Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—S.D.N.Y.: Is the VIX fixed? Trader alleges manipulation of volatility index derivatives, (Mar. 15, 2018)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

A new lawsuit alleges that anonymous traders have been conspiring to manipulate the prices of derivatives based on the Chicago Board Options Exchange (CBOE) Volatility Index (VIX). Filed in the Southern District of New York, the suit joins several similar actions in alleging that some combination of financial institutions, market makers, and/or traders on the CBOE futures and options exchanges have been using a vulnerability in the S&P 500 Index Options (SPX) price settlement process to manipulate derivatives tied to the so-called "fear index." The suit seeks treble damages under the Sherman Act and Commodity Exchange Act (*Musso v. Does*, March 14, 2018).

Manipulating the "fear gauge"? Based on the S&P 500® Index, the VIX measures near-term stock volatility. Various derivatives are based on the VIX including futures, options, exchange-traded funds (ETFs) and exchange-traded notes (ETNs). The settlement price for these derivatives is based not on the spot price but on an auction process called Hybrid Open System (HOSS).

According to academic researchers at University of Texas-Austin, several characteristics of the VIX settlement process leave it particularly open to manipulation. First, a small number of trades in illiquid, deep out-of-the-money options can move the price of the options that the VIX values are derived on, which can significantly swing the value of the VIX. Second, cash settlement of VIX derivatives makes it possible for a would-be manipulator to cash out his position at a deviated price. Third, the settlement process occurs over a short period of time, so a manipulator needs to intervene only during a short window.

The researchers say manipulative VIX trading has certain characteristics that can be seen in the data and causes distinctive price spikes unexplained by other reasons. The lawsuit alleges that this manipulative trading may have partially caused a price collapse on February 5, and continues to occur in the current markets. According to the complaint, an anonymous whistleblower report in February to the SEC and CFTC concurs that this is a possibility. Further, the complaint asserts that two former SEC and CFTC regulators—former SEC Chairman Harvey Pitt and former CFTC Commissioner Bart Chilton—agree that this manipulation could be occurring.

Damages sought. The putative class action, brought by a trader who transacted in various VIX derivatives, alleges that some combination of Doe defendants conspired to manipulate the price of VIX derivatives. The complaint contends that this unlawful conduct violates the Sherman Act, Commodity Exchange Act, and CFTC anti-manipulation regulations, and that it has damaged competition, restrained trade, and distorted prices of VIX derivatives, causing economic damage to the plaintiff. The suit seeks treble damages.

Due to the nature of trading on the CBOE exchanges, the identity of the defendants is currently known only to CBOE and the defendants, and the plaintiff intends to subpoena CBOE for this information. The plaintiff asserts that there must be a conspiracy among multiple defendants, because unilateral action would not be enough to achieve the alleged manipulation.

According to news reports, other similar actions include:

- Atlantic Trading USA, LLC v. Does 1-100, 18-cv-01754, Northern District of Illinois;
- Samuel v. Does, 18-cv-01593-AT, Southern District of New York.

The case is No. 1:18-cv-02269.

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