

Pre-trial Briefing: *CFTC v. Wilson* and the Requirement of Intent to Cause an Artificial Price in Attempted Manipulation Cases

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Futures and Derivatives; CFTC

The Commodity Futures Trading Commission is set to begin its trial of Donald R. Wilson and his proprietary trading firm, DRW Investments, LLC (“DRW”) on December 1, 2016. In advance of this trial, this alert provides the legal theory that will be tested during this trial and other observations related to the CFTC’s pursuit of attempted manipulation.

The trial of this matter became a certainty on September 30, 2016, when a federal judge denied a motion for summary judgment by the CFTC in *CFTC v. Wilson*,¹ and in doing so clarified the standard required to prove the intent element of an attempted price manipulation claim. In its summary judgment briefing, the CFTC argued that it only had to prove that DRW and its principal Donald R. Wilson,² had an “intent to affect the market price.” The court disagreed, holding that the CFTC had to prove that the defendant had an intent to cause an artificial price. Market participants had expressed alarm at the intent standard advanced in the CFTC’s briefing, and subsequently expressed relief at the court’s holding.

However, the court’s ruling ultimately may not provide as much comfort to market participants as the initial reaction suggested. First, determining whether there is sufficient intent to cause an artificial price requires a case-specific, facts-and-circumstances approach, and the facts and circumstances required to show such intent remains an open question. Second, the CFTC may simply bring more enforcement actions under a fraud-based manipulation theory, either alone or in conjunction with price manipulation cases, as fraud-based manipulation has the lower intent standard of recklessness.

CFTC v. Wilson

The CFTC’s allegations concern an exchange-cleared three-month interest rate swap futures contract (the “IDCH Contract”) listed by the International Derivatives Clearinghouse (“IDCH”). The direction and amount of the daily margin payments for the IDCH contract are determined based on a curve IDCH constructs by compiling the daily settlement rates for the various

¹ Memorandum and Order, *CFTC v. Wilson*, 13-civ-7884 (AT) (S.D.N.Y) (Sept. 30, 2016) (“Wilson Opinion”).

² For convenience, we will refer to defendants collectively as DRW throughout this alert.

contract tenors (the “IDCH Settlement Curve”). The daily settlement rates are determined, in part, using the prevailing rates on corresponding contracts in the over-the-counter swap markets (“Corresponding OTC Rates”), with the best bids and offers submitted electronically between 2:45 and 3 p.m. ET (“PM Settlement Period”) limiting the IDCH Settlement Curve. A higher curve increases the profits of parties with a long position in the IDCH Contract.³

By September 2010, DRW had acquired a net long position in the IDCH Contract of about 3,500 contracts with a notional value of \$350 million through bilateral trades conducted with a voice broker. In January 2011, DRW received the ability to place electronic bids, and between January and August 2011, DRW placed 496 bids on IDCH’s electronic platform for the IDCH Contract during the PM Settlement Period that were above the Corresponding OTC Rates. These trades were incorporated into the IDCH’s calculation of daily settlement rates and increased the IDCH Settlement Curve, which benefited DRW as the holder of a large long position in the IDCH Contracts.⁴

In total, DRW placed 2,894 electronic bids that were above the Corresponding OTC Rates, none of which were hit with a corresponding offer. However, one bid did attract MF Global, which did not have the ability to submit an electronic offer. DRW bid a notional amount of \$1 billion, at a value above the Corresponding OTC Rates, and subsequently accepted MF Global’s counteroffer for a \$250 million notional amount. The transaction eventually fell through because paperwork was not submitted in time for IDCH to clear the trade, and MF Global refused to form a new trade.⁵

DRW was aware that its electronic bids influenced the IDCH Settlement Curve. DRW even explained to IDCH that it believed the IDCH Contract was not “economically equivalent” to the OTC market. DRW posted electronic bids that were closer to the (higher) Corresponding OTC Rates so that the IDCH Settlement Curve better reflected what DRW believed to be the true market. CFTC argued that DRW’s actions resulted in the attempted manipulation of the IDCH Contract because DRW intended to affect the price of the contract to benefit DRW’s long position in the OTC market. DRW claimed its trading activities merely reflected its view of the true market price for the contract.

The CFTC moved for partial summary judgment on its attempted manipulation claim arguing that the claim involves only two elements: (1) an intent to affect market prices; and (2) an overt act in furtherance thereof.⁶ Accordingly, since it was undisputed that DRW traded with intent to affect the market price of the IDCH contract and in fact took overt steps to affect the market price, the CFTC argued that it was entitled to summary judgment on its attempted manipulation claim.⁷

³ Wilson Opinion at 5, 7.

