SULLIVAN & CROMWELL LLP

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CFTC v. *Wilson*: Court Rules against CFTC in Commodities Manipulation Bench Trial

Court Holds that Open-Market Bids and Offers Made with an Honest Desire to Trade Cannot Support Liability under the Commodity Exchange Act

SUMMARY

In a November 30, 2018 decision made public on Monday of this week, Judge Richard Sullivan, formerly of the Southern District of New York (now Second Circuit Judge), ruled against the CFTC after a four-day bench trial on claims for commodities manipulation and attempted manipulation in violation of Sections 6(c) and 9(a)(2) of the Commodity Exchange Act ("CEA") (which has since been amended by the Dodd-Frank Wall Street Reform and Consumer Protect Act of 2010). The court concluded that the "Defendants made bids with an honest desire to transact at th[e] posted prices, and that they fully believed the resulting settlement prices to be reflective of the forces of supply and demand." Although defendants understood and intended that their bids would affect settlement prices—and therefore the value of their existing positions—the court held that this "cannot be a basis for liability under the CEA," and "any other finding would be akin to finding manipulation by hindsight."

Judge Sullivan's decision may make it more difficult for both the CFTC and private plaintiffs to bring claims for commodities manipulation or attempted manipulation. This is so because, if other courts follow *Wilson*, open-market transactions that benefit a party's position in an illiquid market will be deemed—without additional evidence of intent to cause artificial prices—insufficient to show liability. It remains unclear, however, how the court's decision will be applied to the additional CEA anti-manipulation provision added by the Dodd-Frank Act. Companies should continue to consult with counsel as to the litigation and regulatory risk for any trading strategies as the legal landscape continues to evolve.

BACKGROUND

On November 6, 2013, the CFTC charged Donald R. Wilson and his company DRW Investments, LLC (together, "DRW") with unlawfully manipulating and attempting to manipulate the price of the IDEX USD Three-Month Interest Rate Swap Futures Contract ("Three-Month Contract") from at least January 2011 through August 2011.[1] The Three-Month Contract was an interest-rate swap futures contract pursuant to which one party paid a fixed interest rate (the "long" party) and the other paid a floating rate (the "short" party).[2]

In September 2010, defendants entered into $150 million and $175 million notional of Three-Month Contracts (the "Swaps") with MF Global and Jeffries & Co., respectively.[3] The margin payments to be received (or paid) by defendants in connection with these contracts were based on a settlement price calculated by IDEX at the end of each trading day. The settlement price calculated by IDEX, in turn, was based on an average of executable bids and offers placed on an IDEX electronic trading platform during a specified 15-minute period (the "settlement window") each day or, failing the existence of any such bids and offers, on prices (the "Corresponding Rates") for other interest rate swap products traded in the over-the-counter ("OTC") market that the exchange considered to be comparable instruments to the Three-Month Contract.

During the life of the Swaps, DRW placed bids for the Three-Month Contract, first via a voice broker and later—after learning that voice bids were not incorporated into the price that determined margin payments on the swaps with MF Global and Jeffries—via direct submission to the IDEX electronic trading platform.[4] DRW intentionally concentrated its bids during the 15-minute settlement window, in part because DRW wanted to ensure that its bids were considered in reaching the settlement price.[5] Although many market participants had anticipated that prices for the Three-Month Contract would approximate the Corresponding Rates for OTC swaps, the bids DRW placed on the electronic platform were substantially higher than the Corresponding Rates, because DRW believed the Three-Month Contracts in fact were substantially more valuable instruments. And, although DRW stood ready and willing to trade on its bids, it knew that there were only a few market participants who had access to the electronic platform that would permit them to hit DRW's bids, and it believed that it was unlikely any market participant would do so. In fact, during the time DRW was bidding, not a single other market participant posted any bids or offers for the Three-Month Contract on the electronic platform.[6]

Over time, DRW raised its bids to increasingly higher prices, resulting in progressively higher settlement prices and significantly increased margin payments paid to DRW on its swaps with MF Global and Jeffries.[7] DRW was aware, and in fact desired, that its bids would have this favorable impact on the value of these two swaps.[8]

The CFTC alleged that DRW's trading activities were intended to—and did—manipulate the market for the Three-Month Contract as a "'banging the close' scheme, in which a trader uses bids or offers to influence a settlement price in his favor."[9] The CFTC claimed that, because DRW "knew there were no other participants" on the IDEX electronic platform, defendants effectively were "yelling into an empty pit" with their bids, and therefore "must have intended to inflate the settlement price in order to gouge their existing swap counterparties."[10] As a result, the CFTC alleged, DRW's "conduct in fact increased the settlement prices of the Three–Month Contract and created artificial prices expressed in rates," thereby "reaping unlawful profits of at least $20 million."[11]

The case was originally assigned to Judge Analisa Torres, who denied DRW's motion to dismiss, motion to transfer, and motion for summary judgment.[12] The case was then reassigned to Judge Richard Sullivan, who held a four-day bench trial in December 2016.

