Author's Note

Having participated in the defense of several firms and people accused of manipulation of futures markets by the CEA and the CFTC, I responded positively to a request from the *Hofstra Law Review* to write an article on the subject of a definition of manipulation. It was published in the fall 1977 *Hofstra Law Review*, Volume 6, pages 41–56. As published, the article is extensively footnoted (twenty-three times). It is reproduced here without the footnotes in the interest of readability.

While I was involved peripherally in others, the article is based on four cases, two accused of short-side manipulations and two of long-side. One ended in a draw and both sides withdrew from further warfare—the CEA probably because it saw a strong possibility of defeat, and the accused firm because of rising time and legal costs and because it was offered cessation of battle without sanction. Two were won on the basis that they acted as prudent merchants. The fourth was the most interesting. Two speculators were long when there was a sharp price increase on the last day of trading. As it developed, the principal short position was also speculative. The central question came down to "When you have got your opponent in your grip, how hard are you allowed to squeeze?"

In the article, I again came down on the side of "Let the market trade out," that there is greater wisdom in market forces than in regulatory bodies.

Toward a Definition of Manipulation

Introduction

Chapter 38

A central focus and important purpose of the CFTC Act and its predecessor on legislation dating back to 1922 is manipulation, its punishment and prevention. Manipulation is prohibited by the rules of exchanges. But the law and the rules of exchanges do not define manipulation, and the only guidelines are the results of legal actions in which specific behavior patterns and actions associated with specific price movements were judged to be or not be manipulation. The legal actions are a matter of record and can be examined, but the judgments and actions of exchanges in suspected manipulative situations are not a matter of public record.

The legal actions and decisions have not resulted in a clear set of guidelines for traders in markets to use when contemplating a given market situation and course of action. There is a line someplace across which they dare not step, but the location of the line is uncertain. There is a need to draw the line for the guidance of traders, both commercials and speculators.

There are two possible approaches to such line drawing. One is to trace decisions of courts and exchanges and the other is look toward that which should and that which should not be tolerated in the context of market effectiveness in price formation and risk management. Their comments are in the direction of the latter approach.

The results are somewhat extreme in the level of tolerance of the use of market power suggested. They stem from the notion that market prices are the result of competitive forces and that competition is a contact sport. The line is put in the direction of tolerance of the use of power and countervailing power to a greater extent than will gain immediate acceptance, and it is recognized that there is a place for the thinking of people of more moderate persuasion. It is hoped that the result will be the beginning of more consideration of the problem than there has been in the past.

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STANDARD DOCTRINE

Section 9b of the CFTC Act provides: "It shall be a felony for any person to manipulate or attempt to manipulate the price of any commodity... or corner or attempt to corner any such commodity." The Congress discussed in hearings or debates from 1936 onward various definitions but deliberately left definition to the courts. The implications are twofold: first, a definition of manipulation is difficult, and second, the circumstances surrounding instances of sharp price variation are so diverse and have so many elements of causation that it is necessary to look at each instance in detail to determine whether manipulation existed and, if so, who was responsible. No manipulation case is ever simple. This is true because the forces that go into the making of prices are numerous and complex, and uncertainty always exists. Prices are the result of interplay of market forces such that the forces toward strength are always in balance with the forces toward weakness. As the relative strengths of market forces change, prices change, maintaining the balance.

A definition of manipulation by Arthur B. March, then president of the New York Cotton Exchange, before a Senate Committee in 1929 has been preserved and generally accepted: "Manipulation is any and every operation or transaction or practice . . . calculated to produce a price distortion of any kind in any market either in itself or in relation to other markets. If a firm is engaged in a manipulation using devices by which the price of contracts for some one month in some one market may be higher than they would be if only the forces of supply and demand were in operation... and any and every operation, transaction, or device employed to produce these abnormalities of price relationships in the futures market, is manipulation." This has been shortened so that in common usage the generally accepted definition is: Manipulation is causing, with intent, the price to be something other than it would have been under the "ordinary" force of supply and demand.

The word "ordinary" gets to be important. The price is the result of forces of supply and demand, and in futures markets this is the supply of and demand for contracts. The whole notion of manipulation is that some forces are ordinary and some are manipulative. It implies a price distorted from the price that would have existed in the absence of the operation, transaction, or practice that is manipulative.