⁴ *Id.* at 7-10.

⁵ *Id.* at 8-9.

⁶ The CFTC brought its claim pursuant to Sections 6(c) and 9(a)(2) of the Commodity Exchange Act (the “Act”), 7 U.S.C. §§ 9 and 13(a)(2) (2006 & Supp. IV). The statutory claim for manipulation is also set forth in the CFTC regulations at Regulation 180.2 pursuant to the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), although the conduct alleged in this matter took place before the implementation of Dodd-Frank.

⁷ *Id.* at 25-26.

The court disagreed with the CFTC's characterization of the first element of attempted manipulation. Specifically, the court held that the CFTC must prove that DRW had an intent to cause an artificial price, not just affect a market price. The court characterized this statement of intent as a well-settled standard.⁸ Having established that the CFTC must show DRW's specific intent to cause an artificial price, the court held that there were facts sufficient for a reasonable jury to conclude that DRW lacked this intent, including: (1) that there may have been a legitimate economic rationale for pricing IDCH's contracts above the Corresponding OTC Rates,⁹ and; (2) DRW in fact attempted to consummate a trade with MF Global at a notional value three times larger than its open long position and above the Corresponding OTC Rates.¹⁰

DRW also moved for summary judgment, arguing that there was no evidence that it had any intent to cause artificial prices. The court also denied DRW's motion, holding that there were sufficient facts for a reasonable jury to conclude that DRW did in fact intend to create an artificial price. Specifically, a jury could make this determination based on evidence that: (1) DRW developed a large long position and then placed electronic bids in the Settlement period, at increasingly higher prices without finalizing a transaction; (2) DRW had the intent of affecting IDCH's settlement curve; and (3) statements made by DRW traders indicating they did not think their bids would be accepted.¹¹

Thus, both sides are subject to the fact finder's determination as to whether DRW merely intended to affect prices (no attempted manipulation) or intended to cause artificial prices (attempted manipulation). Either determination, according to the court, would be reasonable. As the trial is set to begin on December 1 and the court, as opposed to a jury, will be the fact-finder, the parties will learn quickly with whose position the court agrees.

Is the Attempted Manipulation Intent Requirement “Well-Settled”?

As noted above, the court stated that it was a well-settled principle that the requisite intent for an attempted price manipulation claim is whether the defendant intended to cause artificial prices, not merely whether the defendant attempted to affect market prices. Not only was this the

⁸ *Id.* at 26. The CFTC's argument regarding the appropriate intent standard did mirror the language used by the court in a prior opinion denying DRW's motion to dismiss. See *U.S. Commodity Futures Trading Comm'n v. Wilson*, 27 F. Supp. 3d 517, 531–32 (S.D.N.Y. 2014) (“To state a claim for attempted manipulation, the CFTC must allege (1) an intent to affect market prices and (2) an overt act in furtherance thereof.”). Indeed, the CFTC argued vigorously that the law of the case, i.e. that the court's prior decision in the matter on the motion to dismiss, specifically the court's own recitation of the appropriate intent standard, should control its future decisions and dictated that the court adopt the CFTC's argument. However, the court dismissed this language as mere “shorthand” for the “well settled” principle that “the intent to create an *artificial* price is the correct standard.”

⁹ In cleared interest rate swap contracts, the long party, i.e., the party that pays according to a fixed interest rate, benefits disproportionately from the daily exchange of margin, because the margin can be invested and the long party receives margin when interest rates are higher, a characteristic known as the “convexity effect.” Uncleared OTC interest rate swaps contracts lack this characteristic because there is no exchange of margin. Typically, a cleared interest rate contract will include a price adjustment to counteract the convexity effect. The IDCH contract apparently lacked such an adjustment, which is why it would have been more valuable than corresponding OTC swaps.

¹⁰ *Wilson* Opinion at 27.

¹¹ *Id.* at 26.

argument advanced by DRW, but it was also advanced by market participants. In an *amicus* brief filed with the court, several industry participants argued that the CFTC's proposed interpretation would upend decades of legal precedent regarding the requisite intent for attempted price manipulation, including interpretations by the CFTC itself, and would open the floodgates to enforcement actions charging price manipulation for legitimate and necessary trading activities. The CFTC, in its briefing argued the precise opposite: that it is well-settled that intent to affect market prices is all that was required to prove the requisite intent.

