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FINANCIAL MARKETS LITIGATION AND ENFORCEMENT ADVISORY

Second Circuit Opinion Allows Market Manipulation Claims Based on Hedging Activity

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On April 27, the US Court of Appeals for the Second Circuit released its opinion in *Set Capital LLC v. Credit Suisse Group AG*, No. 19-3466 (2d Cir. 2021). The decision is noteworthy because the Court permitted market manipulation claims against an issuer arising from its open-market hedging activities, while rejecting the issuer's explicit disclosure of the hedging as insufficient to avoid liability under the Securities Exchange Act of 1934 and the Securities Act of 1933. In particular, the application of Private Securities Litigation Reform Act (PSLRA) pleading standards regarding scienter to the law of manipulation in the context of open market transactions reflected a surprising application of prior guidance.

The Second Circuit Decision

In *Set Capital*, the Second Circuit reversed a decision of the US District Court for the Southern District of New York and held that plaintiffs had adequately alleged market manipulation and misstatements/omissions in offering documents related to Credit Suisse's issuance of XIV inverse exchange-traded notes (ETNs). The Credit Suisse-issued ETNs, which were inversely tied to an index that tracked futures on the CBOE Volatility Index (VIX), increased in value in times of low volatility and dropped in value when volatility increased. On February 5, 2018— a day later referred to as "Volmageddon" — the market experienced a very sudden and nearly unprecedented increase in volatility, driving up the VIX and causing a rapid drop in the price of the XIV notes. Credit Suisse continuously hedged its exposure to the XIV notes and rapidly adjusted those hedges as the VIX moved by buying VIX futures. Plaintiffs alleged this rapid buying caused a "liquidity squeeze" of the VIX futures market. As the level of the VIX doubled, the value of XIV ETNs plummeted — losing 96 percent of prior day trade value — triggering a redemption by Credit Suisse under the terms of the XIV Notes while Credit Suisse allegedly earned a profit.

For its theory of market manipulation, Set Capital alleged that Credit Suisse hatched a plan to sell a large volume of XIV Notes, knowing or recklessly disregarding the "virtual certainty" that its hedging activity would cause the price of the VIX Futures index to spike upwards due to lack of liquidity, causing the price of Credit Suisse's newly issued XIV Notes to crater and triggering a redemption. The district court found it implausible that Credit Suisse would engage in such speculative, risky, and unnecessary action to decrease the risk of losses from its XIV Notes by increasing its exposure and then purposely crashing the XIV market. Instead, the district court accepted the more benign conclusion that Credit Suisse, like many other companies, issued volatility-related ETNs to earn ordinary corporate profits and engaged in typical hedging activities when unusually volatile market conditions developed.

The Second Circuit rejected the lower court's conclusion and determined that Set Capital's claims were properly pleaded. Pivotal to the Court's reversal was the interaction of two elements of a scheme to manipulate under the securities laws — the requirement of a "manipulative act" and scienter.

With respect to the "manipulative act," the Court recited the existing standard requiring that the act include market activity that sends an "artificial" or "false" price signal to the market and even acknowledged that hedging activity that affects price "is not, by itself, manipulative." Nevertheless, the Court accepted the allegation that Credit Suisse intentionally "flooded" the market with millions of additional XIV Notes as part of a scheme to "enhance" the impact of its hedging activity when it needed to hedge increases in the VIX. The Court applied existing law on the rule intent plays in alleged manipulation cases, stating "[i]n some cases, as here, scienter is the only factor that distinguishes legitimate trading from improper manipulation." In the Court's formulation, whether Credit Suisse's hedging activity was a manipulative act turned entirely on the allegation that Credit Suisse's hedging trades — executed during the most volatile day in market history — were made "for a manipulative purpose — to trigger a liquidity squeeze that would destroy the value of the XIV Notes." The courts application of the standard for alleging manipulation therefore turned on the adequacy of the allegations regarding scienter. More precisely, whether the Complaint met the PSLRA standard in its allegations that Credit Suisse acted with the intent to cause an artificial price.

In that regard, the Court held — as required under the PLSRA's heightened pleading standard — that a reasonable person could find Set Capital's theory that Credit Suisse knowingly and intentionally caused the collapse of its own XIV ETNs as equally compelling as the benign alternative accepted by the district court. Notably, the articulation of the standard by the Court was imprecise, as it explicitly searched only for allegations supporting "conscious misbehavior or reckless[ness]," rather than the specific form of scienter required for the claims made — intentional creation of an artificial price. The Court based its opinion on several alleged facts it believed made more reasonable the theory that Credit Suisse intended the collapse of the XIV ETNs.