The basis for the initiation of an investigation of possible manipulation is usually a sharp variation in price, such as a major move on the last day of trading in an expiring contract. In the succession of cases that have been tried under the CEA and CFTC Acts, the elements of manipulation have been reduced to (1) a distorted price, (2) a dominant or controlling position in deliverable supplies, (3) a dominant or controlling futures position, and (4) manipulative intent.

A manipulation may be either a long-side or a short-side operation. In the classic concept of a long-side manipulation, the operator buys futures in excess of the immediately deliverable supply, accepts the delivery that is made, and exacts a high price from the shorts. The futures price and the price of cash commodity certified for delivery are forced above the current bids for noncertificated supplies in the delivery market, above the prices of other futures contracts, abnormally high in relation to other markets, and high in relation to prices immediately following liquidation of outstanding futures contracts. The longs control the deliverable supply and force the shorts to pay an arbitrary price.

In the short manipulation, the operator puts an inordinant quantity in deliverable position, sells more futures contracts than the quantity of the cash commodity owned, and hammers the price down with delivery. The deliveries fall into weak, unsuspecting hands who must not only redeliver but must sell long positions as well, adding to the debacle.

Such is the standard doctrine of manipulation, its investigation, and prosecution. A suspect price is identified; and if it is a price increase, the identity of a large long is determined, the size of the long position is compared to the open interest and to the certificated deliverable supply, and charges are brought. If the suspect price is a decrease, the large short is identified, his position, trading, and delivery actions are examined in relation to the open interest and certificated deliverable supply, and changes are brought. The futures price is compared to the price reported from transactions between commercial suppliers and users and, if there is a digression, the price is said to be distorted. The intent aspect is treated lightly. If an individual is big enough to do it, he is assumed to be knowledgeable enough to know what he is doing, and the making of money is proof of intent.

For the most part, the material presented in prosecution is confined to the activities of the individual being prosecuted. Comparisons are made with positions and actions of other large-scale operators, but only for purposes of establishing dominance of futures and/or certificated deliverable supply. Only a limited examination of events leading up to and following the climactic situation is made. The questions asked and answered are simple: Was the position large in relation to the open interest? Was the position large in relation to the technically deliverable supply? Was the price of futures different than the reported commercial price? "Yes" answers establish guilt.

The defense in manipulation cases has tended to be simplistic—first, that the prosecution has not established "yes" answers, and second, the individual acted as a prudent merchant, processor, or speculator, as the case may be. The primary reason that defendants are confined to their own behavior is the limited availability of information about the actions of other market participants. The specifics of the futures and cash positions and trading of all large-scale traders are available to the CFTC, but they are held under rules of confidentiality.

Deliverable Supply

The matter of deliverable supply inevitably enters consideration of alleged manipulations. Exchanges, under the jurisdiction of the CFTC, write delivery terms of contracts. Delivery terms must be sufficiently restrictive that they are known and understood. At the same time they must be broad enough that price on delivery is representative of real commercial value. There is a delicate balance. If delivery locations and qualities are numerous so that delivery terms are broad, the use of futures markets is difficult because definition of that which is traded lacks precision. But if delivery terms are extremely narrow, markets are subject to manipulative distortion. If delivery terms are too narrow, it becomes impossible to arbritrage between the prices of the technically deliverable supply and the total supply of the commodity. When there is good arbitrage, a manipulator must control the whole of the supply of the commodity, a virtually impossible task. Thus, delivery terms became central in alleged manipulations. It is necessary to define and identify the deliverable supply.

The establishment of delivery terms is one of the more delicate tasks that exchanges face. They attempt to set delivery terms so precisely representative of commercial value that there is no advantage to the taker or to the maker of delivery, and as a result relatively little delivery is made or taken. Experience proves that when delivery is extensively made and taken, indicating that the terms of delivery are advantageous to one side or the other, trade decreases and finally ceases. The thing that seems to work best is delivery terms as narrow as feasible, that is, delivery at a single or a limited number of points.

In the interest of keeping delivery terms as narrow as possible, it is necessary to put a broad construction on the deliverable supply when matters of alleged manipulation are under consideration. Interpretations of what the deliverable supply is can and do cover a wide range. There is a technically deliverable supply that is the certificated and registered amount in delivery position during the delivery month. One interpretation of the deliverable supply is that it is the amount of the technically deliverable supply minus the amounts of it that are committed for processing or shipment by commercials and thus not available to the shorts for delivery. Such is the most narrow interpretation possible. The case for subtracting the committed part of the technically deliverable supply is extremely weak. Everything is available at a price. Use can be delayed and shipping commitments shifted to other points. Reservation prices represent real commercial value, and if the futures price is less, it is below economic value.

