UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

U.S. COMMODITY FUTURES TRADING COMMISSION, Plaintiff, v. DONALD R. WILSON, JR. AND DRW INVESTMENTS, LLC, Defendants.	:	13 Civ. 7884 (RJS)

DEFENDANTS' POST-TRIAL MEMORANDUM OF LAW

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Artificiality is the *sine qua non* of illegal manipulation. The CFTC, however, never proffered any evidence that Defendants created artificial prices or intended to do so. The incoherence of the CFTC's case was laid bare during summation, when it could not articulate why DRW's bids were artificial as defined by the law. Instead, the CFTC fell back to repeating the mantra that DRW intended to affect settlement prices, ignoring that its effort to reinvent manipulation law to proscribe merely intending to affect prices (as opposed to intending to create *artificial* prices) was rejected by the Court at summary judgment.

The CFTC nominally claims that it has shown that the settlement prices were artificial through proof that DRW improperly acted as "price definers, not traders" in submitting bids to raise settlement prices and obtain greater variation margin. (Tr. 5:1.) The CFTC's circular "primary purpose" theory, by which it invites this Court to transform economically rational bids into legal violations based solely on DRW's alleged motives, finds no basis in the law or common sense. Incidentally, it is also contradicted by overwhelming evidence showing DRW's effort to transact.

The CFTC also endeavored at summation to advance other theories unsubstantiated by the law or evidence. For instance, the CFTC claimed that DRW had caused the lack of participation in IDCH, asserting baldly that "[t]his empty pit was a result of the price distortion that the defendants had caused." (Tr. 697:21-698:3.) But the CFTC had to concede that it "[couldn't] point to anything in evidence of why" other traders did not participate in the IDCH market. (Tr. 730:9-24.) [1] And, in any event, even if there were evidence that DRW somehow

[1] The only "fact" cited by the CFTC to support this theory was that Ms. Ferber of MF Global (who it declined to call to testify) made complaints to Mr. Wilson and perhaps (although there is no evidence of this) she complained to others too. (Tr. 705:25-706:24.) Yet the full audio recording of that discussion, as well as Ms. Ferber's sworn investigative testimony, make clear that (1) Ms. Ferber never actually accused DRW of manipulation; (2) she herself never

scared off other market participants (which there is not), it is unclear how that would constitute manipulation.

The CFTC's theories underwent several transformations throughout the trial and closing arguments. At times the theory appeared to be that the "concentration" and "structure" of DRW's bids, the "absence of evidence" of DRW's valuation, and DRW's purported "intent of defining prices," somehow proved its case. (Tr. 710:15-711:10, 738:21-739:7, 746:17-21.) Yet none of these arguments approach proof of artificiality under the law. And at summation the CFTC made a series of dispositive concessions. It conceded that (i) it could not identify any evidence that DRW ever intentionally bid above its own calculation of fair value; (ii) DRW was actually correct in its assessment that the Three Month Contract was not economically equivalent to an over-the-counter swap; (iii) it was permissible for DRW to bid above the Corresponding Rates based on its valuation; (iv) DRW's bids could have been hit at any time; and (v) it was legitimate for DRW to want to have its bid prices reflected in the settlement curve. (Tr. 703:8-10, 714:14-20, 733:16-17, 738:17-20, 740:14-17.) These concessions demonstrate that DRW's bids were real, executable bids, at prices at which DRW was willing to transact. The effect of ICDH choosing to incorporate these bids into its settlement prices was to move settlement prices toward, rather than away from, the Three Month Contract's fair value. And there was nothing wrong with DRW providing IDCH with the option of incorporating DRW's bids into its settlement curve. These bids cannot be manipulative as a matter of law, and judgment should be entered in Defendants' favor on all claims.

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concluded that DRW had engaged in manipulation; (3) her statements were made as commercial posturing to resolve a problem MF Global had created by busting a trade; and (4) her accusation that DRW "screws people" by only entering bids during the settlement period was based on a factual misunderstanding and was demonstrably wrong. (DX 134; DX159; PX 4, Investigative Testimony of Laurie Ferber ("Ferber Dep."), at 47:16-48:2, 53:20-54:7, 68:16-69:22, 98:6-16.)

Finally, the trial evidence reveals that the CFTC failed to prove an attempt to affect "market prices" required under the applicable version of the Commodities Exchange Act. Rather, DRW's bids only affected IDCH's discretionary establishment of settlement prices, and the CFTC thus had no authority to bring an enforcement action for manipulation in this case.

ARGUMENT

A. There Is No Manipulation Without Intent To Create Artificial Prices

As this Court has held, "there is no manipulation without intent to cause artificial prices."[2] *C.F.T.C. v. Wilson,* No. 13 CIV. 7884 (AT), 2016 WL 7229056, at *12 (S.D.N.Y. Sept. 30, 2016) ("*Wilson II*"). Under Second Circuit law, as well as the CFTC's own administrative rulings, a finding that a trader acts with a *legitimate economic rationale* forecloses a finding of this requisite illegal intent. Judge Schiendlin, in the *Amaranth* class action case, observed that "[i]f a trading pattern is supported by a legitimate economic rationale, it cannot be the basis for liability under the CEA." *In re Amaranth Nat. Gas. Commodities Litig.,* 587 F. Supp. 2d 513, 534 (S.D.N.Y. 2008). Applying that principle, the Court held that plaintiffs had adequately pleaded manipulation because they alleged that defendants orchestrated trades knowing for certain they would lose money on them. *Id.* at 525. In *DiPlacido*, the Second Circuit upheld a CFTC administrative finding of manipulation because, again, the defendant acted in a manner that did not have a rational economic purpose: he was "offering at lower than prevailing bids

[2] The CFTC must establish the following for attempted manipulation: (1) Defendants specifically intended to cause an artificial price; and (2) Defendants committed some overt act in furtherance of that intent. *C.F.T.C. v. Wilson*, 27 F. Supp. 3d 517, 531-32 (S.D.N.Y. 2014) ("*Wilson I*"); *Wilson II* at *12; *C.F.T.C. v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 250 (S.D.N.Y. 2012). To prevail on manipulation claims, it must show: "(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) (internal quotation and citation marks omitted); *Wilson II* at *12-13.

