Beyond Supply & Demand: Manipulation in the Commodities Markets

Thomas B. Hatch and Thomas C. Mahlum, Robins, Kaplan, Miller & Ciresi L.L.P.

The Commodity Exchange Act (CEA) makes it unlawful for anyone to manipulate—or try to manipulate—the price of a nationally traded commodity. The Commodity Futures Trading Commission (CFTC), which regulates commodity futures and options markets, has significantly increased its enforcement filings and investigations of alleged instances of market manipulation in the last two years. For example, reports indicate that the CFTC is currently investigating the silver market and certain energy markets for potential manipulation.

Yet, individual claims for manipulation remain relatively uncommon. The CEA allows traders who suspect manipulation as the source of their losses to 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.

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.[1] The CEA does not define the term "manipulate." The CFTC and federal courts agree that manipulation means the intentional creation of an artificial price by forces other than supply and demand, but no more definite a test exists.[2] Instead, manipulation cases tend to require a fact-specific, case-by-case analysis.[3] As stated by the Eighth Circuit Court of Appeals:

> [T]he test of manipulation must largely be a practical one if the purposes of the Commodity Exchange Act are to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man. The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand.[4]

The two most discussed forms of market manipulation are the market "squeeze" and the market "corner." A corner occurs, for example, 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 must either provide the commodity or find offsetting long contracts to meet their future "sell" obligations—are then cornered into paying the

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price dictated by the dominant market player.[5] 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 interests on the futures market considerably exceed that supply.[6]

Manipulation cases may also involve fraud, deceit, the use of false information or violation of exchange rules. For example, in *United States v. Reliant Energy Servs.,*[7] a criminal case, a trader/supplier was accused of using deceit and misinformation to manipulate the California electricity market. 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 claimed manipulation included unnecessary plant shutdowns and the withholding of available electricity as well as dissemination of false and misleading rumors and information about available electricity to market participants. The allegations were sufficient to sustain criminal indictments.

But actionable manipulation does not have to include fraud or a "corner" or "squeeze". Legitimate transactions coupled with illegitimate intent or improper motive can also constitute market manipulation under the CEA.[8] 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. The court in *In re Amaranth Natural Gas Commodities Litigation* gave this explanation: "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*."[9]

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.[10] A manipulation claim involving a legitimate transaction combined with an improper motive must satisfy each of these elements.

Proof of intent and artificial price are interrelated—especially when the claimed manipulation rests on improper motive. Artificial price is defined as one which does not reflect the basic forces of supply and demand, though there is no universally accepted measure or test of price artificiality.[11] Instead, courts look to:

> [T]he aggregate forces of supply and demand and search for those factors . . . which are not a legitimate part of the economic pricing of the commodity. . . . [W]hen a price is [a]ffected 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.[12]

Wrongful intent can be a factor causing artificial price. For example, if a buyer on a commodities exchange intentionally pays more than required for the purpose of causing the price to be higher than it otherwise would, the resultant price has not been determined solely by the forces of supply and demand and is, consequently, artificial.[13] Proving intent requires demonstrating that "the accused acted . . . with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect legitimate forces of supply and demand."[14] Intent is generally estab

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lished inferentially from the conduct surrounding the alleged manipulation, most often through circumstantial evidence.[15] The intent to influence market price at an amount other than what would normally prevail is intent to create an artificial price.[16]

The link between improper motive and artificial price has been discussed in a number of manipulation cases involving otherwise legitimate market transactions. In *In re Henner*[17] 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.[18] In *CFTC v. Enron,*[19] the CFTC alleged a scheme among Enron traders to manipulate the natural gas market. The court refused to dismiss the CFTC's complaint finding the "buying spree" at the heart of the manipulation allegation helped establish both artificial price and intent to cause the price. In *Anderson v. Dairy Famers of America*[20] a dairy collective allegedly bought cheese in 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 appropriate inquiry "is 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."[21] Making the connection between an intention to cause an artificial price and the existence of an artificial price will necessarily requires a fact-specific, case-by-case analysis, given the near limitless possible underlying reasons and methods and techniques of manipulation.[22]