The first extension of the interpretation of the deliverable supply past the technically deliverable supply is to include all of the commodity in deliverable position that could but has not been certificated for delivery. There are typically substantial quantities at central markets that are not part of the technically deliverable supply but that can be readily made a part by the simple process of grading and making out warehouse receipts. Still further amounts can be made a part of the technically deliverable supply by sorting, screening, and blending. The amount of the total supply at the market that is or can be made eligible for delivery is variable. There have been occasions when the average quality at delivery points is low, so that little can be added to the technically deliverable supply, but such occasions are rare. Traders, both commercial and speculative, pay but little attention to the technically deliverable supply but, rather, watch the total supply at the delivery point during the delivery month.

The first extension of the interpretation of the deliverable supply is totally reasonable. Shorts should be expected to see that the available supply is certificated if they cannot otherwise fulfill their contracts. If they elect to bid up the futures price rather than see that available stocks are certificated, the consequences are quite their own fault, and if accusations of causing price distortion are made, they should be directed at the shorts.

The second extension of the interpretation of the technically deliverable supply is to include stocks that are in normal tributary position that can be put into delivery position without incurring more than normal marketing costs. Delivery points are established at locations of normal market flow, stocks, and use. For example, there is a flow of grains and soybeans to Chicago, stocks are held in store at Chicago, grains and soybeans are processed in Chicago, and there is a regular outflow from Chicago. Supplies in tributary position that can be readily brought in and certificated are reasonably interpreted as being a part of the deliverable supply.

The Congress recognized the need for a broad interpretation of the deliverable supply when, in the Commodity Exchange Act of 1936, it required a grace period of seven business days after the end of trading in a given contract for delivery to be completed.

There is a wide range of interpretations of what constitutes deliverable supply when we add the amounts tributary to the delivery point to the technically deliverable supply. The Congressional mandate seems to be the amount that can be put in deliverable position within seven business days (ten to twelve calendar days). This, in itself, is narrow. Shorts don't just go into the last day of trading short, particularly commercials. They go into the delivery month short and, hence, have a full calendar month to put stocks in delivery position if their short positions cannot be covered at a price less than the price in the tributary area plus normal marketing costs.

Interpretations and measurement of the deliverable supply play a central role in most long-side manipulation cases, and the decision is apt to go the direction of the interpretation. What it goes to is the extent to which shorts are responsible for seeing that they are capable of fulfilling their commitments.

Limitations of Standard Doctrine

The usual treatment of alleged manipulations is much too simplistic for the real world. Markets are competitive and competition is among people. A futures contract is an agreement to later buy and sell a commodity. Trading is in contracts for later consummation. For every commitment to later buy, there is a commitment to later sell; for every long, there is a short. Trades are exercises in futurity, and the future is uncertain.

An investigation of an alleged manipulation requires an inquiry into the cause of the suspect price change; and if the price is judged to have been distorted, an assesment of the responsibility. An adequate inquiry requires a thorough look at all of the market forces that made the price behave as it did. The matter in question must be put into the context of the total market and the actions of all of the people concerned. Such is the case because futures prices are formed in a crucible of competitive forces. They are not learned seminars in which men meet to discuss and arrive at what is judged to be a proper price. They are, in a sense, arenas in which buyers and sellers meet and compete for gains and losses. Prices are competitively determined in contrast to administratively determined.

An inquiry into the cause of a price change and the assessment of responsibility is a complex process because factors affecting prices of a commodity are numerous and complex. The futures market is a central registration point at which all market forces are brought into focus. It is but the tip of an iceberg. To understand a given futures price, it is necessary to look into the total commercial base of the commodity: existing supplies, prospective supplies, rate of use, prospective rate of use.

The economic forces underlying prices are transmitted through the actions of market participants, through people. The behavior of futures prices is the result of the position-taking activity of all traders in futures. The actions of the numerous traders are affected by cash positions and commitments that have been made and by their expectations about price relationships that will exist in the future. All of this is done in a context of uncertainty. Experienced traders are never certain about that which will happen in the future.

At a given time, the futures price of a commodity reflects a balance of forces. The longs are a force toward higher prices, and the shorts are a force toward lower prices. These are countervailing competitive forces. The balance changes as events that affect market actions change.