First, the Court accepted that the complaint plausibly alleged that the Defendants knew that hedging activity "could cause a spike in the price of VIX futures," and a drop in the value of the XIV notes, based on three prior instances of market volatility in which Credit Suisse's hedging activity had allegedly driven up the price of the VIX and created downward pressure on the price of XIV ETNs. Although the Court did not explicitly distinguish knowledge on the part Credit Suisse that its conduct could cause an artificial price, rather than simply a different price, the Court relied on the description of any potential price change as a "liquidity squeeze" to imply some form of artificiality.

Second, the Court accepted that the Complaint reasonably alleged that Credit Suisse issued additional XIV Notes knowing that the issuances would "exacerbate" the liquidity squeeze Credit Suisse had previously observed. The Court credited the allegation that when Credit Suisse issued millions of new notes "it knew that the scale of its hedging strategy would have to increase to account for the additional sales even though the liquidity in the VIX futures market would remain roughly the same." The allegation that Credit Suisse would be increasing the amount of hedging activity while market liquidity would remain the same is not reasonable. Unlike securities, where the available supply of shares is fixed in the short term, the open interest in futures can increase or decrease freely. When hedging the initial issuance of the notes, Credit Suisse directly sold futures (or caused the sale of futures) to hedge the risk that the VIX would fall and the value of the XIV notes would rise; every one of those hedges created a new long interest in VIX futures. When Credit Suisse went to buy those futures back as the price of the VIX rose, the available supply of VIX futures would necessarily have been higher. It was not reasonable for the Court to assume that there would a predictable imbalance in supply or demand — much less one that would result in a "squeeze" or an artificial price.

What This Means for PSLRA Principles

The Second Circuit's reasoning reflects a surprising application of PSLRA principles regarding scienter to an alleged manipulation. Although the Court acknowledged that the defining characteristic of manipulation was artificiality of price, it did not rigorously distinguish between allegations creating an inference that Credit Suisse knew its hedging activities would result in price movements, from allegations inferring that Credit Suisse knew that its actions would create an artificial price, uncoupled from supply and demand rather than reflecting the balance of supply and demand at any particular time. All hedging activity affects supply and demand in the market in ways small or large; those fluctuations change price because the price should be different. Merely alleging that the changes in price due to hedging were large on one day, especially on a day when changes in the market were extreme, should not give rise to an inference of manipulative intent, much less a compelling one. The Court's reliance on an alleged "squeeze" in such a volatile market is a highly uncertain standard for separating price discovery from misconduct.

In addition to its holdings on market manipulation, the Court also held that Credit Suisse's relatively fulsome (and typical) disclosures of its hedging activity were insufficient to disclose the risk. Credit Suisse's offering documents expressly warned investors that inverse ETNs were intended for sophisticated investors, that holding them long-term would likely result in a loss of all or a substantial portion of the investment, and, most importantly, that Credit Suisse would engage in hedging activity to offset potential losses to itself. But the Second Circuit faulted Credit Suisse for including equivocal statements in the offering documents that Credit Suisse's hedging activity "could" or "may" adversely impact the value of the XIV Notes but that it had no reason to believe that that would occur. These "half-truths," as the Second Circuit labeled them, were sufficient to constitute material misstatements or omissions in violation of Section 10(b) of the Exchange Act and Section 11 of the Securities Act where Credit Suisse had knowledge of the effect hedging activity had on the market following three prior volatility events. In other words, the Second Circuit again credited the complaint's allegation that Credit Suisse knew its hedging activity would crater the value of the ETNs. The implicit bases for the Court's determination is that Credit Suisse could be charged with knowledge that a volatility event that had never happened before was "virtually certain" to occur.

Key Takeaways

The Second Circuit's *Set Capital* decision may reflect a departure from past decisions regarding manipulation because it found Set Capital's manipulation theory reasonable based only on the open-market transactions conducted by Credit Suisse. In the context of open-market transactions, as the Court noted, the defining feature of manipulative conduct is the intent of the party trading. The PSLRA sets a high standard for pleading scienter and that standard should be applied to the requirement that the request includes an intent to create an artificial price. The Court's consideration of allegations based on typical hedging activity that could potentially lead to a "squeeze" elides the difference between moments when demand exceeds supply resulting in sharp (but true) price changes, on the one hand, and intentional misconduct. It also is important to be aware that the Second Circuit may view typical disclosures of hedging activity as insufficient in light of *Set Capital*, even where offering documents include statement to the effect that hedging may cause investors to lose significant value in their investments, and particularly where the issuer has knowledge of prior market impact. More broadly, in their disclosures, issuers should be cognizant of the difference between a risk that "may" transpire and a risk that is "likely" or even "certain" to transpire.

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