[and] bidding at higher than prevailing offers," which guaranteed that the defendant would immediately lose money on the trades. *In re DiPlacido*, 2008 WL 4831204, CFTC No. 01-23, at *27-32 (Nov. 5, 2008), *aff'd* 364 F. App'x 657 (2d Cir. 2009). In *Transnor*, a CEA market manipulation case involving wash sales, the Court held that the plaintiff's manipulation claim survived summary judgment because a rational factfinder could find that Defendants sold crude oil at below market prices. *Transnor (Bermuda) Ltd. v. BP North America Petroleum,* 738 F. Supp. 1472, 1475 (S.D.N.Y. 1990). In sum, under *Amaranth*, *DiPlacido*, and *Transnor,* the Court must determine whether DRW's activity was economically rational, or whether DRW deliberately engaged in activity that was designed to be uneconomic.

Further, under the related standard articulated in *United States v. Radley*, the Court need not even inquire into whether the bids at issue were economically rational, so long as the Court finds that the bids were real, executable bids—facts that are not in dispute here. *Cf. United States v. Radley*, 659 F. Supp. 2d. 803, 815 (S.D. Tex. 2009), *aff'd on other grounds*, 623 F.3d 177 (5th Cir. 2011). Defendants submit that *Radley* is a correct articulation of the law, particularly in the case of an illiquid market such as the Three Month Contract market; unlike the Second Circuit cases cited above that arise in liquid markets with active bid-ask spreads that would cause instant losses if violated, in this case, there were no prevailing bids or offers to violate because DRW was the only bidder on the exchange. In this context, any *bone fide* executable order that DRW placed, so long as DRW were willing to transact at the order price, reflected its actual demand and is by definition placed with a legitimate economic rationale.[3] This legal question, however, is academic because there is no evidence that DRW's bids were not economically rational.

[3] While DRW was indeed bidding below its subjective fair value as a matter of fact, as a legal matter it is not clear that Courts should adopt a rule that uniformly prohibits bidding above one's subjective fair value. Unlike a situation in which a trader violates prevailing bids and offers (and

B. All Of The Trial Evidence Proved That DRW's Bids Were Economically Rational And Reflected Its Genuine Demand

The evidence at trial overwhelmingly proved that DRW's bids reflected its genuine demand to transact at prices at which it expected to profit if the bids were hit. All of DRW's witnesses—including Mr. Wilson, DRW trader Mr. Vander Luitgaren, and former DRW trader Mr. Silberberg—testified that they wanted to transact on all the bids they submitted. (Tr. 71:14-20 (B. Vander Luitgaren); Tr. 170:9-15 (C. Silberberg); Tr. 327:6-18 (D. Wilson).) DRW's desire to transact at these levels was based on its analysis that the Three Month Contract had convexity bias, it was not economically equivalent to an OTC swap, and DRW could profitably enter into long positions (particularly in the longer tenors) at prices above the Corresponding Rates but below its view of fair value. (DX 164, Silberberg Decl. ¶ 25; DX 165, Wilson Decl. ¶¶ 45-46.)[4] DRW further believed that these positions would be profitable (if hedged properly) regardless of whether IDCH established settlement prices at the Corresponding Rates or at the higher rates that DRW eventually bid. (Tr. 187:13-188:22 (C. Silberberg).)

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is certain to sustain a loss vis-a-vis the marketplace), a trader could purchase a security above his subjective fair value and nevertheless profit depending on how others trade. For example, market prices for many popular securities (such as Amazon, Microsoft, or Pets.com) have at times soared past what many considered "fundamental value." No court has suggested it would be illegal to trade at such levels, and traders have bought and sold such securities profitably at prices above fundamental value based on their forecasts of others' likely trading behavior. Trading in complex derivative contracts is of course quite different from trading in simple equities. Yet the principle that a trader could purchase a derivative above his view of fair value, with a reasonable expectation of exiting the position at an even higher price, still applies.

[4] Valuing the Three Month Contract required the expertise of DRW's quantitative analysis group, led by Yuhua Yu, who holds a mathematics PhD. (PX 44, Yuhua Yu Dep. 11:8-13, 22:6-10, 30:1-22; DX 165, Wilson Decl. ¶ 39.) Ms. Yu and another of DRW's quantitative researchers, along with a finance professor, authored an article titled "Central Clearing of Interest Rate Swaps: A Comparison of Different Offerings" ("The White Paper") that described their analysis compared the Three Month Contract to other cleared interest rate swap products. (DX 45.)

i. There Is No Evidence To The Contrary

The CFTC adduced no evidence that DRW's bids were not economically rational. There is no evidence that DRW would have lost money on any trade resulting from its bids. (Tr. 740:14-17 ("THE COURT: There is no evidence that I have seen to suggest that the rates at which they are bidding are money losers for them. Is there some that you can point me to? MS. RODRIGUEZ: No, your Honor, I cannot.").) There is no evidence that DRW's bids were not real, executable bids. (Tr. 738:17-20 ("THE COURT "This is a situation where they make bids and the bids could be hit, right? Anybody at any time can say I will take that bid, yes? MS. RODRIGUEZ: Yes.").) There is no evidence that DRW ever deliberately bid above its own analysis of fair value, to the extent that is even legally significant. *Compare* DX 168 (internal DRW email on August 3, 2011 stating "YUHUA MODEL . . . Has 30s @ 102.9 – We are quoting @ 70") *with* PX 110, MacLaverty Decl., Att. 1, Ex. 7 (showing that the highest spread between DRW's bids and the Corresponding Rates occurred on August 12, 2011 and was 101 basis points).[5] There is no evidence that DRW was not willing and eager to transact on its bids.

ii. DRW's Conduct Demonstrates That It Wanted To Transact On Its Bids

DRW's efforts to consummate the ultimately Busted Trade with MF Global further demonstrate its desire to trade on its bids. DRW's excitement at the prospect of transacting was reflected by Mr. Vander Luitgaren's comments on a recorded line, "Wow, awesome. Awesome,

