REPORT

Futures & Derivatives Law

The Journal on the Law of Investment & Risk Management Products

September 2017 · Volume 37 · Issue 8

THE NECESSITY OF PRICE ARTIFICIALITY IN MANIPULATION AND ATTEMPTED MANIPULATION CLAIMS

By Charles Mills and Karen Dildei

Charles Mills is a partner in the Washington, DC office of Steptoe & Johnson LLP. He practices as a member of the firm's Energy and Financial Services Practice Groups. Karen Dildei is an associate in Steptoe & Johnson's Energy Practice Group. The authors thank Steptoe & Johnson partner Daniel Mullen and counsel A. Hunter Hodges for their valuable contributions to this article. The ideas expressed in this article are solely those of the individual authors and are not the views of Steptoe & Johnson LLP, any of its other attorneys, or any of its clients.

For several years various plaintiffs, including the Commodity Futures Trading Commission (CFTC), have advocated positions that would eliminate or minimize proof of price artificiality (*i.e.*, a price that does not reflect the legitimate forces of supply and demand) as an essential element of a manipulation or attempted manipulation claim. They have argued that a lawful derivatives transaction can become an unlawful manipulation or attempted manipulation based solely on a trader's intent to affect a price irrespective of whether the price is artificial or whether the trader had a reasonable basis to believe that the impact of its behavior would impair legitimate market price formation. This argument is flawed and is one of the principal reasons for complaints that the proscription of manipulation has become unreasonably vague in application. Actual or potential price artificiality is the foundation for claims of manipulation and attempted manipulation. Unless there is a harm or dangerous probability of harm to the integrity of market price formation, no claim of manipulation or attempted manipulation should lie.

A. Actual or Potential Price Artificiality is an Essential Element of Manipulation and Attempted Manipulation Claims

Price manipulation theory starts with the public interest in derivatives markets. Commodity Exchange Act (CEA) Section 3 declares Congress' finding that the transactions covered by the CEA "are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating price information to trading in liquid, fair and financially secure trading facilities."[1] This finding endorses the price discovery function of derivatives markets—that derivative market prices reflect the collective opinion of market participants about the present and future values of a commodity. Businesses in turn rely on the collective valuation to inform their

THOMSON REUTERS®

pricing of commodity purchases and sales and their decisions about storage and future production. Based on this finding that derivatives market prices have a broad impact on producers, distributors and customers, Congress declared that the purpose of the CEA is "to deter and prevent price manipulation or any other disruptions to market integrity."[2] The legislative history of the statute is replete with expressions of this purpose, in one place describing price manipulation as an "overshadowing evil that must be eliminated."[3]

CEA Section 9(a)(2) thus declares it a felony for any person "to manipulate or attempt to manipulate the price of" any commodity in interstate commerce, futures contract on or subject to the rules of an entity registered with the CFTC, or swap.[4] Civil liability under CEA Section 6(c)(3) effectively tracks Section 9(a)(2)'s criminal proscription.[5] Although there is no statutory definition of manipulation, the CFTC and the courts for many decades have equated it with causing price artificiality. They have repeatedly held that a manipulation claim requires proof that: (1) the alleged violator possessed an ability to influence market prices; (2) an artificial price existed; (3) the alleged violator caused the artificial prices; and (4) the alleged violator specifically intended to cause the artificial price.[6] The CFTC and the courts have defined an artificial price to be one that does not reflect the "legitimate forces of supply and demand" and have defined manipulation as conduct that both is intended to and can cause market prices "not to reflect the free forces of supply and demand."[7] These requirements flow from the plain meaning of the statute's words—price manipulation—which denote causing an illegitimate effect on price.

Section 6(c)(1) separately grants the CFTC power to adopt rules prohibiting the use or attempt to use any "manipulative or deceptive device or contrivance" in connection with any swap, contract of sale of a commodity in interstate commerce, or futures contract on or subject to the rules of an entity registered with the CFTC.[8] Pursuant to that authority, the CFTC adopted Rule 180.1, which, as relevant here, generally prohibits any person from "intentionally or recklessly" using or employing any manipulative device, scheme or artifice to defraud in connection with any swap, contract of sale of a commodity in interstate commerce, or futures contract on or subject to the rules of an entity registered with the CFTC.[9] Congress modeled CEA Section 6(c)(1) on Securities Exchange Act (SEA) Section 10(b), and the CFTC modeled Rule 180.1 on Securities and Exchange Commission (SEC) Rule 10b-5.[10]

Section 6(c)(1) authorizes the CFTC to prohibit manipulative and deceptive devices and contrivances, but does not change the substantive prohibitions of manipulation and attempted manipulation. The terms of CEA Section 6(c)(1) and Rule 180.1 do not alter the established definition of manipulation or the requirements to prove market price artificiality to establish a charge of manipulation or to prove the potential for market price artificiality for a claim of attempted manipulation. It should be noted, however, that the terms of Section 6(c)(1) grant the CFTC authority to prohibit wrongs beyond manipulation and attempted manipulation. Thus, Rule 180.1 also prohibits wrongs distinct from manipulation and attempted manipulation, such as customer solicitation fraud, in which proof of an actual or potential market price impact would not necessarily be required.

