

Defining market manipulation

Lessons from the commodity position limit rules

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The position-limits rules passed last year by the Commodity Futures Trading Commission (CFTC) landed with a thud. The rules propose to govern derivatives tied to 28 different commodities and limit both certain on-exchange futures as well as some off-exchange options on futures and swaps. Generally viewed as weak, the rules nevertheless drew protest — and a legal challenge — from financial industry members.

As that lawsuit winds its way through the court system, traders may be wondering what framework for enforcement will be used when — and if — the rules ultimately are implemented. Court cases discussing the conduct that constitutes market manipulation can serve as one place to look for guidance.

The Commodity Exchange Act (CEA) makes it unlawful for anyone to manipulate — or try to manipulate — the price of a nationally traded commodity. Traders who suspect manipulation as the source of their losses can sue the person or group they think tried to influence market prices. To succeed, these claims need to show the creation of an artificial market price. Proving artificial price means demonstrating that something other than legitimate market forces affected a commodity's price during the period of alleged manipulation. Sometimes an otherwise legitimate transaction may run afoul of the CEA if it is combined with an improper motive.

Though breaking (or following) any surviving position-limit rule won't by itself determine a claim of manipulation, the analytical framework behind a legal claim of manipulation may very well be what determines the ultimate sanction should a position-limit rule violation occur. In addition, a market manipulation claim remains a stand-alone way for traders to recover losses when something other than legitimate market forces are at work.

Understanding manipulation

The CEA prohibits the manipulation or attempted manipulation of the price of commodities and futures contracts and the prohibition may be enforced by the CFTC or a private party. Dodd-Frank amended the CEA so that it also prohibits manipulation on commodity swaps. The statutes don't define the term "manipulate," but both the CFTC and federal courts agree that manipulation means the intentional creation of an artificial price by forces other than

legitimate supply and demand.

Courts have not created any single test to decide whether manipulation exists. Instead, manipulation cases get fact-specific, case-by-case consideration.

The two forms of market manipulation most discussed by courts are the market "squeeze" and the market "corner." A corner happens when a dominant market player has a near monopoly holding of a cash commodity and also holds "long" futures contracts to buy in excess of the amount of the commodity actually available. The shorts — who either must provide the commodity or find offsetting long contracts to meet their future "sell" obligations — are then cornered into paying the price dictated by the dominant market player. In a squeeze, there may not be an effort to obtain an actual monopoly of the cash commodity, but supplies are low for other reasons and open interest on the futures market considerably exceed that supply.

Manipulation cases may also involve fraud, deceit, the use of false information or violation of exchange rules. A case involving a trader/supplier accused of using deceit and misinformation to manipulate the California electricity market serves as an example. To avoid losses on a long position and increase the price of electricity, the trader/supplier sought to create the appearance of an electricity shortage. The U.S. government indicted the trader on criminal charges for manipulation. The claimed manipulation included unnecessary plant shut-downs and the withholding of available electricity, as well as dissemination of false and misleading rumors and information about available electricity to market participants.

But actionable manipulation does not have to include fraud or a "corner" or "squeeze". Legitimate transactions coupled with illegitimate intent or improper motive also can constitute market manipulation. Improper motive can serve as the basis of a claim for manipulation because motive is directly related to the legitimacy of the signals regarding value or worth that are the heart of a true market price. Wrongful intent distorts the legitimate forces of supply and demand that are otherwise assumed to have created the market price. One court said it this way: "Because every transaction signals that the buyer and the seller have legitimate economic motives for the transaction, if either party lacks that motivation, the signal is inaccurate. *Thus a legitimate transaction combined with improper motive is commodities manipulation.*"

Proving an improper motive market manipulation claim

Under the CEA a claim for market manipulation exists when:

1. The defendant possessed an ability to influence market prices;
2. An artificial price existed;
3. The defendant caused the artificial price; and
4. The defendant specifically intended to cause the artificial price.

A manipulation claim based on a legitimate transaction combined with an improper motive must show each of these elements.

Proof of intent and artificial price are interrelated — especially when the claimed manipulation rests on improper motive. Courts define artificial price as one that does not reflect the basic forces of supply and demand. With no universally accepted measure or test of price artificiality, courts look at the aggregate forces of supply and demand and try to determine if something other than a legitimate factor has affected the price of the commodity. The presence of any such illegitimate factor or factors usually means the existence of an artificial price.

Wrongful intent can be a factor causing artificial price. For example, if a buyer on a commodity exchange intentionally pays more than required for the purpose of causing the price to be higher than it otherwise would, the resulting price has not been determined solely by the legitimate forces of supply and demand and thus is artificial.

Courts say that to prove intent, there must be a showing of conduct specifically undertaken to make a price or price trend in the market other than that resulting from legitimate forces of supply and demand. Often no clear evidence of that intent is available. Instead courts usually look to the circumstantial evidence surrounding the alleged manipulation and infer the needed wrongful intent from it.

The link between improper motive and artificial price has been discussed in a number of manipulation cases involving otherwise legitimate market transactions. In one case, a trader bought eggs right before the closing bell on a particular day and, for the purpose of increasing the closing price, bid at a price substantially above where the previous transactions had occurred. The reviewing judicial officer deemed that the trader's intent resulted in an artificial price. In another, the court deemed "buying sprees" in the natural gas market enough to show both artificial price and intent to cause the price.

In *Anderson v. Dairy Farmers of America* — a case handled by this article's authors — a dairy collective allegedly bought cheese in an effort to shore up prices and protect a long position in a related

market. The Anderson court found that to determine the existence of an artificial price for the purposes of a CEA manipulation claim, the question was "whether the specific facts of a case support a finding that the commodity price was determined by forces other than legitimate supply and demand and whether a defendant intended to cause that artificial price."

The court also said making the connection between an intention to cause an artificial price and the existence of an artificial price would require a fact- and case-specific analysis, given the near limitless possible underlying reasons and methods and techniques of manipulation.

Market manipulation claims involving improper motive also require proof of an ability to influence prices and causation of an artificial price. Like artificial price and intent, ability and causation are related. Market control is not necessary. Buying or selling large amounts of a commodity, particularly in a concentrated time period, can show both an ability to influence price and causation of an artificial price, especially in thinly traded markets.

Conclusion

Market prices for commodities and futures should reflect the legitimate forces of supply and demand. The CFTC's position-limit rules seek to spare the market from harm by speculation outside those natural forces. Whatever the fate of the position-limits rules, actions for market manipulation continue to provide a framework for addressing the economic harm that results when traders leave genuine economic purpose behind and seek to distort a natural market price. Transactions involving actual risk to the buyer or seller are not spared from the market manipulation inquiry. When combined with an ability to influence prices, actual risk-taking transactions motivated by a wrongful intent that cause an artificial price may qualify as actionable manipulation under the CEA — and for the penalties that wait to be developed under the CFTC's new and unexplored rules.

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