The objective is fully competitive markets, and under conditions of pure or perfect competition no one market force can have an appreciable impact on price. Such atomistic competition is a laudable goal but does not exist in the real world. There are large-scale operators in markets. The really large entities in markets are the commercials who, backed by cash positions, can be powerful forces with disruptive capabilities. There are large-scale speculators in markets. Their disruptive capabilities are less than the commercials because (1) the size of the positions that they may take is limited by both governmental and exchange regulation; and (2) except as they take delivery, they lack a cash base with which to back their futures operation. For example, a commercial who is short three million bushels of corn is much more of a market factor than a speculator who is short a like amount because he is much more apt to move corn into a deliverable position than is the speculator.

Inherent Conflict

All of this leads to a matter of basic conflict in the administration of markets. Markets are competitive contests among people whose judgments are backed with money and where gains and losses are at stake. Competition markets are inherently conflictive. The formulation of prices is a process of conflict between buyers and sellers. Each uses the power, however small, at his command. Every participant in the market has some power, and the large traders have more power, individually, than do the small traders. Each has an impact on price that is proportional to the size of his position. The basic principle in the establishment of competitive prices is the use of conflict to discover value—to tell people to use their beginning power to establish price.

Market regulation by government and by exchanges is an administrative limitation of market power. It is a limitation of the conflict that is inherent in competitive price formation. It is a regulating of the principle of competitive price formulation. Market regulation is directed toward the prevention of the establishment of prices that reflect something other than real commercial value. At the same time, market regulation prevents the establishment of fully competitive prices. Hence, a conflict in principles and objectives exists.

Exchanges and government are sensitive to the contests that sometimes occur near the expiration of contracts. When they note congested situations—those in which there is a large open interest and a small deliverable supply or in which a large proportion of the open interest is held by one or a few interests—they sometimes take steps to assume an orderly liquidation. Orderly is usually construed as without much price variation. Their powers of moral suasion are great. Some exchanges have rules under which they can direct liquidation or fix settlement prices. This process reduces the extent to which the full forces of competition are allowed to work themselves out in price formulation. Any directed settlement reduces the strength of one side or the other and is thus in itself a manipulation.

On the one hand, we seek situations in which economic forces are expressed through traders, each of whom has no perceptible influence on price—that is, the absence of the use of power. On the other hand, we recognize the need for power to be met with countervailing power. It boils down to a matter of degree of conflict that should be tolerated. To what extent should parents let their quarrelling children settle their own differences? When should the neighbors call the police when there is a husband-wife conflict, and at what stage of mayhem should the police haul the combatants off to seperate points of incarceration? These are delicate questions. The very notion that parents or police will intercede is conducive to further conflict, and the notion that parents or police will let them fight it out is conducive to settlement. If government and exchanges intercede, the integrity of the market is weakened and intercession is conducive to further conflict.

How Much Tolerance?

How much conflict, hence how much distortion, to tolerate in the interest of market integrity? Perhaps the game of basketball is a good example. It is a non-contact sport in which there is a lot of contact. The guiding principle is "no harm, no foul." The comparable principle in futures markets would be "no cash price and movement distortion, no punishable distortion." What the principle says is that traders in futures markets should be put on notice that they are expected to honor their contract commitments to buy and sell and that there will be no intercession until the commerce in the commodity is affected.

Under such a principle, the judgment of whether a price was or was not distorted would go to the cash price of the commodity and to the flow of the commodity to and from the delivery point. A long-side manipulation would be judged to have existed if the cash price of the commodity at the delivery point was higher than it would have been under ordinary forces of supply and demand so that a more than economically necessary amount of the commodity was moved in to delivery position. A short-side manipulation would be judged to have existed if the cash price of the commodity at the delivery point was lower than it would have been under the ordinary forces of supply and demand and the stocks that were moved into delivery position were returned to the deliverers and had to be moved out at losses. The principle would tolerate the free interplay of forces in futures with their accompanying gains and losses so long as the cash price was not disturbed.

A strong case can be made for the application of such a principle. First, it would strongly reaffirm the integrity of contracts and thus reduce the likelihood of distorted futures prices. If the shorts knew that no one would lean on the longs in the interest of "assuring an orderly liquidation," they would be more apt to look further forward in deciding on actions to take in liquidating positions and/or preparing to make delivery. If the longs knew that it would be incumbent on them to accept delivery and use it or merchandise it to users, they would be more prudent about persisting in long positions. The way that market regulation has marked out in the past is that most of the leaning has been on the longs so that shorts have been somewhat confident of protection. The longs have recognized the need to be prepared to take delivery and dispose of it. There have been a lot more accusations of long manipulation than there have been of short manipulation. But markets sometimes expire weak and sometimes strong.