CFTC's Typical Articulation of Manipulative Intent Standard

Multiple CFTC enforcement actions settled over the past several years illustrate how the agency typically characterizes the requisite intent for both completed and attempted price manipulation claims and lays out the key caselaw that developed those standards.¹² As to completed price manipulation, the CFTC sets out the elements as follows:

- (1) the defendant had the ability to influence market prices;
- (2) the defendant specifically intended to do so;
- (3) artificial prices existed; and
- (4) the defendant caused an artificial price.¹³

Taking these elements at face value and in isolation, there would appear to be no requirement to prove an intent to cause artificial prices—instead, there appears to simply be a requirement that the person intended to *influence* market prices, and then a requirement to prove that an artificial price was created and was caused by that person.¹⁴ However, in the discussion following its recitation of these elements, the CFTC states that it must show that the defendant's actions were taken with the purpose of causing a price “that did not reflect the legitimate forces of supply and demand,” i.e., an artificial price, citing the key case *In re Indiana Farm Bureau*.¹⁵ This discussion appears to introduce “intent to cause an artificial price” as an element, even though the elements themselves appear on their face to have no such requirement.

The CFTC asserts that the “intent standard [for attempted price manipulation] is the same as that for manipulation.”¹⁶ In one recent case, the CFTC recited the elements of attempted price manipulation as: “(1) an intent to affect the market price; and (2) an overt act in furtherance of

¹² See e.g., *In re UBS AG and UBS Securities Japan Co., Ltd.*, CFTC Docket No. 13-09 (Dec. 19, 2012) and *In re Barclays plc et. al*, CFTC Docket No. 12-25 (Jun. 27, 2012).

¹³ *UBS* at 54.

¹⁴ The Second Circuit in *DiPlacido v. CFTC* has held that the CFTC's articulation of the elements for completed price manipulation is not arbitrary or capricious. See *DiPlacido v. Commodity Futures Trading Comm'n*, 364 F. App'x 657, 661 (2d Cir. 2009). However, some courts have articulated the elements for completed price manipulation cases slightly differently than the CFTC. For example, in *In re Amaranth*, the Second Circuit set out the elements as follows: “(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.” *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 173 (2d Cir. 2013).

¹⁵ *Id.*, citing *In the Matter of Indiana Farm Bureau Cooperative Association, Inc., and Louis M. Johnston*, CFTC No. 75-14, 1982 WL 30249, at *4 (Dec. 17, 1982).

¹⁶ *Id.*

that intent,”¹⁷ which is the exact formulation the CFTC argued for in *Wilson*, and which, on its face, has no requirement of intent to cause an artificial price. But the CFTC’s application of the facts and circumstances to these elements suggests that underpinning the concept of an “intent to affect the market price” is actually an intent to cause an artificial price. The CFTC again quotes *Indiana Farm Bureau* for this proposition, stating “it is not necessary to prove that the accused knew to any particular degree of certainty that his actions would create an artificial price. It is enough to present evidence from which it may reasonably be inferred that the accused ‘consciously desire[d] that result, whatever the likelihood of that result happening from his conduct.’”¹⁸

Note that completed price manipulation has three elements that attempted manipulation does not: (1) ability to influence prices; (2) existence of an artificial price; and (3) the defendant’s causation of that artificial price. In other words, determination of an actual artificial price is fully incorporated into the analysis of a completed price manipulation claim, whether the intent element requires an intent to cause an artificial price or merely an intent to influence prices. As a theoretical matter, the distinction between the two intent elements is important. As a practical matter, once it is proven that there was an intent to influence market prices coupled with actually causing an artificial price, it may be difficult to show that the intent to influence market prices was not also an intent to cause the artificial price that resulted.

Attempted price manipulation, however, does not require proof of an actual artificial price, even if the requisite intent is “intent to cause an artificial price.” Otherwise attempted price manipulation would be completed manipulation. Accordingly, the distinction between intent to simply affect the market price and intent to cause an artificial price is a critical one, because that intent, coupled with an overt act will lead to liability. Yet, in articulations of the attempted manipulation intent standard, as reflected in recent CFTC enforcement actions, this distinction has not always been clearly stated. Again, the CFTC will rely on the specific facts and circumstances of each case to prove the intent element, which leaves market participants without clear guidelines as to what will trigger an enforcement action based on attempted manipulation.