[5] The CFTC has argued from the Complaint to its closing arguments that whether Defendants intentionally bid below their assessment of fair value was *not* at issue. The Complaint alleges that DRW believed fair value was 240 basis points *above* the Corresponding Rates in the 30-year tenor, far above any bid submitted by DRW. (Compl., ECF No. 1, at ¶ 42.) Similarly, the CFTC's summary judgment brief alleges that DRW submitted bids *toward*, not above, its view of fair value. (Mem. of Law in Supp. of Pl.'s Mot. for Partial Summ. J., ECF No. 109, at 9.) And CFTC's counsel echoed this position at summation, confirming that "[Defendants'] belief in fair value isn't where they get in trouble." (Tr. 732:16-17.)

awesome." (DX 136; DX 154.) When the trade was not cleared, Mr. Wilson demanded that the parties re-initiate the trade.[6] Mr. Wilson was furious when MF Global refused to do so. (DX 165, Wilson Decl. ¶¶ 107-112; Tr. 340:24-341:8; DX 159.) Although the Busted Trade was not consummated, the evidence surrounding it confirms that DRW wanted to transact. This disproves the allegation made in the Complaint—and, extraordinarily, repeated in the CFTC's summation without any evidentiary basis—that DRW pulled its bids down soon after the settlement period to avoid transacting. (Compl. ¶ 57; Tr. 738:23-25.)

DRW's pattern of generally bidding higher prices over time shows a desire to transact. DRW began by submitting electronic bids near the Corresponding Rates (where it had transacted in September 2010) and, as those bids did not lead to trades, DRW gradually increased the spread between its bids and the Corresponding Rates. It did so until its bids approached its assessment of fair value. (Joint Proposed Findings of Fact and Conclusions of Law, ECF No. 169, at ¶ P158; Tr. 57:18-25 (B. Vander Luitgaren); DX 167, Evans Decl. ¶ 70.) The CFTC cannot dispute that this is a rational approach to trying to attract a counterparty. Bizarrely, however, the CFTC at one point in its summation argued that if DRW wanted to transact, it would have raised its bids:

> MS. RODRIGUEZ: . . . What you see is – if they're really trying to attract counterparties during that period where it plateaued, they would have done a different series of bidding structures to attract more counterparties, but they didn't do that.
>
> THE COURT: What would they have done? I'm not sure I follow you.
>
> MS. RODRIGUEZ: They would have changed their prices.
>
> THE COURT: They would have gone higher?

[6] The parties had agreed to a ten year swap at 16 basis points over the Corresponding Rates for a notional value of US $250 million. This trade would have been two and half times larger than DRW's largest established position in the ten-year tenor. (DX 165, Wilson Decl. ¶ 102.)

MS. RODRIGUEZ: Yes.

(Tr. 719:11-19.) The CFTC's assertion here is nonsensical in light of its theory in the Complaint (and repeated in its summation) that bidding higher above the Corresponding Rates would make the prices *more* artificial and is illegal. Further, it is contradicted by the CFTC's pre-trial proposed statement of facts which stated "DRW regularly and systematically placed bids in the PM Settlement Period at *generally increasing* levels above Corresponding Rates." (Joint Proposed Findings of Fact and Conclusions of Law ¶ P146 (emphasis added).) Regardless, the evidence proved that DRW *did* raise its bids after the "plateau" referenced by Ms. Rodriguez once the outputs from its valuation model made it sensible to do so. (*See* Section B(i), *supra*).[7] And the manner in which DRW raised its bids over time corroborates its demand.

DRW also engaged in extensive bidding that furthered its ability to transact at the prices desired while having no impact on the settlement prices. On 108 of 117 days, DRW entered bids *before* the settlement period, and DRW submitted over 1,000 bids—approximately 40% of its bids in the relevant period—that never touched the settlement window. (Tr. 477:3-479:4; PX 94, Declaration of George H. Malas ("Malas Decl.") Att 1.) Furthermore, DRW frequently modified its bids through a time-consuming, manual process to maintain a constant spread between its bids and the Corresponding Rates throughout the day, even when this meant submitting *lower* bids during the settlement period than it would have otherwise. (Tr. 294:25-295:12 (D. Wilson); Tr. 209:20-210:14 (C. Silberberg).)

DRW's bids were open for extensive periods of time when assessed in the context of the futures markets as well. DRW's bids that were open during the settlement period were posted for approximately 21 minutes on average (longer than the entire 15-minute settlement period),

[7] As stated in the White Paper, increases in interest rate volatility lead to increases in the valuation differential between the Three Month Contract and the OTC Swap. White Paper at 1.

and its other bids were posted for an average of 33 minutes. (Tr. 496:12-25 (R. MacLaverty).) DRW thus exposed its bids to significant market risk. (DX 166, Harris Decl. ¶ 67 & Exhibit 6; PX 110, MacLaverty Decl., Att. 2, ¶ 88; DX 167, Evans Decl. ¶¶ 43-45; PX 94, Malas Decl. Att. 1.) All of this evidence proves that DRW undertook significant efforts, and subjected itself to risk, in attempts to transact that had no impact on settlement prices.[8]

iii. Dr. Harris' Valuation And Analysis Corroborate The Economic Rationality Of DRW's Bids

The economic rationality of DRW's bids is further corroborated by Dr. Harris' analysis and valuation of the Three Month Contract. Dr. Harris testified to the "structural reason that cleared futures contracts (like the Three Month Contract) deviate in value from their non-cleared OTC interest rate swap counterparts." (DX 166, Harris Decl. ¶ 126.) He then performed a valuation of the Three Month Contract using the widely adopted Hull-White model, from which he concluded, "DRW's bids on the Three Month Contract were in line with rational economic models of the fair value of the contract." (DX 166, Harris Decl. ¶ 95.)

