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## District Court Judge Rejects CFTC Manipulative Intent Standard

OCTOBER 12, 2016

**Summary:** On September 30, 2016, Judge Analisa Torres of the Southern District of New York issued an order resolving competing motions for summary judgment in the Commodity Futures Trading Commission's (CFTC) ongoing action against Donald R. Wilson and his firm, DRW Investments LLC, (together, DRW) for allegedly manipulating and attempting to manipulate the settlement price of certain interest rate futures contracts.<sup>1</sup> The order provides important guidance regarding the requisite intent to establish a manipulation or attempted manipulation claim under the Commodity Exchange Act (CEA).

The CEA's longstanding manipulation standard has always required proof that the defendant specifically intended to manipulate the market. However, the parties proposed substantially different interpretations of how this element should be applied in practice. The CFTC argued that this standard could be met by merely establishing "an intent to affect market prices." DRW, supported by *amici curiae*, argued that the CEA requires proof that a defendant acted with the specific intent to create an "artificial price," a significantly higher standard grounded in the traditional test of manipulation. In her order, Judge Torres agreed with DRW and held that "there is 'no manipulation without intent to cause artificial prices.'"<sup>2</sup>

**Implications:** The court's decision provides important protections to market participants engaged in legitimate trading strategies and is a blow to the CFTC's effort to lower the standard for proving price manipulation. This decision may hinder the CFTC's ability to prosecute manipulation cases under the new anti-manipulation provisions added by the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>3</sup>

**Background:** The CFTC alleges that DRW manipulated and attempted to manipulate the price of the IDEX Three-Month Interest Rate Swap Futures Contract (the Three-Month Contract) in violation of CEA Sections 6(c) and 9(a)(2).<sup>4</sup> In its complaint, the CFTC alleges that DRW placed fictitious bids during the Three-Month Contract's settlement period for the purpose of affecting the Three-Month Contract's settlement price. As a result, according to the CFTC, DRW allegedly manipulated the price of the Three-Month Contract in its favor.<sup>5</sup> Both before and during the litigation, DRW admitted

that it intended to affect the Three-Month Contract's settlement price.<sup>6</sup> However, DRW argued that the Three-Month Contract was undervalued and that it posted bids to correct a fundamental mispricing, not create an artificial price.<sup>7</sup>

Prior to this litigation, DRW's conduct was investigated by the International Derivatives Clearinghouse, the CFTC's Division of Clearing and Intermediary Oversight, and the National Futures Association, each of which apparently concluded that DRW's conduct was justified or not manipulative.<sup>8</sup> Nonetheless, the CFTC took the position that DRW's conduct was intended to affect the price of the Three-Month Contract and, therefore, violated Sections 6(c) and 9(a)(2) of the CEA.

CEA Section 6(c) provides that:

It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance. . . .

CEA Section 9(a)(2) prohibits “[a]ny person [from] manipulat[ing] or attempt[ing] to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity.” Because “manipulation” is not defined in the statute, the courts have developed a four-part test that requires the CFTC to prove:

- (1) that the accused had the ability to influence market prices;
- (2) that [the accused] specifically intended to do so;
- (3) that artificial prices existed; and
- (4) that the accused caused the artificial prices.<sup>9</sup>

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.<sup>10</sup>

**Decision:** In its motion for summary judgment on its attempted manipulation claim, the CFTC argued that it could establish its claims by showing DRW had an intent to “affect market prices.”<sup>11</sup> DRW argued that manipulation claims require proof that the defendant intended to create an artificial price. Several key futures industry participants submitted an *amicus* brief in support of DRW's position, arguing that the CFTC's intent standard for attempted manipulation “departs in a significant respect from decades of settled law.”<sup>12</sup> The standard, they argued, was that the CFTC had to prove that the defendant “specifically intended to create an artificial price—a price that does not reflect the legitimate forces of supply and demand.”<sup>13</sup>

Ultimately, the court agreed with DRW and the *amici*, stating plainly that:

CFTC's interpretation is incorrect. The CFTC must prove that Defendants had the specific intent to affect market prices that “did not reflect the legitimate forces of supply and demand.” This means, that there is “no manipulation without intent to cause artificial prices.”<sup>14</sup>

In a footnote, the court further asserted that the CFTC “base[d] its position on shorthand language suggesting that the intent standard is merely the intent to affect prices. But it is well settled that the

intent to create an artificial price is the correct standard.”<sup>15</sup>

The case is now set for trial, which is currently scheduled to begin on December 1, 2016.

**Conclusions:** This decision is a setback for the CFTC, which has been aggressively pushing to expand its anti-manipulation authority.<sup>16</sup> While the distinction between the intent to “affect market prices” and the intent to “create an artificial price” may not have much practical effect in the most egregious cases, it may make it more difficult to establish manipulation claims in more complicated matters.