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.[23] 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.[24] In *In re Amaranth*, a group of natural gas traders acquired a large number of long contracts and began a practice of selling off a significant number of them in the last half hour of trading in order to depress market prices to benefit a position held in another market. The court found that ability to control the market and causation of an artificial price had been adequately pled on allegations that the traders' scheme depressed the price of gas during the time the traders controlled 40% of the outstanding gas futures on the market during the relevant time period and executed 70% of the market's trades.[25]

Conclusion

Market prices for commodities and futures should reflect the legitimate forces of supply and demand. Market manipulation occurs 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—potentially allowing recovery by individual traders harmed by the manipulation as well as civil and other penalties imposed by the CFTC.

Thomas B. Hatch and Thomas C. Mahlum are partners at Robins, Kaplan, Miller & Ciresi L.L.P., Minneapolis, Minnesota. Trial attorneys practicing in the areas of business and financial litigation, they have represented investors seeking recovery under the CEA for market manipulation. Mr. Hatch may be reached at tbhatch@rkmc.com *and his full biography is available online at* http://www.rkmc.com/Thomas_Hatch.htm*. Mr. Mahlum may be reached at* tcmahlum@rkmc.com *and his biography can be found at* http://www.rkmc.com/Thomas_Mahlum.htm*.*

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[1] 7 U.S.C. §§ 13(a)(2), 13(b), 25(a)(1). In addition, Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amends the CEA to prohibit any person using or attempting to use any manipulative or deceptive device or contrivance in connection with any swap, contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity. The text of the new section is patterned after Section 10(b) of the Securities Exchange Act of 1934, which has been interpreted by courts to cover intentional or reckless conduct that deceives or defrauds market participants.

[2] *See, e.g., Frey v. CFTC,* 931 F.2d 1171, 1175 (7th Cir. 1991).

[3] *See, e.g., In re Soybean Futures Litig.,* 892 F. Supp. 1025, 1044 (N.D. Ill. 1995).

[4] *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971).

[5] *Cargill*, 452 F.2d at 1162.

[6] *CFTC v. Enron Corp.,* No. H-03-909, 2004 BL 2949, *7 (S.D. Tex. Mar. 9, 2004).

[7] *United States v. Reliant Energy Servs. Inc.,* 420 F. Supp. 2d 1043, 1058-60 (N.D. Cal. 2006).

[8] *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513, 530 (S.D.N.Y 2008).

[9] *Id.* at 534. (Emphasis added).

[10] *Id.* at 530. *See also Anderson v. Dairy Farmers of America, Inc.*, No. 08-4726, 2010 BL 228930 (D. Minn. Sept. 30, 2010).

[11] *In re Soybean Futures Litig.***,** 892 F. Supp. 1025, 1047 (N.D. Ill 1995).

[12] *In re Ind. Farm Bureau Coop Ass'n,* [1982-1984 Transfer Binder] Comm. Fut .Law. Rep. (CCH) ¶21,766 at 27,288 n.2.

[13] *Enron,* No. H-03-909, 2004 BL 2949 at *10.

[14] *Indiana Farm Bureau,* ¶ 21,796 at 27,283.

[15] *Id*.

[16] *Reliant Energy,* 420 F. Supp. at 1058-59.

[17] *In re Henner*, 30 Agric. Dec. 1151 (1971).

[18] *Id.* at 1198.

[19] *Enron,* No. H-03-909, 2004 BL 2949 at *8-9.

[20] *Anderson,* No. 08-4726, 2010 BL 228930.

[21] .*Id* at *10-11.

[22] *Cargill,* 452 F.2d at 1163.

[23] *In re Amaranth,* 587 F. Supp. 2d at 530.

[24] *See Enron,* No. H-03-909, 2004 BL 2949 at *9.

[25] *In re Amaranth,* 587 F. Supp. 2d at 523.

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