Securities Regulation Daily Wrap Up, COMMODITY FUTURES—S.D.N.Y.: Will 1980s ‘squeeze’ ruling cast shadow over DRW case?, (Jul. 14, 2016)

Click to open document in a browser

By Mark S. Nelson, J.D.

The CFTC replied to an industry-led friend of the court brief that accused the agency of trying to lower the standard for holding traders liable for market manipulation. The briefing battle centers on how the CFTC, industry groups, and the defendants in a case pending in the federal trial court in Manhattan interpret a 1980s-era Commission decision adopting the specific intent standard. The court granted the industry groups’ bid to offer their view of the CFTC’s suit against Donald Wilson and DRW Investments, LLC because they bring a "unique" perspective as compared to others involved in the case (*CFTC v. Wilson*, July 13, 2016).

CFTC counters amici. The CFTC sued Wilson and DRW for market manipulation and attempted market manipulation (with related aiding and abetting claims against Wilson) nearly three years ago this coming November based on Wilson’s and DRW’s alleged manipulative trading in the IDEX USD three-month futures contract. The district court previously denied Wilson’s and DRW’s bid to dismiss the CFTC’s case.

In its reply to the industry amici, the CFTC countered that amici seek to impose a standard on attempted manipulation claims that goes against three decades of case law since a 1980s Commission decision on which the agency said amici "disproportionately rel[y]." According to the CFTC, it need only prove intent to affect market prices and an overt act in furtherance of that intent; the agency said artificiality is not a required element.

The CFTC also distinguished its case against Wilson and DRW from the 1980s precedent by noting the traders there never admitted to trying to implement a long manipulative squeeze, whereas Wilson and DRW sought to establish prices they believed to be "fair." A footnote explained what the CFTC views as the difference between lawful trading to earn profits and unlawful "altruistic" trading to fix prices thought to be incorrect.

A group of amici, led by CME Group Inc., Commodity Markets Council, Futures Industry Association, Inc., Intercontinental Exchange, Inc., and the Managed Funds Association had argued that the CFTC’s complaint against DRW and Wilson was designed to roll back 30 years of precedent requiring proof of specific intent to create an artificial price in attempted manipulation cases. According to them, the complaint’s "short-hand" recitation of the offence elements skirts the artificial price requirement.

Amici concluded that the CFTC’s shift away from its own precedent would undermine legitimate market behavior by subjecting traders to greatly expanded potential liability. In essence, the groups said a trader could be held liable for manipulation if she knows the activity will create a new price. Amici said this behavior could be viewed by the CFTC as "intent to affect price."

History lesson. The disputed intent requirement has roots in a 1982 CFTC administrative matter set in a time period when U.S. farmers shipped large quantities of grain to the former Soviet Union (now Russia) and there were at least sporadic quality issues with the U.S. corn harvest. The respondents in *In the Matter of Indiana Farm Bureau Cooperative Association, Inc.* allegedly manipulated the CBOT July 1973 corn futures contract by liquidating their long position in the final 20-30 minutes of trading in the contract after the Chicago Board of Trade’s directors opted to remove the maximum daily limit for the last day of trading. According to the CFTC’s Division of Enforcement, the respondents unlawfully engaged in a "squeeze" that forced shorts to pay artificial prices instead of finding better deals in the cash market.

The administrative law judge concluded that prices for the contract were artificial, but found the respondents lacked intent to manipulate the contract and thereby produce those artificially high prices. In fact, the law judge said it was impossible to say when the price for the contract became artificial.

The CFTC’s enforcement division appealed and the Commission, with the Chairman and one other commissioner writing separately to concur, upheld the law judge, finding that the evidence failed to show the respondents acted with the requisite intent. The Commission majority explained that the enforcement division

had alleged a specific intent violation, but later tried to persuade the law judge that the standard should be general intent. Looking back to *In the Matter of Hohenberg Brothers*, the majority said the required mental state is "specific intent" which it explained means "purposeful conduct." As a result:

> [W]e hold that in order to prove the intent element of a manipulation or attempted manipulation of a futures contract price under §§6(b) and 6(c) of the Commodity Exchange Act, as amended, it must be proven that the accused acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand influencing futures prices in the particular market at the time of the alleged manipulative activity.

At the end of its discussion of intent, the majority noted that market dominance (*i.e.*, a corner or near corner in the cash market with a big long interest in the futures market) can lay the base for a long manipulative squeeze. Later, in reviewing the facts of the matter, the majority would explain that the respondents never laid the base for a squeeze. Instead, other factors may have accounted for the observed market volatility:

> The evidence demonstrates that any relative overall cash corn shortfall that did occur in the Chicago area was the product of a "natural" corner, due to transportation shortages, heavy export shipments and quality problems. [citation omitted] Apparently, a number of shorts who had made no delivery preparations stayed in the market speculating on the imposition of federal export controls on corn which had been threatened in June by the Department of Commerce and which would have brought prices down. This threat was not lifted until after the close of trading on July 18, and perhaps the uniqueness of this particular market situation is attributable to the confluence of these factors [two paragraphs later, the majority suggested the shorts' behavior was "irresponsible"].

A concurrence by then-Chairman Philip McBride Johnson agreed with the majority's recitation of the specific intent standard and its finding that factors unattributable to the respondents led to price volatility. But the chairman disagreed with the majority's casting aside of the law judge's finding that prices in the CBOT July 1973 corn futures contract were artificial. He also disagreed with how the majority tried to harmonize some of the Commission's prior decisions.

Commissioner James Stone ended his concurrence with an observation about the persistence of questions about the intent standard and a warning about trading when markets become chaotic: "The debate over price artificiality and intent has gone on for many years, and it will presumably continue. Prospective holders of dominant futures positions would be well advised to keep their offsetting orders squarely within the price bounds prescribed by the supply and demand conditions in the underlying cash markets."

The case is No. 13-cv-07884.

Attorneys: Jonah McCarthy for the CFTC. Boris Bershteyn (Skadden, Arps, Slate, Meagher & Flom LLP) for CME Group Inc., Commodity Markets Council, Futures Industry Association, Inc., Intercontinental Exchange, Inc. and Managed Funds Association.

Companies: DRW Investments, LLC; CME Group Inc.; Commodity Markets Council; Futures Industry Association, Inc.; Intercontinental Exchange, Inc.; Managed Funds Association

LitigationEnforcement: ClearanceSettlement CommodityFutures Derivatives Enforcement ExchangesMarketRegulation FraudManipulation RiskManagement Swaps NewYorkNews