However, the CFTC's proposed standard would have had potentially significant consequences for market participants. Sophisticated traders are always conscious of the impact caused by their activities, and it would be extremely difficult, if not impossible, to reliably distinguish between traders that were merely conscious of their market impact and traders that intentionally moved market prices. Further, many legitimate trading strategies are specifically intended to affect market prices; as *amici* noted, “[e]ach time a market maker submits a higher bid or lower offer to provide more competitive pricing, it does so with the intent to affect price.”<sup>17</sup> Thus, while the legacy standard may make it more difficult for the CFTC to establish manipulation claims, the “artificial price” requirement provides significant safeguards to prevent legitimate—and beneficial—trading strategies from being incorrectly labeled as manipulative.

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<sup>1</sup> Memorandum and Order, *CFTC v. Wilson & DRW Investments*, No. 13-cv-7884 (S.D.N.Y. Sept. 30, 2016) [hereinafter DRW Order].

<sup>2</sup> *Id.* at 25-27 (quoting *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 183 (2d Cir. 2013)).

<sup>3</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, H.R. 4173 § 753 (July 21, 2010) (amending the Commodity Exchange Act (codified at 7 U.S.C. § 1 et seq.)). For example, CFTC Rule 180.2 implements CEA section 6(c)(3), which was added by the Dodd-Frank Act. The CFTC has stated previously that in applying rule 180.2 it will be “guided by the traditional four-part test for manipulation that has developed in case law arising under 6(c) and 9(a)(2).” *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41,398, 41,407 (July 14, 2011).

<sup>4</sup> See Complaint for Injunctive Relief, Civil Monetary Penalties, and Other Equitable Relief, *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. Nov. 6, 2013).

<sup>5</sup> *Id.* at 3.

<sup>6</sup> The Three-Month Contract provides that the settlement price is based on (1) consummated trades during a 15-minute settlement period; (2) bids or offers submitted during the settlement period; or (3) the prevailing rates for over-the-counter (OTC) interest rate swaps. DRW Order at 5-6. Because the Three-Month Contract was thinly traded, there were virtually no trades during the settlement window during the period at issue in the litigation. As a result, DRW's bids were allegedly used to set the settlement price for the contract. *Id.* at 4-10.

<sup>7</sup> Specifically, DRW believed that the Three-Month Contract was being incorrectly priced as economically equivalent to OTC interest rate swaps. *Id.* at 10. However, this pricing model did not reflect the fact that the Three-Month Contract was cleared through a centralized clearinghouse that

imposed daily variation margin payments, based on the Three-Month Contract's daily movements. *Id.* at 3-7. If the contract gained (lost) value, a counterparty with a short (long) position would be required to post additional margin, which would be paid to the party on the opposite side of the trade. *Id.* These daily variation margin payments could then be invested for additional profits, which, due to something known as the convexity effect, predictably provides greater benefits to counterparties with long positions in the contract. *Id.* As a result of this convexity effect, DRW believed the fair value of the Three-Month Contract was higher than that of similar OTC swaps, which do not provide for daily variation margin payments. *Id.* at 10.

<sup>8</sup> *Id.* at 10-11.

<sup>9</sup> See, e.g., *DiPlacido v. CFTC*, 364 F. App'x 657, 661 (2d Cir. 2009).

<sup>10</sup> See *CFTC v. McGraw-Hill Cos.*, 507 F. Supp. 2d 45, 51 (D.D.C. 2007).

<sup>11</sup> CFTC Reply Memorandum in Support of its Motion for Summary Judgment at 4, *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. Jan. 12, 2016).

<sup>12</sup> Brief of the CME Group Inc., the Commodity Markets Council, Futures Industry Association, Inc., Intercontinental Exchange, Inc., and Managed Funds Association as *Amici Curiae* at 2, *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. Jan. 12, 2016).

<sup>13</sup> *Id.* at 2.

<sup>14</sup> DRW Order at 26 (quoting *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 183 (2d Cir. 2013)).

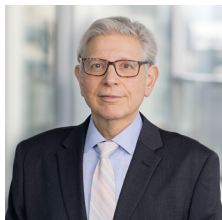
<sup>15</sup> *Id.* at 26 n.14.

<sup>16</sup> See Alexander Osipovich, *CFTC Flexes Muscles in Kraft*, DRW Cases, RISK.NET, Sept. 15, 2016.

<sup>17</sup> Brief of the CME Group Inc., the Commodity Markets Council, Futures Industry Association, Inc., Intercontinental Exchange, Inc., and Managed Funds Association as *Amici Curiae* at 10, *CFTC v. Wilson*, No. 13-cv-7884 (S.D.N.Y. Jan. 12, 2016).

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