Although not all of DRW's bids were below the valuations calculated by Dr. Harris, this does not imply that DRW bid above its own view of fair value because Dr. Harris did not replicate DRW's model. Rather, Dr. Harris constructed his own model, which corroborates the valuation differential between the Three Month Contract and the OTC swaps that was reflected in DRW's bids. (681:5-682:14 (J. Harris).) Dr. Harris' model also demonstrates that the valuation differential increased with the longer tenors and changed as market conditions, such as volatility, evolved. (DX 166, Harris Decl. ¶ 96 & Exhibits 3A-3G.) There is no evidence to

[8] DRW also never submitted offers during the relevant period, even though doing so, as the CFTC's expert MacLaverty admitted, would have been a "better way" to raise settlement prices "[i]f that were your goal." (Tr. 528:10-529:21 (R. MacLaverty).)

contradict this analysis: Mr. MacLaverty's critique of Dr. Harris' model was excluded in its entirety as "unreliable." *Wilson II* at *11.

iv. IDCH's Actions Corroborate The Economic Rationality Of DRW's Bids

The economic rationality of DRW's bids is further corroborated by the decision of IDCH, which had a strong self-interest in establishing fair and appropriate settlement prices, to incorporate these bids into its settlement prices. IDCH, aware of DRW's view that the Three Month Contract had a higher value than a corresponding OTC swap, facilitated DRW's ability to stream bids electronically by introducing it to SkyRoad. (DX 63; DX 76.) When DRW began to enter electronic bids over the Corresponding Rates in January 2011, IDCH *chose* to incorporate them into the IDEX Curve from which settlement prices were derived. Although IDCH could have chosen not to do so, it informed all clearing participants that establishing settlement prices that are a more accurate reflection of the market was "prudent from a risk management perspective." (DX 89; PX 6, Kopera Dep. 15:22-18:17, 21:20-24:25; PX 3, Dundon Dep. 70:22-71:15, 77:13-17; DX 66; Tr. 398:18-22 (R. MacLaverty).) It also informed clearing participants that it had chosen *not* to include price alignment interest ("PAI") in the Three Month Contract and had shared its reasons with the CFTC. (DX 89.) Thus, both the CFTC and IDCH should have expected that eventually traders would bid at rates above the Corresponding Rates that reflect the convexity bias and lack of PAI.

IDCH's decision to incorporate DRW's bids became subject to scrutiny in April 2011. Jefferies had complained to the CFTC's Division of Clearing and Intermediary Oversight ("DCIO") that IDCH's settlement prices were inconsistent with Jefferies' understanding that the Three Month Contract would be economically equivalent to an OTC swap. At that time, IDCH was fully informed that DRW was the only market participant placing orders on the electronic

exchange, that DRW's bids had not been hit in nearly three months, that DRW's bids were significantly above the Corresponding Rates, and higher settlement prices led to higher variation margin for DRW's open positions. (Tr. 396:6-18, 412:21-413:9, 417:12-418:1 (R. MacLaverty).) And IDCH defended its decision to incorporate DRW's bids into its settlement prices. In a letter sent by IDCH CEO Garry O'Connor to the CFTC DCIO on or about April 12, 2011 (the "IDCH April 12 Letter"), IDCH represented, among other things, that (i) IDCH had discretion to establish settlement prices that were a fair and appropriate reflection of the market; (ii) the Three Month Contracts should be valued differently than OTC contracts; and (iii) the settlement prices established by IDCH were proper under the Three Month Contract's contractual terms.[9] (DX 10, IDCH April 12 Letter.)

IDCH continued to incorporate DRW's bids into its settlement prices throughout the relevant period. (PX 96, Malas Decl. Att. 3.) IDCH never requested that DRW, at any time after it began submitting electronic bids, discontinue doing so. (Tr. 203:8-10 (C. Silberberg); Tr. 309:6-16 (D. Wilson); PX 3, Dundon Dep. 100:2-102:2, 145:5-21.) Although two IDCH employees (only one of whom appeared at trial) held opinions that they believed DRW's bids were improper, neither of them ever informed DRW of this during the relevant period. (Tr. 104:11-23 (J. Shay); Tr. 309:6-16 (D. Wilson); PX 3, Dundon Dep. 100:2-102:2, 145:5-21.) Moreover, the ill-informed trial testimony of John Shay, aside from being irrelevant to whether DRW intended to create artificial prices or to any other legal issue in this case, was not credible in light of his conceded ignorance about IDCH's relevant procedures and actions.

[9] On or about April 12, 2011, CFTC provided DRW with a copy of the IDCH's April 12, 2011 Letter. (DX 9; DX 10.) DRW relied on it in deciding to continue its practice of submitting electronic bids for Three Month Contracts, including bids above the Corresponding Rates posted during the Settlement Period. (DX 165, Wilson Decl. ¶¶ 128-129.)

Shay asserted—contrary to undisputed evidence in the record that, incidentally, had been available to him—that DRW was bidding only during the settlement period. (Tr. 90:7-16 (J Shay).) Shay then claimed that IDCH decided to shut down the exchange because of "certain egregious behaviors" by DRW. (Tr. 94:16-95:7 (J Shay).) That opinion was grounded in Shay's incorrect belief that DRW was only bidding during the settlement period. (Tr. 91:3-7 (J Shay).) Moreover, Shay admitted that he lacked any knowledge about (i) IDCH's communications with DRW, (ii) IDCH's settlement price rules, (iii) IDCH's discretionary authority to ignore bids in its settlement price calculation, and (iv) IDCH's response to Jefferies' complaint. (Tr. 102:13-103:6, 104:6-24, 117:9-118:14, 126:13-21 (J. Shay).) Shay acknowledged that he was not even aware of what steps IDCH Chief Executive Officer O'Connor or Chief Risk Officer Dundon may have taken to satisfy themselves that DRW's bids were not manipulative. (Tr. 101:21-24 (J. Shay).) In short, Shay's legally irrelevant opinion that DRW's "egregious" conduct caused IDCH to shut down the exchange lacked any grounding in the relevant facts.[10]

Shay's testimony—which was not corroborated by any other evidence—also cannot be reconciled with undisputed facts or simple logic. IDCH's rules allowed IDCH to disregard DRW's bids in establishing the settlement curve if IDCH determined that using the bids would lead to a price that was not fair and appropriate. (DX 83 at Rule 1002(i).) Further, IDCH's rules provided IDCH with authority to take measures against DRW if it believed DRW's conduct was manipulative. (DX 83 at Rule 205, Rule 306.) Given these rules, there would have been no reason to shut down the exchange on account of DRW. And when IDCH decided to delist the

[10] Despite the fact that Shay lacked any knowledge to support the opinion he would offer, the CFTC nevertheless trumpeted his testimony in its opening statement, only to abandon its significance thereafter. Shay's extraordinary testimony was never cited by the CFTC during summations in the course of being asked repeatedly by the Court for an evidentiary basis that Defendants intended to create artificial prices.