Ultimately, the language defining the elements of both completed and attempted price manipulation can be traced back to a 1977 CFTC decision, *In re Hohenberg Bros.*, a case the CFTC cites frequently when setting out the attempted manipulation intent standard. In *Hohenberg Bros.*, the CFTC stated:

[M]anipulation has been defined generally as conduct intentionally engaged in resulting in an artificial price, i.e., a price that does not reflect the basic forces of supply and demand. A finding of manipulation in violation of the Act requires a finding that the party engaged in conduct with the intention of affecting the market price of a commodity (as determined by the forces of supply and demand) and as a result of such conduct or course of action an artificial price was created. An attempted manipulation, on the other hand, is simply a manipulation that has not succeeded—that is, the conduct engaged in

¹⁷ *Id.* at 56. Courts reciting the elements of attempted manipulation claims have also used the same language the CFTC has used recently: “(1) an intent to affect the market price of a commodity; and (2) some overt act in furtherance of that intent.” *U.S. Commodity Futures Trading Comm’n v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 250 (S.D.N.Y. 2012)

¹⁸ *In re Barclays* at 27.

has failed to create an artificial price. An attempted manipulation requires only an intent to affect the market price of the commodity and some overt act in furtherance of that intent.¹⁹

This would appear to support the argument that neither completed nor attempted price manipulation requires an intent to cause an *artificial* price. However, in the same opinion, the CFTC stated that there is “no difference in the intent required to accomplish a manipulation and that required by an attempted manipulation, which is simply the performance of an act or conduct *which was intended to effect an artificial price.*”²⁰ In 1982, the CFTC in *Indiana Farm Bureau* seemed to clarify that the latter was the appropriate standard stating, “the Commission explained that the intent requirement, which is the same for a manipulation and an attempted manipulation, is ‘the performance of an act or conduct which was intended to effect an artificial price.’ We adhere to this general description.”²¹

Legal Effect of the Court’s Decision in *Wilson*

The upshot is that both the CFTC and DRW were, at least in a sense, correct about how well-settled their competing arguments regarding the requisite intent for an attempted price manipulation claim. Indeed, both could point to language from the same 1977 case to support their arguments. The legal effect, then, of the court’s decision on the motion for summary judgment is to clarify that the requisite intent for proving attempted price manipulation is the same standard CFTC appeared to articulate in *Hohenberg Bros. and Indiana Farm Bureau*, a standard which the CFTC and courts have always drawn heavily from, even as they sometimes used arguably imprecise language in articulating and applying the standard. There is now, however, a clear, bright line rule. In order to prove attempted price manipulation, the CFTC must show: (1) an intent to cause an *artificial* price; and (2) an overt act in furtherance thereof.

Manipulation Claims Are Here to Stay Notwithstanding *Wilson*

While the legal effect of the court’s decision in denying the CFTC’s motion for summary judgment seems clear, it will take some time for the practical effects to reveal themselves. Some observers have argued that the CFTC has recently attempted to broaden its anti-manipulation authority, including by lowering the intent standard for attempted price manipulation from “intent to cause artificial prices” to “intent to affect market prices.” On this view, the court’s ruling on the intent standard might constitute a significant setback for the CFTC, which could lead them to bring fewer manipulation enforcement actions in the future. However, this assumption is likely flawed. First, the court’s decision in *Wilson* may not have raised (or re-raised) the bar for an attempted price manipulation claim as much as it might appear at first blush, as discussed above. Second, even if the CFTC is inclined to bring fewer *price* manipulation cases, it may well bring more *fraud-based* manipulation cases.

¹⁹ *In re: Hohenberg Bros.*, CFTC Docket No. 75-4, Comm. Fut. L. Rep. (CCH) ¶ 20,271 (February 18, 1977) (Feb. 18, 1977).

²⁰ *Id.* (emphasis added).

²¹ *In re Indiana Farm Bureau*, at *4. In *Indiana Farm Bureau* the CFTC also clarified that the intent required was specific intent, rather than general intent.

Facts and Circumstances: Manipulation Is in the Eye of the Beholder

While market participants may have cheered the court's decision in *Wilson*, DRW did not necessarily "win." As noted above, DRW itself moved for summary judgment on both the completed and attempted price manipulation claims, arguing that there were no facts suggesting it intended to cause an artificial price. The court disagreed on the basis of evidence indicating that DRW opened a large long position and then placed bids without finalizing a transaction, that DRW had the intent of affecting IDCH's settlement curve, and that DRW traders made statements that they did not think their bids would attract offers. These factors, according to the court, constituted sufficient evidence to allow a fact-finder to conclude that DRW did attempt to manipulate the price of the IDCH Contract. As the court acknowledged, however, this conduct could be also consistent with innocent trading, especially when considering that DRW seemed to have a legitimate, economic rationale for hoping one of their bids above the Corresponding OTC Rates would get hit with a corresponding offer, and indeed attempted to transact when MF Global showed interest in their bids. Nevertheless, to escape liability for attempted price manipulation, DRW must convince the court as the fact finder that its conduct was not intended to create an artificial price.

