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INSIGHTS

"Bring Out Your Dead!" - In CFTC v. Wilson, Court Reminds CFTC that Market Manipulation Requires an Artificial Price

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On November 30, 2018, a federal court rejected the Commodity Futures Trading Commission's ("CFTC") allegations of market manipulation in *CFTC v. Wilson* ("*DRW*") and found in favor of the defendants, Donald R. Wilson ("Wilson") and his company, DRW Investments, LLC (together "DRW"). According to Judge Richard Sullivan (appointed to the 2nd Circuit Court of Appeals during the pendency of the matter and writing the decision while sitting by designation in the United States District Court for the Southern District of New York), "the CFTC … failed to prove that Defendants intended to cause artificial prices" and "its case founders on its abject failure to produce evidence – or even a coherent theory – supporting the existence of an artificial price." In a three-sentence statement on the decision, the Chairman of the CFTC was quick to note that the case applied the CFTC's authority as it stood prior to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

For Monty Python fans, this case can be summed up by reference to the "Bring Out Your Dead" skit where a man attempts to deliver an elderly man – still alive – to a cart manager collecting the dead. The elderly man protests, insisting he is not dead, but the younger man argues to the cart manager that the elderly man is already dead or will be soon enough and should be carted away. Imagining the CFTC as the younger man asking the cart master (*i.e.*, the Court) to look past the law and just treat the old man as a dead man (*i.e.*, Wilson as a manipulator), you can hear the cart master protesting and noting that the young man's request is against regulation, the old man protesting, and the young man urging the cart manager to overlook the formalities. Lucky for Wilson, that is where the similarities end. Here, instead of caving (and killing the elderly man), the cart master/judge stood his ground and rejected the notion that a core requirement (death/an artificial price) can be overlooked or otherwise fabricated.

The CFTC's defeat in this case probably should not come as a surprise considering the CFTC's burden when applying its pre-Dodd-Frank authority. However, as much as the outcome, it is important to keep in mind that the CFTC brought the case in the first place, that it survived a motion for summary judgment by the defendants, and that the Chairman's initial statement attempts to contain the decision to the CFTC's pre-Dodd-Frank authority. While the decision should encourage defendants, the circumstances surrounding it should continue to serve as a caution to market participants.

The Facts

By mid-2010, Wilson had come to believe that regulatory changes would cause uncleared interest rate swaps to migrate into exchanged-traded, centrally cleared contracts. He also believed that the relevant centrally cleared contract – the IDEX USD Three-Month Interest Rate Swap Futures Contract cleared by the International Derivatives Clearinghouse ("IDCH") – was not economically equivalent to the uncleared swaps it looked like and to which it was priced at the time.

His calculation of the fair value of the futures contract was well above the value of the uncleared swap contract because the futures contract was impacted by "convexity bias" (or the "convexity effect"). Convexity bias here refers to the effect that variation margin has on the value of a cleared interest rate swap or futures contract. Specifically, in the case of cleared interest rate contracts, the long position receives variation margin when interest rates are high, increasing the value of the position by providing margin that can be reinvested during high-yield periods, while the short position *pays* variation margin during such high-yield periods and only receives variation margin when interest rates drop (making reinvestment of margin relatively unattractive). The settlement price of the IDCH futures contract was not automatically adjusted for convexity bias, and the market in 2010 did not appear to account for it.

Wilson's strategy was to arbitrage the cleared and uncleared markets ahead of the futurization of interest rate swaps and benefit when the market recognized and began valuing the convexity bias inherent in the IDCH futures contract. To do this, DRW executed over-the-counter ("OTC") swaps and cleared them to develop a net long position, including $150 million with MF Global and $175 million with Jeffries, priced approximately 2-3 basis points above the OTC price.

Initially, DRW placed binding voice bids with brokers but was surprised to learn that voice bids did not contribute to setting the daily settlement price for the IDCH futures contract. Instead, the settlement price was set based upon the following hierarchy: (1) the midpoint of the electronically submitted bids and offers during the period of 2:45 – 3:00 PM Eastern ("Window"); (2) the settlement price of any trades consummated during the Window; or (3) the prevailing OTC price published daily. Because the futures contract was extremely illiquid, the price was regularly set by the published OTC price.

Upon learning that his voice bids were not contributing to the price, DRW acquired software to be able to submit orders electronically and began submitting bids with the knowledge and intent that his bids would be reflected in the price of the futures contract. In fact, one of his employees commented that the price previously had been set by a swap curve but now was set by DRW. From January to August 2011, DRW submitted over 2,500 electronic bids without any being transacted against.

On February 2, 2011, DRW was notified that MF Global was interested in trading but lacked the necessary software to transact electronically. DRW offered to trade up to $1 billion and the parties agreed to $250 million at 16 basis points above the OTC price. However, in the midst of a massive snow storm, the IDCH did not clear the trade, and MF Global subsequently broke the trade, accusing DRW of market manipulation. MF Global ultimately paid $850,000 to avoid litigation over the broken trade.