Three Month Contract, it informed the CFTC that it was doing so because it did not expect it to generate significant interest, not because of misconduct by DRW. Moreover, it did not request permission to delist the Contract until December 2011, four months after DRW stopped placing bids. (PX 109, Van Wagner Decl., Ex. 1.).

Regardless, any concerns that Shay or Dundon allegedly harbored were overruled by the decision of IDCH's CEO Garry O'Connor to continue incorporating the bids *after* he received DRW's detailed explanation in writing on February 18, 2011 of its bidding strategy and math behind it. (PX 3, Dundon Dep. 124:15-126:8; DX 76.) That IDCH decided to incorporate DRW's bids into its settlement prices is a significant indicator that those bids were economically rational because, as CFTC's expert MacLaverty conceded, IDCH had "their own self-serving reasons for making sure that the settlement price that they come to is a fair price . . . [b]ecause they may live and die on that price" if one of the parties defaults. (Tr. 394:16-23.)

C. <u>None Of The CFTC's Novel Artificiality Theories Are Tenable</u>

As best as can be divined from the CFTC's shifting and self-contradictory positions, the CFTC advanced four theories of artificiality: (i) DRW's bids were artificial because DRW *primarily* intended to influence prices to obtain more variation margin; (ii) DRW's bids were artificial because they were in excess of the Corresponding Rates; (iii) DRW's bids were artificial because DRW believed they would not be hit; and (iv) DRW's bids were artificial because DRW's conduct constitutes "banging the close." All of these theories lack merit.

i. The CFTC's "Primary Purpose Theory" Was Rejected By This Court At Summary Judgment

The CFTC's contention that attempted manipulation requires merely an intent "to influence prices," as opposed to an intent to create *artificial* prices, was rejected by this Court as "incorrect" under "well-settled principles." *Wilson II* at *12, *14. The fact that DRW intended

to influence settlement prices in a direction that would also provide DRW with greater variation margin does not render its intention to influence prices illegal. The *Transnor* court, citing CFTC administrative precedents, held that a manipulation claim cannot be sustained merely because the trader's activities benefited him, stating, "*a trader is entitled to act in his best interest so long as he does not act with manipulative intent*." *Transnor*, 738 F. Supp. at 1495-96 (citing *In re Ind. Farm Bureau Coop. Ass'n*, CFTC No. 75-14, Comm. Fut. L. Rep. P 21796, 1982 WL 30249, at *6 (C.F.T.C. Dec. 17, 1982)) (emphasis added). In other words, the CFTC's theory that DRW's economically rational bids were somehow artificial because DRW's purported *primary* purpose was not to transact but to influence prices could not be sustained—even if proven to be correct, which it was not—because intending to influence prices is not unlawful.[11] Indeed, anyone conducting any significant transaction in an open market would be aware that his trade "affects" market prices. There is simply no basis in the law or common sense to hold that otherwise legitimate trading is illegal based on what "primary purpose" the trader had in mind.

ii. The CFTC's Theory That The Corresponding Rates Were The Non-Artificial Prices Relies Entirely On MacLaverty's Unsubstantiated, Unreliable, And Illogical Opinions

The fact that DRW's bids were above the Corresponding Rates also cannot be a basis to find an intent to create artificial prices. The CFTC conceded that DRW was correct in its assessment that the Three Month Contract was not economically equivalent to an OTC swap:

> THE COURT: Are you suggesting that these really are the economic equivalent of the OTC swap rate?
>
> MS. RODRIGUEZ: No, we are not suggesting that.

[11] Further, even if intending to influence prices were unlawful (which it is not), no liability could be found where DRW's bids also reflected its genuine demand. *See S.E.C. v. Masri*, 523 F. Supp. 2d 361, 373-74 (S.D.N.Y. 2007).

(Tr. 703:8-10.) The Corresponding Rates therefore do not represent rates established by "legitimate forces of supply and demand" for the Three Month Contract but rather the intersection of supply and demand for a fundamentally *different* product. (DX 166, Harris Decl. ¶¶ 28, 125.) It would not make any sense to require that the price of one product equal the price of a different product with a different value. Yet the CFTC nevertheless fell back on its argument that the non-artificial prices should have been "at or near" the Corresponding Rates:

> THE COURT: But, again, I just didn't see much in the way of evidence offering a coherent or pinpointed view of what the fair value is other than Mr. MacLaverty basically saying that it ought to be at or near the corresponding rate, the OTC swap rate. So is that the position? It ought to be two or three basis points above the corresponding rate? That's the natural value as opposed to the artificial value that these guys were peddling?
>
> MS. RODRIGUEZ: Yes, that would be the more at the natural value.

(Tr. 713:3-13.) MacLaverty's opinions here—which provide the sole evidentiary support for the CFTC's position—are not grounded on any analysis and cannot withstand scrutiny.

MacLaverty never bothered to perform a valuation of the Three Month Contract. (Tr. 440:8-13 (R. MacLaverty).)[12] Because of his failure to do any actual analysis, he could not even say whether DRW's bids were artificially high or artificially low:

> THE COURT: All right. But I just want to be clear on this. You're saying 70 basis points -- a spread of 70 basis points is artificial?
>
> THE WITNESS: Correct.
>
> THE COURT: You just can't say whether it is artificially high or artificially low?
>
> THE WITNESS: That's correct.

[12] MacLaverty volunteered that he "wasn't asked" to perform a valuation, and the CFTC, despite having its own Office of the Chief Economist at its disposal, did not proffer any other evidence regarding the Three Month Contract's value either. (Tr. 426:2-3.)

