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ALERT MEMORANDUM

District Court Rules That Where Bids Have an Underlying Legitimate Economic Rationale, Intent to Affect Prices Is Insufficient to Establish Market Manipulation

December 6, 2018

On November 30, 2018, Judge Richard Sullivan[1] issued a long-anticipated decision in favor of the defendants in *Commodity Futures Trading Commission v. Wilson*, No. 13 Civ. 7884, following a four-day bench trial in December 2016 before the U.S. District Court for the Southern District of New York. The court held that the CFTC failed to meet its burden of proof in establishing claims of market manipulation or attempted market manipulation under Sections 6(c) and 9(a)(2) of the Commodity Exchange Act ("CEA") based on trading by Donald R. Wilson and his firm DRW Investments LLC ("DRW") of a particular exchange-traded interest rate swap futures contract (the "IDEX Three-Month IRS Contract"). The court found that although the defendants' trading affected the price of the IDEX Three-Month IRS Contract in a way that benefitted defendants' existing positions, there was no evidence that the resulting price was "artificial," which the Second Circuit has held is a necessary element in establishing market manipulation under the CEA.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Lewis Liman
+1 212 225 2550
lliman@cgsh.com

Victor Hou
+1 212 225 2609
vhou@cgsh.com

Colin Lloyd
+1 212 225 2809
clloyd@cgsh.com

Rishi Zutshi
+1 212 225 2085
rzutshi@cgsh.com

Russell Mawn
+1 212 225 2467
rmawn@cgsh.com

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

[1] Judge Sullivan was elevated to the U.S. Court of Appeals for the Second Circuit on October 17, 2018.

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Key Takeaways

The *Wilson* decision is significant because it rejected the CFTC's argument that the artificiality element could be satisfied merely by showing that a market participant structured bids in a manner intended to affect settlement prices. Because the defendants had a "legitimate economic rationale" for the bids they submitted, the court held that defendants' intent to trade in a manner that affected settlement prices does not itself create liability for market manipulation under the CEA.

Nonetheless, it is quite possible that the *Wilson* decision will not lead the CFTC to abandon its view that trading activity intended to create, or with reckless disregard for creating, a material market impact, is unlawful. The CFTC might instead rely on provisions added to the CEA by the Dodd-Frank Act, which were not at issue in *Wilson*. For example, the CFTC might argue that transacting in a large volume in a very short period of time constitutes a "manipulative device" prohibited by amended Section 6(c)(1) of the CEA and CFTC Rule 180.1, as it did in its October 2013 settlement with JPMorgan in connection with the "London Whale" swaps trades.[2] Or the CFTC might argue that such trading violates the post-Dodd-Frank prohibition on trading that demonstrates intentional or reckless disregard for the orderly execution of transactions during a closing period.[3] Market participants should accordingly remain wary of trading strategies that are intended to have a material impact on market prices.

Background

In August and September 2010, DRW established a net long position of more than $300 million notional in various tenors of the IDEX Three-Month IRS Contract by entering into trades with Jefferies & Co. and MF Global, which were cleared through the International Derivatives Clearinghouse ("IDCH").[4] DRW entered these trades at rates that were only two to three basis points higher than the rates for comparable over-the-counter swaps.[5] DRW believed, however, that the fair value of the IDEX Three-Month IRS Contract was significantly higher because of structural features that differentiated these contracts from uncleared, over-the-counter swaps.[6]

Specifically, IDCH required the posting of variation margin at the end of each day based on its internally calculated settlement price in connection with these contracts.[7] If the IDEX Three-Month IRS Contract settlement price closed higher than the price at which DRW acquired its long position, DRW stood to collect additional margin that it could then reinvest.[8] As a general proposition, this reinvestment opportunity is worth more to DRW as the long party because the long party by definition collects its margin in a higher interest rate environment than the short party (known as the "convexity effect").[9] While some clearinghouses account for the convexity effect by adjusting variation margin payments for short versus long positions, IDCH did not do so, giving rise to the arbitrage opportunity that DRW identified.[10]

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[2] *See In the Matter of JPMorgan Chase Bank, N.A.*, Comm. Fut. L. Rep. (CCH) ¶ 32,838 (Oct. 16, 2013).

[3] *See* CEA § 4c(a)(5)(B); *see also* Antidisruptive Practices Authority, 78 Fed. Reg. 31890, 31895-96 (May 28, 2013) (interpreting this section of the CEA to prohibit trading on a "registered entity" (such as a futures exchange or swap execution facility) that intentionally or recklessly disrupts trading during the closing period of a futures contract, option, or swap by, for example, causing consecutive prices to diverge, weakening the correlation between price changes and volume of trades, creating a level of volatility that dramatically reduces liquidity, causing the price of a derivative and its underlying physical commodity or financial instrument to diverge, or causing spreads between contracts for near months and remote months to diverge).

[4] *Wilson*, No. 13 Civ. 7884, at 7-8.

[5] *Id.* at 8.

[6] *Id.* at 7.

[7] *Id.* at 6-7.