THE DECISION

On November 30, 2018, the court ruled against the CFTC on both its manipulation and attempted manipulation claims, and entered judgment for the defendants. As to market manipulation, the court rejected the CFTC's theory that, because DRW was the only participant active on the IDEX electronic platform, its bids on that platform were "illegitimate" and necessarily "created artificial settlement prices"[13] that were "not based on the basic forces of supply and demand but instead . . . on DRW's self-serving actions."[14] To the contrary, the court held that DRW bid on the open market based on its "methodology for ascertaining the fair market value for the Three-Month Contract," which "actually contributed to price discovery rather than price manipulation."[15] The court went on to observe that the theory articulated by the CFTC—that "*any* price influenced by Defendants' bids was 'illegitimate'"—would "read out the artificial price element" of commodities manipulation "by collapsing it into the subjective intent requirement."[16] Further, the CFTC's approach would "encroach on legitimate economic decisions" by preventing "market participants with open positions from ever making additional bids," which would "discourage the very activity that underlies the integrity of the market they seek to protect."[17]

As to attempted manipulation, the court held that the CFTC had failed to establish an intent to manipulate, because, under the relevant CEA provisions, "mere intent to affect *prices* is not enough; rather the CFTC must show that Defendants intended to cause *artificial* prices" but failed to do so (which also provided a "second basis" for dismissing the CFTC's market manipulation claim).[18] In this regard, the court acknowledged that defendants had "made numerous trades during the [settlement period] with an understanding that such bids would affect the settlement price" for the Three-Month Contracts, and, indeed, that defendants "were determined to do just that." But, the court found, DRW's submission of numerous bids during the settlement period that were intended by defendants to affect the settlement price could not satisfy the statutory "intent" requirement, because DRW "sincerely believed the fair market value of the Three-Month Contract was higher than the bids they submitted."[19] Because DRW submitted "real bids, at prices at which [it was] willing to transact, which were open on the market for long periods of time," the court found "no reason to think" that DRW believed it was submitting "artificial" bids.[20] The court pointedly criticized the CFTC's use of the "slogan" "banging the close," finding that "Defendants' explanation of their bidding practices as contributing to price discovery in an illiquid market makes sense and is supported by the evidence."[21] The court ultimately concluded that "[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."[22] Rather, "[i]t is only the CFTC's Enforcement Division that has persisted in its cry of market manipulation, based on little more than an 'earth is flat'-style conviction that . . . manipulation must have happened because the market remained illiquid. Clearly, that is not enough to prove market manipulation to attempted manipulation."[23]

IMPLICATIONS

The court's decision offers significant implications for CFTC investigations, CFTC enforcement actions, and private actions under the CEA by making it more difficult to prove commodities manipulation or attempted manipulation. The court has clarified that a showing that open-market transactions benefit a party's position at settlement is, without additional evidence of intent to cause artificial prices, insufficient to support liability under Sections 6(c) and 9(a)(2) of the CEA, as those provisions existed before the Dodd-Frank amendments. This is contrary to the CFTC's longstanding position in benchmark rate cases, and therefore may provide companies with leverage in ongoing CFTC investigations. The decision may also deter the CFTC or private plaintiffs from bringing similar cases on a "banging the close" theory of liability.

It is unclear, however, how the decision will be applied to the CFTC's expanded anti-manipulation authority under the Dodd-Frank Act. Companies should therefore consult with counsel about the litigation and regulatory risk of various trading strategies, and continue to monitor the legal landscape, particularly if the CFTC appeals the decision.

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ENDNOTES

1 *CFTC* v. *Wilson*, 27 F. Supp. 3d 517, 527 (S.D.N.Y. 2014).

2 *CFTC* v. *Wilson*, No. 13 Civ. 7884 (RJS) (KNF), ECF No. 207 at 3–4.

3 *Id.* at 8.

4 *Id.* at 8–9.

5 *Id.* at 9.

6 *Id.*

7 *Id.* at 11–12.

8 *Id.* at 12–13.

9 *Wilson*, 27 F. Supp. 3d at 526 (internal quotation marks omitted).

10 *Wilson*, No. 13 Civ. 7884, ECF No. 207 at 23 (internal quotation marks omitted).

11 *Wilson*, 27 F. Supp. 3d at 526–27 (internal quotation marks omitted).

12 *Id.* at 522, 540; *CFTC* v. *Wilson*, 2016 WL 72209056, at *1, *15 (S.D.N.Y. Sept. 30, 2016).

13 *Wilson*, No. 13 Civ. 7884, ECF No. 207 at 16 (internal quotation marks omitted).

14 *Id.* (internal quotation marks omitted).

15 *Id.* at 16–17.

16 *Id.* at 18 (emphasis in original) (citing *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 183 (2d Cir. 2013)).

17 *Id.* (quoting *In re Amaranth Nat. Gas Commodities Litig.*, 587 F. Supp. 2d 513, 534–35 (S.D.N.Y. 2008)).

18 *Id.* at 19, 25 n.17 (emphasis in original).

19 *Id.* at 19–21.

20 *Id.* at 22 (internal quotation marks omitted).

21 *Id.* at 21, 25.

22 *Id.* at 26.

23 *Id.*

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