(Tr. 425:23-426:19 (R. MacLaverty).) He therefore had no idea whether DRW's bids were closer to, or further from, the Three Month Contract's fair value than the Corresponding Rates, and his opinion that the non-artificial prices through August 2011 should have been "at or near" the Corresponding Rates is disconnected from any notion of value. When asked to provide any reason at all that bids 70 basis points above the Corresponding Rates were problematic, the only reason he advanced was that the bids were not based on a "properly calibrated model"—an opinion that had already been excluded by the Court pre-trial as "unreliable." (Tr. 430:21-431:4 (R. MacLavertly); *Wilson II* at *11.)[13]

MacLaverty's opinions were also self-contradictory and illogical. He contradicted himself as to whether he believed the prices should be at or near the Corresponding Rates because (i) that is where transactions had taken place in September 2010, or because (ii) IDCH's rules provided that the Corresponding Rates could be used as default rates. He initially adopted the former position, testifying "[a]bsent DRW's actions, in accordance with IDCH rules, the Three-Month Contract should have settled at or near the Corresponding Rates" because "there were other trades that occurred not flat to corresponding rates but close, and they were real trades." (Tr. 481:13-22, 487:14-480:10 (R. MacLaverty).) MacLaverty could not provide any rationale, however, as to why transaction prices for those "real trades" from September 2010 would be a better barometer of non-artificial prices than the price that was agreed (even though ultimately not cleared) between MF Global and DRW at 16 basis points over the Corresponding Rates in the ten-year tenor in February 2011, or the unwind price that Jefferies and DRW agreed

[13] MacLaverty later admitted that he could not even say whether the highest bid DRW ever submitted, approximately 100 basis points over fair value, was closer to or further from the contract's value than the Corresponding Rates. (Tr. 456:8-11 (R. MacLaverty).)

at approximately 100 basis point over the Corresponding Rates in the 30-year tenor in August 2011. (Tr. 452:14-19 (R. MacLaverty); Tr. 493:8-494:8 (R. MacLaverty).)[14]

MacLaverty also conceded that in the relevant markets "a day is an eternity," further undermining the justification for using transaction prices from months earlier to determine a non-artificial price. (Tr. 495:19-25 (R. MacLaverty).) Moreover, all of the trial evidence demonstrates that the transaction prices in September 2010 were far *below* fair value; even MF Global came to this realization. (PX 4, Ferber Dep. at 98:6-16 (conceding that DRW had a "superior understanding" of the Three Month Contract at the time that it entered into these positions); *see also* DX 166, Harris Decl. ¶ 10(h) ("DRW's profits . . . stemmed from interest rate movements and the fact that DRW entered into a long position in the Three Month Contract at below fair value."); (Tr. 175:10-22 (C. Silberberg).)

Not surprisingly, MacLaverty backed off the opinion that the September 2010 transaction prices determined what the non-artificial price should have been, saying instead that when he opined that the settlement prices "should have been at or near the Corresponding Rates," he "was capturing the rule in my mind when I made this statement." (Tr. 491:8-20 (R. MacLaverty).) Yet IDCH's rules prioritized bids such as DRW's over the Corresponding Rates, and IDCH, under its rules, had also determined that DRW's bids were a *better* source for a "fair and appropriate" settlement price than the Corresponding Rates. (DX 10.)

When confronted by the fact that his opinion, which purported to be grounded in IDCH's rules, was squarely at odds with how IDCH described its rules in its April 12 Letter, MacLaverty

[14] MacLaverty's explanation that the unwinds negotiated in August 2011 and the Busted Trade agreed through a voice broker do not constitute "trades" because they were not done in an "open and competitive marketplace" cannot be reconciled with his opinion that the non-artificial prices should be based on the September 2010 transactions, which also were completed through a voice broker. (DX 165, Wilson Decl. ¶ 49.)

invented a new opinion. He stated that although IDCH had "full knowledge" of DRW's bidding when it asserted that its settlement prices (reflecting DRW's bids) were fair and appropriate in the April 12 Letter, "it wasn't intuitively obvious" that DRW's bids were "much of a problem .... until May when it became more clear .... [b]ecause the bids were entered at wider spreads to the corresponding rates than they had been [previously]." (Tr. 403:7-10, 418:8-11, 420:5-16, 423:10-12 (R. MacLaverty).) This newfangled opinion cannot even stand up to MacLaverty's own report, which shows that for five days *before* IDCH sent the April 12 letter, DRW was consistently bidding 70 approximately basis points over the Corresponding Rates in the 30-year tenor—which was approximately the same spread it bid in May. (PX 110, MacLaverty Decl., Att. 1, Exhibit 7.) Moreover, IDCH continued to incorporate DRW's bids into its settlement prices in May and throughout the relevant period. (PX 96, Malas Decl. Att. 3.) In sum, neither the September 2010 trades, nor IDCH's rules, provide any basis for MacLaverty's opinion that the non-artificial settlement prices should have been at or near the Corresponding Rates.

MacLaverty's opinions aside, all of the evidence at trial established that the Corresponding Rates were significantly below the Three Month Contract's fair value because of the differential caused by the convexity bias. (DX 166, Harris Decl. ¶¶ 30, 98.) It follows that DRW's bids were *closer* to the Three Month Contract's fair value than the Corresponding Rates. Activity that moves prices toward, rather than away from, fair value is also not manipulative as a matter of law. *Cf. Sullivan & Long, Inc. v. Scattered Corp.,* 47 F.3d 857, 861-862 (7th Cir. 1995) (holding that the defendant's short sales of a stock that it recognized was overvalued based on "a superior interpretation of public information . . . [was] not market manipulation, but arbitrage"); *see also Cohen v. Stevanovich*, 722 F. Supp. 2d 416, 421 (S.D.N.Y. 2010) (holding that moving prices toward their intrinsic values is not manipulative).

iii. The CFTC's Theory That DRW Believed Its Bids Would Not Be Hit Is Factually Incorrect and Legally Irrelevant

The CFTC's theory that DRW's bids were artificial because DRW believed that they would not be hit is factually and legally wrong. Trial testimony showed that Messrs. Wilson, Silberberg, and Vander Luitgaren reasonably believed throughout the relevant period that DRW's bids could have been hit. Wilson believed (correctly) that other parties had the capability to submit orders electronically and that IDCH was encouraging participants to do so, as shown by the testimony of former IDCH executive Kopera and by IDCH's representation that electronic orders had been submitted since 2009. (PX 6, Kopera Dep. 72:7-20, 73:21-74:5, 74:21-25; DX 10.) Wilson also believed that additional parties that did not have that capability might acquire it, and that other parties could view electronic bids on the screen and then attempt to transact through a voice broker, just as MF Global had in February 2011. (DX 165, Wilson Decl. ¶¶ 97-98); *see also* Tr. 63:2-10 (B. Vander Luitgaren); Tr. 178:17-179:2 (C. Silberberg).)

