

[Securities Regulation Daily Wrap Up, TOP STORY—N.D. Ill.: Cboe wins dismissal of VIX manipulation suit, \(May 30, 2019\)](#)

Securities Regulation Daily Wrap Up

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By [Anne Sherry, J.D.](#)

Traders argued that Cboe continued to promote products based on its volatility index despite knowing of price manipulation in the marketplace.

The district court in Chicago dismissed a lawsuit alleging that the Chicago Board Options Exchange enabled price manipulation in products based on Cboe's volatility index, or VIX. The Exchange Act-based manipulation claim was doomed by a failure to plead loss causation or scienter; the plaintiffs also failed to allege damages to sustain a claim under the Commodity Exchange Act. The court, however, rejected Cboe's argument that it enjoyed absolute immunity from the lawsuit as a self-regulatory organization (*In re Chicago Board Options Exchange Volatility Index Manipulation Antitrust Litigation*, May 29, 2019, Shah, M.).

Also called the "Fear Index," the VIX is a benchmark index based on S&P 500 options that reflects expected market volatility in the near term. While the VIX cannot be traded directly, Cboe offers futures, options, and exchange-traded funds tied to the VIX. These products are cash-settled, with options expiring on a weekly basis. According to the plaintiffs, who traded VIX products, certain features of the settlement process made it especially susceptible to manipulation, but Cboe chose not to enforce its rules against manipulation so that it could continue to profit from the VIX products. The complaint alleges violations of the securities antifraud provisions and the Commodity Exchange Act; it also brings claims against unnamed "Doe" defendants that allegedly manipulated the settlement values for VIX options and futures.

No immunity or preclusion. Cboe argued that the Exchange Act claim should be dismissed on the basis of absolute immunity afforded to self-regulatory organizations, but the court disagreed. While SROs are entitled to immunity when they perform their statutory functions, exchanges are also private entities that act in their own business interests. Courts make case-by-case determinations as to SRO immunity based on the nature of the function the SRO performs.

Cboe is immune from a private action under the Exchange Act for failing to enforce rules prohibiting manipulation or declining to discipline market manipulators, the court wrote. However, at the motion-to-dismiss stage, it framed the plaintiffs' claim as one based on Cboe's non-immune acts. When it promoted the VIX products, designed the settlement process, and listed them on its exchange, Cboe acted in its private capacity.

The court was also unmoved by Cboe's argument that the securities fraud claim was precluded because the SEC approved aspects of the VIX enterprise. Regulatory approval only precludes a private right of action if Congress intended as much when passing the relevant statute. Cboe cited cases where the court recognized that the SEC's approval of acts could preclude an antitrust claim because of a "repugnancy" between the antitrust and securities provisions, but it pointed to no cases finding preclusion between two aspects of the same regulatory regime. Here, the private right of action and the SEC oversight regime were not repugnant to one another, but complementary, as both have the ultimate goal of preventing manipulation. Allowing the private suit does not frustrate Congress's intent that the SEC regulate the markets, the court reasoned.

Exchange Act elements. Ultimately, what brought down the plaintiffs' securities law claim were the statutory elements themselves. In an apparent issue of first impression for the court, it extended the fraud-on-the-market presumption of reliance, which usually applies to misrepresentations, to the manipulation scenario. The manipulation was "communicated to the public" in the sense that it was incorporated into the pricing of the VIX securities. Applying the presumption, then, the plaintiffs adequately alleged reliance.

However, the plaintiffs faltered on loss causation. Although the case concerned manipulation rather than misrepresentations, the court declined to relax the standards to plead loss causation. Because the plaintiffs have access to information about their own trades, they should have been able to identify specific transactions where they lost money, but they did not do so.

The complaint also failed to plead with particularity facts giving rise to a strong inference of scienter. The plaintiffs argued that the VIX's unique importance to Cboe's success meant that management must have known about the manipulation, but it continued to offer and advertise the VIX. This was nothing more than a generalized profit motive common to all corporate executives, the court concluded—Cboe earned the same trading fees from the allegedly manipulative trades as for any legitimate transaction. Even the plaintiffs' explanation why the design features of the VIX made it prone to manipulation were insufficient to show that Cboe included them to facilitate manipulation. A more compelling inference was that Cboe thought that it had included adequate safeguards.

Commodities Exchange Act. The court likewise dismissed the plaintiffs' claim under section 25(b)(1)(A) of the Commodity Exchange Act, which imposes liability on an exchange for damages caused by its failure to enforce its rules and regulations. The complaint did make a sufficiently concrete allegation that every time a Doe manipulated the VIX futures, Cboe failed to enforce its rules prohibiting manipulation, and that this failure was in bad faith. As with the securities claim, however, the claim was doomed by a failure to allege actual damages. The plaintiffs did not assert that the market was constantly suppressed or inflated, so their general allegations of harm were insufficient.

The plaintiffs have leave to file an amended complaint by June 19.

The case is [No. 18 CV 4171](#).

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Companies: DRW Holdings, LLC; CBOE Exchange, Inc.; CBOE Global Markets, Inc.

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