial since 2008, but also for the overarching tenor of the opinion. The CFTC had argued that defendants, responding to a perceived undervaluing of certain swaps, had engaged in market manipulation by placing bids designed to drive up the price of those swaps, thereby benefiting from gains to preexisting long positions and from daily margin payments. Judge Sullivan pulled no punches in concluding that efforts to drive prices towards their "true" value are not the same thing as manipulation, alternatively describing the CFTC's arguments and evidence as "absurd," "sermonizing," "tautological," and on par with an "earth is flat" denial of basic facts. In addition to its harsh criticism of the CFTC's case, the court arguably set a higher bar for the government to establish the artificial price element of market manipulation claims, expressly rejecting the CFTC's long-held position that proving a defendant's subjective intent to affect the price of commodity could alone satisfy this requirement. What effect the decision will have on the CFTC's appetite for pursuing market manipulation—particularly at trial—remains to be seen, but the court's emphatic dismissal will undeniably serve as an important benchmark for market participants assessing enforcement risk in an area of law with few judicial precedents to draw on for guidance.

I. Background

In November of 2013, the CFTC filed a complaint against Chicago-based trader Don Wilson and DRW Investments, LLC (collectively, "DRW") in the Southern District of New York, arguing that they had manipulated and attempted to manipulate the price of a commodity interest in violation of the Commodity Exchange Act ("CEA"). At the center of DRW's defense was its assertion that it had discovered an arbitrage opportunity in the market for certain interest rate swaps between those available on the over-the-counter ("OTC") market and those offered through certain derivative clearing organizations, including International Derivatives Clearinghouse ("IDCH"). Specifically, DRW argued, and Judge Sullivan accepted, that the IDEX USD Three-Month Interest Rate Swap Futures Contract (the "Three-Month Contract") should be priced above the OTC equivalent product because the Three-Month Contract required counterparties to make daily margin payments reflecting any losses from a particular day's activity. Importantly, because the party that is "long" in its swap position can reinvest those payments in relatively better market conditions, the presence of daily margin payments creates a "convexity effect" that distorts the value of a cleared contract relative to OTC swaps.

To capitalize on the perceived arbitrage opportunity, DRW took a long position in the Three-Month Contracts. However, DRW eventually recognized that, per the terms of the Three-Month Contracts, margin payments would be determined by IDCH based on, in order of priority: (1) electronically submitted bids and offers that were open between 2:45 and 3:00 p.m. EST (the "PM Settlement Period"); (2) the settlement price of consummated trades made during the PM Settlement Period; and (3) the prevailing interest rates in the OTC swap markets. DRW therefore began placing a large percentage of its bids during the PM Settlement Period, aware that doing so would result in a higher price for the Three-Month Contract. However, as the court recognized, the price at which DRW made daily bids always remained below what DRW viewed to be the "actual" price.

Despite offering a better-than-going rate for swaps on the IDCH exchange on a near-daily basis, DRW found very few counterparties willing to engage with them. Indeed, over an eight-month period in 2011, DRW submitted more than 2,500 such bids but failed to consummate a single transaction. The CFTC viewed this activity as an attempt to "bang the close," and generate improper profits by increasing the daily margin payments to which they were entitled from the counterparties to their preexisting long positions.

II. Analysis

The court began by laying out no less than five major gaps in the government's evidence:

> First, there is no evidence that DRW ever made a bid that it thought might be unprofitable. . . . Second, there is no credible evidence that DRW ever made a bid that it thought could not be accepted by a counterparty. . . . Third, the CFTC provided no credible evidence as to what the fair value of the contract actually was at the time DRW was making its bids. . . . Fourth, there is no credible evidence that DRW's bidding practices ever scared off would-be market participants. . . . And finally, there is no evidence that DRW ever made a bid that violated any rule of the exchange—a fact the CFTC conceded in its closing argument.

Diving into the analysis, the court examined the four elements of market manipulation as set out by the Second Circuit: (1) Defendants possessed an ability to influence market prices; (2) an artificial price existed; (3) Defendants caused the artificial prices; and (4) Defendants specifically intended to cause the artificial price.[1] While the court was satisfied that the CFTC had established DRW's ability to influence market prices, the court concluded that the CFTC's "case founders on its abject failure to produce evidence—or even a coherent theory—supporting the existence of an artificial price." The court took great issue with the CFTC's expert who, rather than establish what the non-manipulated price would have been, continuously argued that unconsummated transactions should not have been permitted to affect the price, clinging to that view "as an article of near religious conviction" despite the fact that it had "no basis in law or logic and was contradicted by the contract's very terms and IDCH's own rules."