Following the broken trade, the IDCH opened an investigation into DRW's electronic trading practices. DRW explained its strategy and indicated that it placed bids during the settlement period to aid in price discovery. The inquiry closed without further action. Separately, the IDCH also rejected a complaint from Jeffries about the settlement prices (which were rising as a result of DRW's bids). IDCH communicated to Jeffries that electronic bids/offers provided a more accurate valuation and noted other parties (e.g., DRW) understood that the contact did not include an adjustment to address convexity bias and should be valued accordingly. The CFTC's Division of Clearing & Intermediary Oversight also rejected a request from Jeffries that the CFTC force IDCH to change the settlement price.

In August 2011, DRW unwound its open positions for approximately $20 million (priced to the IDCH settlement price set by DRW's bids). Separately, Jeffries sued the IDCH and its parents, accusing them of fraud, fraudulent inducement, promissory estoppel, breach of contract, and negligent misrepresentation based upon the theory that the IDCH misrepresented the futures contract as economically equivalent to the OTC swap. That claim was rejected in arbitration.

Nevertheless, the CFTC in November 2013 filed a complaint accusing Wilson and his company of violating Sections 6(c) and 9(a)(2) of the Commodity Exchange Act (the "CEA"), which generally prohibit manipulating or attempting to manipulate the market price of any commodity.

The CFTC's Theory and Where it Failed

To prove market manipulation pursuant to Sections 6(c) and 9(a)(2) of the CEA, the CFTC must prove that (1) the defendant(s) specifically intended to cause an artificial price, (2) the defendant(s) possessed the ability to influence the market price, (3) an artificial price existed, and (4) the defendant(s) caused the artificial price. However, the Court found that "the CFTC offered no evidence or explanation demonstrating that IDCH settlement prices were artificially high." Further, the Court found that "the CFTC failed to prove that Defendants intended to cause artificial prices." Rather, all of the evidence proved "beyond the shadow of a doubt" that DRW believed the fair market value was above the prices at which they were bidding. In so doing, the Court flatly rejected the CFTC's complaint that knowingly or intentionally submitting bids in a manner to influence the market settlement price amounts to market manipulation under the provisions of the CEA at issue.

The CFTC's claims at times appeared to be closer to "gaming" cases (i.e., taking advantage of a perceived market design flaw) or "self-help" cases (i.e., market participants engaging in conduct intended to affect market prices to correct a perceived market flaw) brought by the Federal Energy Regulatory Commission (FERC), or possibly spoofing cases (submitting bids or offers without the intent to transact) brought by the CFTC, rather than a traditional CFTC market manipulation case. The CFTC's allegations boiled down to allegations that (1) DRW intended to exploit a perceived flaw in the IDCH contract, and (2) DRW established a long position and placed bids during the settlement period that were unlikely to result in executed trades with the intent to affect or influence the daily settlement rate and benefit its long position.

With respect to recognizing a "flaw" in the contract and trying to take advantage of it, the Court concluded, "[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." With respect to the validity of the bids placed during the settlement period, the Court found that the "Defendants made bids with an honest desire to transact at those posted prices, and that they fully believed the resulting settlement prices to be reflective of the forces of supply and demand." Moreover, "Defendants were able to articulate an economically rational theory justifying their bids."

The Court implied that it *might* have reached a different conclusion had the "Defendants had some knowledge of market inefficiency that enabled them to gouge their existing swap counterparties with impunity." The Court also noted that there was no evidence that "DRW ever made a bid that it thought might be unprofitable." Nor did the Court find any credible evidence that "DRW ever made a bid that it thought could not be accepted by a counterparty," that "DRW's bidding practices ever scared off would-be market participants," or that "DRW ever made a bid that violated any [exchange] rule."

In a brief December 3, 2018 statement, CFTC Chairman Giancarlo acknowledged the decision, indicated the agency is considering next steps, expressed resolve to "continue to vigorously enforce the Commission's anti-manipulation provisions and to prosecute cases through trial where necessary," and apparently sought to contain the import of the Court's decision by reminding the audience that the decision "involves the CFTC's pre-Dodd Frank legal authority."

Can Market Participants Rely on This Decision?

An important question remains as to whether this decision is forever confined to the CFTC's legacy (i.e., pre-Dodd-Frank) manipulation authority or whether the reasoning applies equally to the CFTC's newer anti-fraud authority (or to the nearly identical FERC anti-fraud authority). There certainly is a basis for interpreting the scienter requirement embedded in the Commission's new authority to require an intent to create an artificial price (or some other form of fraud) that should lead to the same outcome under the new standard. However, that question has been saved for another day and another defendant.

Putting this legal question aside, market participants should take note of the CFTC's willingness to bring this case in the first place and the Chairman's initial, arguably dismissive, response to the decision. Together, these may signal agreement by the CFTC – or at least its Chairman – with FERC's broad interpretation of fraud, which FERC defines to include "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market." It is this broad definition of fraud – and possibly FERC's use of *effect* as a proxy for "purpose" – that has led to an aggressive application of FERC's manipulation rule and complaints that the rule is overly vague and unclear.

While *DRW* may embolden defendants in both CFTC and FERC enforcement matters going forward, and market participants might take some comfort in the outcome, market participants also will be wise to recognize that, until the next case is decided, relying on the decision in *DRW* prospectively may give them a front-row seat for that next case. The cart manager stood his ground in *DRW*, but early indications are that the loss here may not have changed the underlying perspective of the younger man.