[8] *Id.* at 7.

[9] *Id.* at 5.

[10] *Id.* at 5-7.

After establishing its long position, DRW continued to submit bids for the IDEX Three-Month IRS Contracts at prices that it believed were below the contracts' fair value. DRW also recognized that these bids would affect IDCH's calculated settlement price, based on the procedures set forth in the contracts themselves, and thereby increase the variation margin payments owed to DRW on its existing long position.[11] The IDCH calculated the daily settlement price primarily on the mid-point of the bids and offers made in the final 15 minutes of the trading day, regardless of whether trades were actually consummated at those prices.[12] From January 24, 2011 to August 12, 2011, DRW placed 2,895 bids—61% of which fell in this final 15 minute period.[13] Not a single trade was consummated—which the CFTC characterized as "yelling into an empty pit"—but 1,024 of these bids were incorporated into IDCH's settlement price calculation.[14]

There was, however, a single "almost-trade" that the court found supported DRW's contention that it was actually seeking to execute trades based on its bids. On February 2, 2011, DRW and MF Global agreed to a transaction in IDEX Three-Month IRS Contracts well above prevailing rates for comparable uncleared, over-the-counter contracts—consistent with DRW's valuation theory.[15] IDCH was, however, unable to clear the trade that day, and MF Global backed out the following day.[16] Wilson sought to have the exchange compel the trade, but eventually accepted an $850,000 payment from MF Global to settle the dispute.[17]

This "busted trade" triggered an investigation by IDCH. In response to inquiries from IDCH, DRW explained its valuation theory around the IDEX Three-Month IRS Contract, even submitting a white paper on the subject.[18] After the investigation, IDCH never required DRW to change its bidding practices, and explicitly rejected Jefferies's request to disregard DRW's bids in determining settlement price.[19] Jefferies then escalated complaints about IDCH and DRW to the CFTC, seeking to amend IDCH's settlement price methodology and/or amend the terms of the IDEX Three-Month IRS Contract, but the CFTC director of the Division of Clearing & Intermediary Oversight rejected these efforts.[20] Following these complaints, DRW continued placing bids at ever increasing prices "in order to attract new swap counterparties."[21]

Finally, on August 12, 2011, DRW unwound its positions with Jefferies and MF Global "at or near the settlement prices established by IDCH for the prior day."[22] Jefferies later conceded that these prices, well above the uncleared market and the initial price of the IDEX Three-Month IRS Contracts, were "commensurate" with the values calculated by their own experts.[23]

Absence of Evidence

The court took the CFTC to task for its failure to meet its evidentiary burden at trial and specifically noted five categories of evidence that the CFTC did not provide, describing these as "concessions, almost."[24] First, "there is no evidence that DRW ever made a bid

[11] *Id.* at 8.

[12] *Id.* at 6.

[13] *Id.* at 11-12.

[14] *Id.* at 12, 23. The CFTC's complaint in this case emphasizes just how illiquid this product was. On 118 trading days in the 9 month period at issue, "there was not a single consummated on-exchange trade of the [IDEX] Three-Month [IRS] Contract, and DRW alone, placed 100% of the electronic bids for long positions during this period; there were no offers for short positions placed at all." Compl. ¶ 58, *Wilson*, No. 13 Civ. 7884 (S.D.N.Y. Nov. 6, 2013).

[15] *Wilson*, No. 13 Civ. 7884, at 9.

[16] *Id.*

[17] *Id.*

[18] *Id.* at 10.

[19] *Id.* at 10-11.

[20] *Id.* at 11.

[21] *Id.* at 12.

[22] *Id.* at 13.

[23] *Id.*

[24] *Id.*

that it thought might be unprofitable."[25] Second, "there is no credible evidence that DRW ever made a bid that it thought could not be accepted by a counterparty."[26] 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."[27] Fourth, "there is no credible evidence that DRW's bidding practices ever scared off would-be market participants."[28] Fifth, "there is no evidence that DRW ever made a bid that violated any rule of the exchange."[29]

In contrast, the court noted that while defendants were not obliged to do so, they offered "ample and persuasive" evidence that the IDEX Three-Month IRS Contract was not the economic equivalent of an uncleared swap, that the contract's true value was in fact higher than DRW's bids, and that DRW's bidding practices were not price manipulation but legitimate price discovery.[30]

The District Court's Decision

The court held that DRW's activity did not constitute market manipulation or attempted market manipulation under the CEA. The court held that a showing that DRW intended to impact the settlement price of the contracts was not sufficient to show that the resulting price was artificial, particularly because DRW reasonably believed that there was a legitimate economic rationale for the bids that it submitted and that trades executed at those levels would have been profitable to it. The court repeatedly credited the defendants' arguments and evidence introduced at trial which led it to the "inescapable conclusion" the DRW's bids, and the consequent settlement prices, were the result of free competition."[31]

Market Manipulation

The Second Circuit has held that market manipulation under the CEA requires proof of four elements: "'(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.'"[32] The court found there was "no question" that DRW had the ability to influence price, which DRW "themselves acknowledged and understood."[33]

