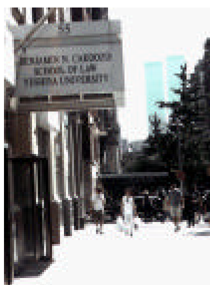

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The Cardozo Insider: Commodities Manipulation

Commodities Manipulation and Other Fun Things to Do, if You Have Lots of Money - - By David Case

by David Case

According to the statute, it is illegal to manipulate commodities markets. However, due to jurisdictional concerns and a lack of authoritative caselaw, most practitioners are at a loss to define exactly what manipulation is, and what sorts of behavior effect a commodities market in a way that will expose a participant in over the counter transactions to civil liability.

The definitional concern and the jurisdictional concern are the subject of many debates, CLEs, and law reviews. However, for the purposes of someone who is filling in for the celebrated Upsiderisk, a brief discussion of the issues will suffice for those whose careers may place them in the unsavory position of advising clients that their "ingenious" idea for making money on the commodities markets, is in fact illegal.

Defining Artificial Prices

As the law now stands, the simplest form of manipulation of a commodities market is any behavior which results in the creation of "artificial prices." Unfortunately, as of yet, we are unsure as to what constitutes an artificial price. Currently, the best definition is that the price at which a commodity or its derivatives are trading "does not reflect the market or economic forces of supply and demand operating upon the price of the particular contract under scrutiny. It is, in economic language, a nonequilibrium price."

However, your friends who opted to get their PhD in economics may point out to you that market behavior is chaotic, in that it at any given moment the market is striving to reach an "equilibrium" price. Market actors can argue with a straight face that their behavior reflects a rational reaction to supply and demand. In fact, there have been cases where counsel has been able to convince triers of fact that their clients behavior was rational and not of bad intent.

In the past, great commodities manipulations have been characterized by "corners" or "squeezes," whereby an actor manipulates the price or supply of a spot product to produce an "artificial" price of futures or options. In a corner, the actor buys the entire stock of a spot product. Great Western Food Distributors v. Brannan, 201 F. 2d 476, 478-79 (7th Cir. 1953), cert. denied 345 U. S. 997 (1953.). In a "squeeze," a party takes advantage of a shortage in the spot market, by taking long futures or options position. Cargill, Inc. v. Hardin, 452 F.2d 1154, 1161-1163 (8th Cir. 1971), cert. denied 406 U.S. 932 (1972).

However, the modern, fashionable manipulator seems to relish the thought of leveraging legal mechanisms outside the commodity exchanges to limit the supply of a good in the spot market. See, e.g., In re Fenchurch Capital Management, Ltd., [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) 26,747 (1996) (Manipulating futures market for T-bills by entering into "repo" agreements which would temporarily limit the supply of certain T-bills, forcing short suppliers to deliver higher grades of T-bills.) Unfortunately, this case was settled by means of a settlement order.

Making the situation all the more complicated, other less fashionable, yet all the more deadly, manipulators will take advantage of various players in the commodities markets tendency to "delta hedge," or construct their futures or options portfolio to follow the spot market. Hence, a market can become squeezed due to the appearance of a change in the supply on the spot market created by a wily manipulator. Moreover, some in the market may legitimately choose to hedge in markets other than those in which their product is traded.

Bryan H. Booth, Prudence Or Paranoia: Considering Stricter Regulation Of The International Over-The-Counter Derivatives Market, 5 Duke J. Comp. & Int'l L., 499, 518 (1995).

Others find that the best way to manipulate markets is by attempting to give other players in the market misperceptions of supply and demand. This is often done through increased market activity, through either non-competitive bidding, wash trades, or fake trades. Charles R. P. Pouncy, The Scienter Requirement and Wash Trading in Commodity Futures; the Knowledge Lost In Knowing, 16 Cardozo L. Rev. 1625, 1638 (1995).

In terms of enforcement of an action claiming market manipulation (either brought as a private action, or by the CFTC's division of enforcement) the Plaintiff bears the burden of showing; 1) The alleged manipulator had the ability to influence market prices; 2) The price was artificial, i.e. did not reflect the legitimate forces of supply and demand; 3) The alleged manipulator caused the price to become artificial; and 4) The alleged manipulator intentionally caused the artificial price. In re Cox, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) 23,786 at 34,061 (1987). [hereinafter The Cox Test].