The court also discredited the CFTC's position 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." This argument by the CFTC leaned heavily on a well-worn administrative decision, *In re Indiana Farm Bureau Cooperative Association, Inc*.[2] But, as the court explained, "dictum in its own thirty-five year-old administrative decision" cannot support an "intent-based approach to assessing artificial price . . . , which taken to its logical conclusion would effectively bar market participants with open positions from ever making additional bids to pursue future transactions." The court's rejection of this argument is another setback to the CFTC, which has consistently argued, with limited success, for anti-manipulation regulatory authority that is untethered from the requirement of an artificial price.[3]

Notably, however, while chastising the CFTC for its "attempt to read out the artificial price element of the [CEA's manipulation] test by collapsing it into the subjective intent requirement," the court may have added a burden—if not an additional element—to that same test. Late in its analysis, the court observed, "[t]he inescapable conclusion from the evidence introduced at trial is that DRW's bids, and the consequent settlement prices, were the result of free competition,

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[1] *In re Amaranth*, 730 F.3d 170, 183 (2d Cir. 2013) (*quoting Hershey v. Energy Transfer Partners*, 610 F.3d 239, 247 (5th Cir. 2010)).

[2] 1982 WL 30249 (CFTC Dec. 17, 1982).

[3] For instance, the *DRW* court had previously rejected the exact same argument during pre-trial motions in this case. *See CFTC v. Donald Wilson & DRW Inv., LLC*, 2016 WL 7229056 at *7 (SDNY Sept. 30, 2016) ("The CFTC interprets this language as holding that the intent standard is merely the 'intent to affect market price.' The CFTC's interpretation is incorrect."). Similarly, the CFTC had argued unsuccessfully in *CFTC v. Kraft*, 153 F. Supp. 3d 996 (N.D. Ill. 2015), that its Rule 180.1 circumvented both the artificial-price and the specific-intent elements of proof for manipulative trading.

since sophisticated market participants would surely have accepted [DRW's] open bids if they thought they were above market value." Following from that observation, the court held that in the absence of establishing that DRW had somehow evaded market risk, "the CFTC's failure to articulate any theory as to why the market was inefficient, or why would-be counterparties were prevented from enforcing market discipline by hitting DRW's allegedly inflated bids, is ultimately fatal to its claim." In describing this line of reasoning as "ultimately fatal to the claim," the court may have introduced a requirement that, where a CFTC defendant exposes itself to market risk, the government bears the burden of establishing an alternative explanation (such as market inefficiency) for their failure to experience the consequences of that risk. It will be interesting to see which, if any, future courts look to the decision here for support of this novel theory.

Lastly, the court turned to the attempted market manipulation claim, which "[u]nlike market manipulation, . . . does not require proof of an artificial price—only that Defendants '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.'" But, once more, the CFTC's case failed to get out of the gate. As the court again explained, "the mere intent to affect *prices* is not enough; rather, the CFTC must show that Defendants intended to cause *artificial* prices—i.e., prices that they understood to be unreflective of the forces of supply and demand." Judge Sullivan decided that not only had the CFTC failed to meet its burden under the applicable preponderance of the evidence standard, but that the evidence had actually affirmatively disproven their case: "In fact, the trial testimony and exhibits prove beyond the shadow of a doubt that [DRW] sincerely believed the fair market value of the [IDCH swaps] was higher than the bids they submitted over the course of the alleged conspiracy." As a result, the price increase that DRW was attempting to cause was not artificial and, therefore, did not constitute attempted market manipulation.

III. Conclusion

As the court observed, "[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." Indeed, the court noted that virtually all market participants (or, as the court explained it, everyone except the CFTC's Enforcement Division and its expert witness) eventually concluded that DRW's analysis of the arbitrage opportunity was correct. The court chastised the CFTC for failing to recognize these facts and persisting in what it called an "'earth is flat' style conviction" in pursuing the case. Whether the Commission retreats from its aggressive position in light of this decision and the additional potential hurdle erected to bringing such a claim by Judge Sullivan will be important to monitor moving forward.

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