The court focused instead on the definition of an "artificial price" meaning a price that "'does not reflect basic forces of supply and demand.'"[34] The court found that the CFTC "offered no evidence or explanation demonstrating that IDCH settlement prices were artificially high."[35] On the contrary, the court noted numerous factors supporting DRW's valuation of the IDEX Three-Month IRS Contracts, including DRW's attempt to complete the busted trade with MF Global and MF Global's settlement payment, the eventual unwinding price of the contracts, Jefferies's explicit acknowledgement of the contracts' value, and DRW's own economic analysis.[36]

The court also rejected the CFTC's "tautological fallback argument" that "any price influenced by Defendants' bids was 'illegitimate,' and by definition 'artificial,' because Defendants understood and intended that the bids would have an effect on the settlement prices."[37] The court noted that if this theory were taken to its logical conclusion it "would effectively bar market participants with open positions from ever making additional bids to pursue future

[25] *Id.*

[26] *Id.*

[27] *Id.* at 14.

[28] *Id.*

[29] *Id.*

[30] *Id*. at 17.

[31] *Id.*

[32] *Id.* at 15 (quoting *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 173 (2d Cir. 2013)).

[33] *Id.*

[34] *Id.* at 16 (quoting *CFTC v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 246 (S.D.N.Y. 2012)).

[35] *Id.*

[36] *Id*. at 16-17.

[37] *Id.* at 18.

transactions."[38] The fact that "DRW's bids affected the settlement price for its open positions . . . and that Defendants intended as much" is "insufficient to establish the existence of an artificial price."[39]

Attempted Market Manipulation

The court further held that attempted market manipulation, an additional charge brought by the CFTC, similarly requires that "Defendants intended to cause *artificial* prices."[40] Because the court found credible the economic rationale for DRW's valuation and testimony that DRW never bid above their own valuation, the court also rejected this theory.[41]

Banging the Close

While not a different charge, the court separately addressed the CFTC's oft repeated theory that DRW was "banging the close"—a practice the court found ill-defined but that generally requires a high volume of trading near the relevant closing period to affect the settlement price in order to benefit an even larger position elsewhere.[42] Here again the court accepted the proposition that DRW "made numerous trades . . . with an understanding that such bids would affect the settlement price."[43] The court, however, noted that the number of bids "says nothing about whether [DRW] understood those bids to be artificially high."[44]

The court found DRW's trading pattern to be supported by a reasonable economic valuation of the trades, even though the market was so illiquid that no counterparties were willing to transact with DRW on the thousands of bids it submitted.[45] The court also found that the single busted trade with MF Global was evidence that the bids could have potentially attracted counterparties and that DRW intended to trade on its bids.[46] Furthermore, the court was persuaded that DRW's bidding practices served another legitimate purpose: "contributing to price discovery in an illiquid market."[47]

The court concluded that "[s]ince Defendants' trading pattern is supported by a legitimate economic rationale, it 'cannot be the basis for liability under the CEA.'"[48] In sum, the court opined, "[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."[49]

Additional Implications

The *Wilson* decision is significant because the court refused to allow evidence that a market participant intended to affect market prices to substitute for a showing that the resulting market prices were artificial for purposes of establishing market manipulation under the CEA. Given that all trading can generally be presumed to have impact, the court explicitly recognized the risks of adopting the CFTC's arguments on this issue, observing that "'[t]he 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.'"[50]

The "artificial price" requirement undoubtedly increases the burden on the CFTC to prove manipulation claims in the future and provides protection for legitimate trading activities that have beneficial price discovery effects. Nonetheless, the court's detailed dissection of the gaps in the evidence put forward by the CFTC will also provide important

[38] *Id.*

[39] *Id.*

[40] *Id.* at 19 (emphasis in original).

[41] *Id.* at 19-21.

[42] *Id.* at 21.

[43] *Id.* at 21-22.

[44] *Id.* at 22.

[45] *Id.* at 23-24.

[46] *Id.* at 23.

[47] *Id.* at 25.

[48] *Id.* (quoting *In re Amaranth Nat. Gas Commodities Litig.*, 587 F. Supp. 2d 513, 534 (S.D.N.Y. 2008)).

[49] *Id.* at 26.

[50] *Id.* at 18 (quoting *In re Amaranth*, 587 F. Supp. 2d at 534).

guideposts for regulators seeking to distinguish this case in the future. For example, a court might find that manipulation has been established based on a trading pattern that has a legitimate economic rationale, if that trading pattern violated an exchange's rules or drove away other market participants. Market participants should therefore continue to be attentive to any indicia that may raise questions about the "legitimacy" of their activity in the eyes of regulators and courts.

While the decision is a setback for the CFTC's aggressive market manipulation enforcement agenda, the CFTC may seek to invoke other tools in its arsenal, such as Rule 180.1 or disruptive trading prohibitions. The decision may also well cause the CFTC to think twice about bringing manipulation cases in federal courts rather than in administrative proceedings before its own judges.

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