Notably, IDCH was established at a time when many market participants anticipated a shift away from the enormous OTC interest rate swap market toward cleared interest rate swap futures products like the Three Month Contract.[15] (DX 165, Wilson Decl. ¶¶ 29-30.) Even the CFTC's own expert, Mr. MacLaverty, testified that "thousands" of persons could have been watching this market. (Tr. 504:25-505:05 (R. MacLaverty).) Moreover, as long as IDCH remained open for business, it signaled to the marketplace (and DRW) that IDCH was attempting to attract additional market participants. (Tr. 506:22-507:12 (R. MacLaverty); DX 162, Luitgaren Decl. ¶ 37.)

[15] OTC interest rate swaps are among the most widely traded swap contracts. (DX 166, Harris Decl. ¶ 16.)

IDCH, which had superior knowledge regarding the level of interest and activity in the market, never informed DRW during the relevant period that it was not promoting its product or that DRW's bids could not be hit. (DX 165, Wilson Decl. ¶¶ 123-124, 126-127, 130; PX 3, Dundon Dep. 100:2-102:2.) Rather, IDCH only announced its belief that it was unlikely to generate significant trading in the Three Month Contract in a letter submitted to the CFTC on December 1, 2011 requesting to delist the Contract. This was over four months *after* DRW stopped submitting electronic bids. (PX 109, Van Wagner Decl., Ex. 1.)

Whether DRW had little subjective expectation that its bids would be hit is legally irrelevant in any event. As a matter of common sense, no trader can know with certainty that a bid will not be hit, so long as that market is open; traders can only have expectations, which even the most self-assured would have to acknowledge could be wrong. In addition, there is no law imposing a duty on a trader to assess the depth of an open marketplace before placing orders. Such a rule would be untenable, imposing an impossible duty on traders (at the peril of being sued by the CFTC) to determine in advance the appetites of all other potential market participants, known and unknown, as to whether they might transact on an order. It would also chill trading in any new, illiquid market where there is a possibility that the market will not develop and those who placed orders in it could be accused *post-hoc* of entering orders they "knew" would not be hit. Thus, there is good reason why there is no judicial support for this novel theory being advanced by the CFTC Staff in this case.

iv. The CFTC's "Banging the Close" Label Is Both Meaningless and Misplaced

The CFTC repeatedly affixed the label of "banging the close" to Defendants' conduct. Yet doing so does not spare the CFTC from its burden to prove artificiality, which it cannot do.[16] Further, the "banging the close" precedents are all distinguishable from this case because they involve trading activity, such as violating bids and offers, that is demonstrably uneconomic.

In *DiPlacido*, the CFTC alleged that the defendant entered into OTC derivative contracts whose value was determined by the settlement price of certain electricity futures contracts, and then bought or sold those futures contracts at prices higher or lower than prevailing prices, respectively, for the alleged purpose of increasing the value of its OTC positions. *In re DiPlacido*, 2008 WL 4831204, at *3, *aff'd* 364 F. App'x 657 (2d Cir. 2009). In its administrative decision, a CFTC administrative judge found that buying contracts for more than the prevailing price, or selling for less than the prevailing price, was "uneconomic," and engaging in trading activity with "no apparent economic rationale" is sufficient to show manipulative intent. *Id* at *28. Similarly, in *Welsh, Pia*, and *Moore Capital*, a trader placed orders to *buy* platinum and palladium futures in the last seconds of a two-minute closing period (despite being subject to less favorable prices) with the intent to *raise* prices. Complaint, ECF No. 1, *C.F.T.C. v. Welsh* (S.D.N.Y. No. 12-cv-1873); Consent Order, *In re Moore Capital Mgmt., LP., et al.*, CFTC No. 10-09 (Apr. 29, 2010); Consent Order, *In re Pia*, CFTC No. 11-17 (Jul. 25, 2011). The alleged trading was uneconomic because "a buyer of futures contracts

[16] The Dodd-Frank Act amended the Commodity Exchange Act to prohibit the "disruptive practice" of "demonstrate[ing] intentional or reckless disregard for the orderly execution of transactions during the closing period." Section 747, Dodd-Frank Wall Street Reform and Consumper Protection Act, 7 U.S.C. § 6c(a) (2011). This provision, which arguably encompasses the conduct that prior to Dodd-Frank had been considered "banging the close," is not a legal issue in this case (aside from its not fitting the facts here in any event).

should want to buy at the lowest price possible." Complaint, *C.F.T.C. v. Welsh*, (S.D.N.Y. No. 12-cv-1873); *see also, e.g.* Consent Order, *In re Marathon Petroleum Co. LLC*, CFTC No. 07-09 (Aug. 1, 2007) (holding that artificial prices result when traders buy at higher prices than necessary or sell at lower prices than necessary); Consent Order, *In re Shak, et al.*, CFTC No. 14-03 (Nov. 25, 2013) (same).

In contrast, DRW submitted bids at prices it believed would lead to profitable transactions. That none of DRW's electronic bids were hit leads to the basic economic inference—that even the CFTC's own expert had to concede—that DRW could only have transacted by bidding even higher. (Tr. 424:22-425:4, 516:10-13 (R. MacLaverty.)[17]

D. <u>The CFTC Failed To Prove DRW Caused The Settlement Prices At Issue</u>

To prevail on its manipulation claims, the CFTC must also prove by a preponderance of the evidence that if artificial prices existed, Defendants' actions were a "proximate cause" of those artificial prices. *Wilson II* at *13-14. The chain of proximate cause is broken when "a subsequent participant exercises judgment that is 'truly independent'—judgment that is not the product of 'pressure or misleading information provided by the actor whom the plaintiff seeks to hold liable.'" *Higazy v. Templeton*, 505 F.3d 161, 181 (2d Cir. 2007) (internal citations omitted); *see also Townes v. City of N.Y.*, 176 F.3d 138, 147 (2d Cir. 1999).[18] Here, IDCH made an

[17] The CFTC's failure to prove artificiality is dispositive of not only its manipulation and attempted manipulation claims but also its control person and aiding and liability claims against Mr. Wilson, which require an underlying violation. *See In re Platinum & Palladium*, 828 F. Supp. 2d 588, 599 (S.D.N.Y. 2011); *C.F.T.C. v. Standard Forex, Inc.*, No. CV-93-0088, 1993 WL 809966, at *13 (E.D.N.Y. Aug. 9, 1993).