Second, it would lead to the improvement of delivery terms of contracts. When there is full arbitrage between the futures price and all of the supply of the cash commodity, manipulation is virtually impossible. The manipulator would have to control a significant share of the total supply and extract a monopoly price from the users. Thus, distorted futures prices would call attention to the lack of sufficient arbitrage, hence to weaknesses in contract terms.

Third, it would avoid the necessity for judging how much exploitation of an advantageous position is permissable and how much is too much, how much distortion of futures prices to tolerate. Suppose the price of a commodity is \$2.00 per bushel and that a large long finds the shorts in a disadvantageous position. It is doubtful that anyone would argue that he was manipulating if he liquidated at \$2.00 $^{1}/_{4}$. It is probable that he would be accused if he were able to and did force the price to \$3.00 on the last day. The point is that there is a line drawn somewhere if futures prices are not allowed to seek their own competitive level. Should it be at \$2.05 $^{1}/_{4}$ but not at \$2.05? It should be kept in mind that a trader is a competitive, profit-oriented person. In such a circumstance, we are really asking the question: At what price is the long obligated to take his hands out of his pockets? It is the short who is bidding the price up. It is an unnatural act to cut off his profit. It is a heavy burden on the long to require that he act against his own best financial interest.

The problem of saying this much but no more tolerance of a futures price out of line with the cash also involves the uncertainty always present in markets. Suppose that in the above circumstance the long puts a price of \$2.10 1/4 on his contracts because he honestly believes that he can accept delivery and merchandise the commodity at such a price, that \$2.10 1/4 represents real commercial value. Suppose further that the price goes to \$2.10 1/4, he liquidates, and the cash prices subsequently fail to go to above $2.01. Should he be held accountable for his bad judgment? Suppose that the price subsequently goes to $2.20; should he be held accountable for his bad judgment in liquidating too soon? How much tolerance is a thorny question.

The problem also involves who to blame; the long stands with his hands in his pockets or goes out for coffee. It is the short who has put himself in an untenable position and who must put the futures price above real commercial value. Who is the more responsible for the distortion? It is the shorts who have acted irresponsibly toward their contractual obligations. But they too must be allowed to make honest mistakes.

The judgment of how much tolerance to allow is also a heavy burden to put on regulatory bodies, whether they are business conduct committees of exchanges or the CFTC. The trader has to know in advance what he can and cannot do. It is not sufficient to remind him that he has a responsibility to see that there is an orderly expiration. He must be told (although in practice he never is) what is disorderly. When the regulator draws the line, either before the event or after, as in the case of manipulation trials before exchanges or the CFTC, he is forming and enforcing a judgment about what a proper price is or was and is thus becoming a manipulator.

Conclusion

The application of the principle of judging market—hence people—behavior on the cash rather than futures prices goes beyond generally accepted doctrine about manipulation. But generally accepted doctrine does not define manipulation. The definition ebbs and flows as cases are tried. No clear line that traders can identify and be guided by has been drawn. Each new case has required the drawing of a new line because the circumstances surrounding each case are peculiar to it.

The judgment of guilt or innocence in alleged manipulations is not a simple matter. It is the more difficult as the definition of manipulation is the more narrowly drawn and as it relates to futures prices. Markets are immensely complex because the forces going into the formation of prices are multitudinous and because the forces are implemented by people who act in a context of uncertainty. The judgment of manipulation is first a matter of identifying a distorted price which, in itself, can never be done with precision and certainty. Second, it is a matter of evaluating the behavior of people who act in a context of competiveness and uncertainty for reasonableness. The central question in judging manipulation is whether the market participants—merchants, warehousemen, processors, speculators—acted with prudence and reasonableness in their various roles and with proper regard for the orderliness and integrity of the market.

All of this argues for a broad definition of manipulation and a high level of tolerance for the competition that is the essence of futures markets. Such a definition would free the market to police itself, and unfettered the market is a powerful policeman. Manipulation is its own worst enemy because to manipulate a price is to put it where it does not belong. The overpriced inventory or the underpriced commitment is a target for the rest of the market to shoot at, and shoot it will. A limited amount of regulation is conducive to prudence and reasonableness, hence to orderly markets.