On the other hand, a footnote in Cox may have eliminated the Commission's burden of showing prongs 2 and 3 of The Cox Test, rendering market manipulation a crime of specific intent. The court opined that "[W]hen a price is affected by a factor which is not legitimate, the resulting price is necessarily artificial. Thus, the focus should not be as much on the ultimate price, as on the nature of the factors causing it." Cf. In re Soybean Futures Litigation, 892 F.Supp. 1025, 1056-1057, 1995 U.S. Dist. LEXIS 3967, Comm. Fut. L. Rep. P 26,476 (N.D.Ill., 1995) (footnote in Cox is "mere dictum"); In re Sumitomo Copper Litigation, 182 F.R.D. 85 (S.D.N.Y., 1998) (Plaintiff's must establish that an artificial price does, in fact, exist); In the Matter of Donald D. Dial et al, CFTC Docket Nos. 80-19, 81-3, 1987 WL 107137 at *13 (1987) (ALJ denying summary disposition in the absence of Division being able to present statistical evidence as to causation.)

Moreover, in recent years, the Division has been held to a tougher standard than just showing that "manipulation could have happened" it must show that manipulation of the entire market is "more probable than not." In the Matter of Louis Abrams et al. CFTC Docket No. 88-10 Comm. Fut. L. Rep. 26,479, 1995 WL 455791 at *5 (1985) quoting In re Buckwalter, [1990-1992 Transfer Binder] Comm.Fut.L.Rep. (CCH) 24,995 at 37,684 (1991).

Jurisdictional Issues

The other hot button issue in commodity manipulation is whether or not US Courts, and/or the CFTC have jurisdiction over manipulation of domestic commodities, when the manipulation is consummated on foreign OTC markets. As we all know, swap contracts are exempted from regulation from the Commodity Exchange Act (CEA). However, OTC contracts do not exactly parallel their exchange-traded cousins. However, to some degree the two are interchangeable. It is not difficult to claim that an actor would avoid entering into a transaction through an exchange, opting instead for the OTC transaction for any number of reasons, good or bad.

At the moment, the treasury amendment only covers transactions that are carried out by institutional investors. The institutional investors often have a choice as to the marketplace in which the transactions will be carried out. They may be on a domestic exchange or OTC market, or on another continent. However, these transactions will have an inevitable and sometimes immediate effect on domestic exchanges.

It is easy to state that markets are inevitably connected to each other, and that a fraud in one market can be the proximate cause of an injury to another. Though it is easy for most lay people, and most courts, to conceptualize interconnectedness between physical commodities traded over the counter and futures based on physical commodities, many have trouble comprehending how the same can be true in supposedly "infinite" financial derivatives.

Moreover, it remains an open question whether the Commodity Exchange Act grants jurisdiction over manipulative behaviors that are aimed at and effect domestic exchanges, even when the activity is carried out on foreign over-the-counter markets.

Again, we are left with little guidance. The Current Restatement of Foreign Relations provides that a five-part balancing test by which a court could apply a foreign law to an American transaction. However, the second restatement, as applied, instituted a balancing test which included a balancing of whether the "required conduct" was to have taken place in the other state. Hence, if a court focuses its inquiry on whether or not a manipulative transaction could have taken place in the US, and finds that the manipulator deliberately executed a transaction under the auspices of a foreign jurisdiction, it will see that the conduct, indeed was required to have taken place in the foreign country.

Another way of considering manipulation is as a plague upon two markets. Courts have seen themselves as enforcing Congress's desire not to be a base of operations for a fraud on any market. Hence, if one reviews the average manipulation or squeeze in reverse, it can be seen as use of American exchanges to obtain a hedge at an improper price for a foreign OTC product. This may, under the view that Congress intended the CEA to retain jurisdiction over all frauds, be an avenue for jurisdiction.

On the other hand, this jurisdictional theory has its detractors, especially those who can ably point out (by analogy from anti-trust law) that Congress did not intend to police every conspiracy in the world involving a conspirator that may be reached by federal court service of process. Yet, since the CFTC has been free to police manipulation when it occurs on wholly domestic markets, this may in fact be what Congress has intended. Unfortunately, there has been little authority as to Congressional intent vis-a-vis foreign manipulation. At the same time, there is some hesitancy on the part of congress to attempt to regulate foreign transactions.

What this means, folks, is that in a compliance position role, when faced with "innovative" trading strategies one must be acutely aware of the risk of traders performing trades on foreign markets that will run afoul of US Commodities regulations – no matter how much a trader may tell you they are exempted from domestic regulation.