[18] Proximate cause precedents drawn from the federal tort law context are applicable here because proximate cause under the CEA is a "concept drawn from tort law." *See In re Cox*, CFTC No. 75-16, Comm. Fut. L. Rep. P. 23786, 1987 WL 106879, at *21 (July 25, 1987) (Comm'r West, dissenting).

independent decision that was not "the product of pressure or misleading information" to incorporate DRW's bids into the calculation of its settlement curve. *Higazy*, 505 F.3d at 181.

When establishing settlement prices, IDCH knew that: (i) DRW held long positions in the Three Month Contract that would result in margin payments to DRW if settlement prices rose; (ii) DRW was posting certain bids during the Settlement Period for, among other things, the purpose of providing the IDCH with information that could be considered in determining settlement prices; (iii) DRW's bids were higher than the Corresponding Rates; and (iv) IDCH had discretion under its rules to disregard the bids if it thought it appropriate to do so.[19] One IDCH employee (Dundon) even testified that he raised concerns about DRW's bids to IDCH's CEO (O'Connor), who was the ultimate decision-maker in this matter. (PX 3, Dundon Dep. 124:15-126:8.) IDCH considered these concerns, as well as the complaint raised by Jefferies, and *chose* to incorporate DRW's electronic bids into its settlement prices throughout the relevant period. IDCH's determination that DRW's bids were a more appropriate basis for settlement prices than the Corresponding Rates is further demonstrated by the fact that between August 13, 2011, and August 31, 2011, IDCH established settlement prices above the Corresponding Rates in the absence of any bidding activity by DRW. (PX 94, Malas Decl. Att. 1; PX 96, Malas Decl. Att. 3.)[20] IDCH's "truly independent judgment" forecloses the conclusion that DRW *caused* the prices observed during the relevant period. *Higazy*, 505 F.3d at 181.

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[19] Put another way, the undisputed evidence showed that DRW could not and did not "force" IDCH to incorporate DRW's bids into settlement prices, regardless of the imprecise language in an internal email.

[20] The data produced by IDCH during the investigation only provides settlement price information through August 31, 2011. (PX 96, Malas Decl. Att. 3; DX 74.)

E. Trial Evidence Reveals That The CFTC Lacks Statutory Authority In This Case

Despite the CFTC's promises in the Complaint that it would prove manipulation of "market prices," the trial evidence showed only an attempt to affect settlement prices in an illiquid market. The consequence is that the CFTC lacked the statutory authority to pursue this case in the first place. The Complaint alleged violations of §§ 6(c) and 9(a)(2) of the CEA as they existed in 2006, *before* the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). *See, e.g.*, Compl. ¶¶ 63, 70. Prior to the Dodd-Frank Act, CEA § 6(c) authorized the CFTC to bring anti-manipulation actions "[i]f the Commission has reason to believe that any person . . . has manipulated or attempted to manipulate ***the market price*** of any commodity…" 7 U.S.C. § 9 (2006) (emphasis added). Accordingly, both courts and CFTC administrative tribunals have held that manipulation of a "market price" is a necessary element of a pre-Dodd Frank manipulation claim. *See, e.g.*, *Parnon Energy*, 875 F. Supp. 2d at 241 (CEA makes it unlawful to "manipulate or attempt to manipulate the 'market price of any commodity'" or futures contract); *In re Ind. Farm Bureau Coop. Ass'n,* 1982 WL 30249, at *7 (CFTC required to prove that the defendant "acted (or failed to act) with the purpose . . . of causing or effecting a *price or price trend in the market* . . . influencing *futures prices in the particular market* at the time of the alleged manipulative activity.").

Settlement prices, of course, are mere pronouncements by exchanges, rather than the market price of a commodity of futures contract. Accordingly, in construing whether affecting settlement prices could fall within the Commodity Exchange Act, some courts have observed affecting settlement prices *per se* cannot qualify as manipulation where the settlement prices are determined by an exchange in a discretionary manner. *See, e.g. Vitanza v. Bd. of Trade of the City of N.Y.,* No. 00 cv 7393(RCC), 2002 WL 424699, at *1 (S.D.N.Y. Mar. 18, 2002)

(dismissing a private manipulation claim because "the settlement price is not the value of the contract itself or the value of the commodity underlying the contract"). When actors have improperly affected market prices of actual trades and settlement prices are derived automatically from such trades, however, Courts have understandably recognized that an improper effect on market prices (by definition) involves a corresponding effect on settlement prices. *See In re Amaranth Nat. Gas. Commodities Litig.*, 587 F. Supp. 2d at 526 (allowing a manipulation claim to proceed because the plaintiffs alleged "not only that defendants manipulated settlement prices, *but also* that that manipulation *altered the prices* of NYMEX natural gas futures."); *DiPlacido v. C.F.T.C.*, 364 Fed. App'x. 657, n.1 (2d Cir. 2009) (commenting that a settlement price calculated by trading is within the Commodity Exchange Act and distinguishable from one calculated by a formula as in *Vitanza*).

Here, DRW was the only bidder, there was no bid-ask spread, and there were no consummated trades. IDCH's settlement rates were not driven automatically by prices of consummated trades (as in *DiPlacido*) but, rather calculated by IDCH exercising its discretion and evaluating a "hierarchy of inputs" as in *Vitanza*. (PX 3, Dundon Dep. 63:11-65:19, 70:22-71:15.) Fundamentally, DRW's conduct was no different than its expressing opinions to IDCH for consideration. Such opinions could have been (and were at times) transmitted via letter or phone call, but eventually happened to be conveyed via bids because IDCH required the same. Accordingly, DRW's purported manipulation of ICDH settlement prices in an illiquid market is insufficient to sustain a claim under the CEA.

CONCLUSION

For the foregoing reasons, Defendants respectfully submit that judgment should be entered in their favor on all claims.

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New York, New York

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on December 21, 2016 service of the foregoing document was made to all counsel of record via ECF.

Dated: December 21, 2016
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