Similarly, market participants should not assume that, in light of *Wilson*, their trading activities will be shielded from scrutiny as possible price manipulation. As noted above, price manipulation has always been "characterized by fact-specific, case-by-case analysis."²² It remains to be seen, even given *Wilson*, how aggressive the CFTC will be in interpreting trading activity, that could plausibly be innocent, as actions constituting attempted price manipulation. If the CFTC continues to refer to *Indiana Farm Bureau* as its guide, then the CFTC's holdings in that case may provide some clue for market participants on where the agency will draw the line between legitimate market activity and activity the CFTC will deem containing the intent to manipulate: "market participants have a right to trade in their own best interests without regard to the positions of others as long as their trading activity does not have as its purpose the creation of 'artificial' or 'distorted' prices...But once it is demonstrated that the alleged manipulator sought, by act or omission, to move the market away from the equilibrium or efficient price—the price which reflects the market forces of supply and demand—the mental element of manipulation may be inferred."²³

It is also worth noting that, although the CFTC is now clearly required to show "intent to cause an artificial price," nothing in the court's decision suggests that the CFTC is required to show, in an *attempted* price manipulation case, that an artificial price could actually have resulted from the defendant's conduct.²⁴ Because showing the existence and causation of an artificial price is one of the most difficult elements of proof in a price manipulation case, if the CFTC does not prove that an artificial price could have resulted from attempted price manipulation, it may well continue to investigate and bring actions under an attempted price manipulation theory where it is unable to prove a completed price manipulation.

²² *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1044 (N.D. Ill. 1995)

²³ *In re Indiana Farm Bureau* at *6-*7.

²⁴ *Cf. In re Indiana Farm Bureau* at *7 ("it is not necessary to prove that the accused knew to any particular degree of certainty that his actions would create an artificial price.")

Fraud-Based Manipulation

Even if the CFTC is inclined to bring fewer price manipulation cases following *Wilson*, this does not mean it will bring fewer manipulation cases overall. In addition to the prohibition of price manipulation under CFTC Rule 180.2 (and the statutory provisions of Sections 6(c) and 9(a)(2) of the Act), CFTC Rule 180.1 also prohibits fraud-based manipulation. To prove fraud-based manipulation, whether completed or attempted, the CFTC does not need to show causation of an artificial price, and does not need to show intent to cause an artificial price. Instead, the CFTC need only show that a defendant took actions that were intended to mislead the market, for example by falsely signaling its demand for a certain commodity or its intention to enter a certain trade. The CFTC has shown its willingness to aggressively bring cases under Rule 180.1, as recent filings show.²⁵ Importantly, a fraud-based manipulation claim can be proven if the defendant *recklessly* took actions that would mislead market participants. Thus, in a fraud-based manipulation case, the CFTC does not need to show specific intent to mislead investors, but “an extreme departure from the standards of ordinary care which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”²⁶

Thus, given the availability of fraud-based manipulation as a theory of liability which may be easier for the CFTC to prove than price manipulation, market participants may soon see more fraud-based manipulation cases, or fraud-based manipulation cases brought more frequently in conjunction with price manipulation cases.

Trade Monitoring

Because the CFTC is not likely to bring fewer manipulation cases, market participants need to continue to exercise diligent oversight over their trading activity. Firms should have sufficient trade surveillance systems that monitor trading activity in order to raise red flags for the internal review of potential manipulation. Firms should also have clear and strong anti-manipulation rules in their trading policies and procedures, and provide specific training on what is prohibited. It is also important that firms train their traders on the importance of the language they use when discussing trading strategies, as communications about trading strategies are frequently used as evidence in determining manipulative intent. For example, the court in *Wilson* determined that, because DRW traders had indicated that they did not think their bids would attract an offer, a jury could find evidence of manipulative intent. When discussing trading strategies, traders should be mindful of how statements could be perceived by the CFTC and used by the agency to craft a price or fraud manipulation case.

²⁵ See *U.S. Commodity Futures Trading Comm'n v. Nav Sarao Futures Limited PLC*, 15-cv-03398 (N.D. Ill. 2015) in which the CFTC found that the defendants' modification of an off-the-shelf trading platform to enable large, aggressive spoofing tactics constituted use of a manipulative device.

²⁶ *Id.* at 1015.

Covington will continue to monitor the DRW case and all other enforcement actions with a view toward the development and implementation of trade practice policies and procedures that correlate to the CFTC's approach to manipulation. If you have any questions concerning the material discussed in this client alert, please contact the following members of our CFTC practice:

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