The CFTC, in its preamble to its *Federal Register* release for final Rule 180.1, explained this distinction. Because Rule 180.1 prohibits not only manipulation and attempted manipulation, but also frauds that do not impact the integrity of market prices, a violation of Rule 180.1's prohibition of fraud "may exist in the absence of any market or price effect."[11] This guidance relied on the Supreme Court's interpretations of SEA Section 10(b) and SEC Rule 10b-5 that recognized that "the interest in preserving the integrity of the securities markets was one of the purposes animating Exchange Act Section 10(b), but rejected the notion that section 10(b) is limited to serving that objective alone."[12] Nothing in this rationale suggests that Rule 180.1 eliminated the need to prove price artificiality in order to establish a claim of manipulation or attempted manipulation.

B. Claims of Attempted Manipulation Should Require a Showing of a Dangerous Probability of Harm to Market Integrity

The first question for any claim of attempted manipulation is whether the actual or contemplated behavior could materially threaten market integrity. Everything else, including a trader's intent, should be secondary. This principle, which flows directly from the CEA's finding that there is a national interest in fair markets that promote price discovery and liquidity, has been largely lost in the extensive attention given instead to the separate element of intent. If the actual or contemplated behavior does not involve a dangerous probability of causing market price artificiality, a claim of manipulation or attempted manipulation is unwarranted. Allowing attempted manipulation claims with respect to behavior that poses no probability of danger to a market risks ensnaring legitimate trades, which could undermine the CEA's price discovery and liquidity objectives. Accordingly, when a trader acts in compliance with market rules and does not endeavor to impair or has no capacity to impair the integrity of market price formation, no claim under the CEA should lie.

The Supreme Court addressed this principle in *Spectrum Sports, Inc. v. McQuillan,*[13] in the analogous context of a claim of attempted monopolization under the Sherman Act. The issue before the Court was whether proof of an intent to monopolize and some act in furtherance of it was sufficient to state a claim of attempted monopolization where the alleged wrongdoer had no actual capacity to gain a monopoly. The Court held that a wrongful intent to monopolize alone is insufficient to state a claim of attempted monopolization; rather, there also must be proof of a "dangerous probability" that the actor could effectuate the wrongful intent.[14] The Court therefore overturned the lower court's judgment of attempted monopolization upon concluding that, although the defendant possessed an intent to monopolize, there was no dangerous probability it could establish a monopoly.[15]

Spectrum Sports applies the more universal principle that attempt violations should be limited to conduct or planned conduct that has the capacity—and is likely—to cause harm. Attempt claims should not be based on hypothetical concerns or an imagined market outcome that a trader has no ability to cause. Claims based on abstract legal and economic theories divorced from market effects should not be actionable. The Supreme Court's formulation of a "dangerous probability" captures that principle, as could other formulations. In the context of CEA manipulation the quantum of evidence necessary to meet a "dangerous probability" standard will vary depending on the facts. Where abuse of market power is the concern, evidence of both a capacity to harm the integrity of market pricing and a design to do so would be needed. In contrast, a plan to spread false material information in the market, where the harm can be effectuated quickly with relatively little effort, might present a dangerous probability at a much earlier stage. But even that analysis will depend on the facts. For example, a knowing false statement that a major Midwest gas pipeline has been shutdown (when in fact it has not) might be grist for a claim of manipulation or attempted manipulation if made by a gas trader in communications with traders in Midwest gas markets because in that context a false rumor of such misinformation could present a dangerous probability of materially distorting gas futures and cash market prices. The same false statement made by a college sophomore in her physics class in Southern California, absent other facts, would not support a claim.

The elements for CEA manipulation (*i.e.*, that an alleged violator must possess the ability to influence market prices, in fact have caused an artificial price, and specifically have intended to cause an artificial price) essentially embody the same principle announced in *Spectrum Sports*. Where a trader's actual or contemplated conduct does not pose a dangerous probability of causing an artificial market price, the conduct should not be charged as attempted manipulation. This is especially germane to cases where manipulative intent is inferred from trading patterns alone. Where it is improbable that trading behavior could or would create market price artificiality, *Spectrum Sports* and CEA precedents support the conclusion that no claim of attempted manipulation should lie.

The CFTC's early decision in *In re Hohenberg Bros. Co.*[16] stating that a claim of attempted manipulation requires showing of only: (1) an intent to affect the market price; and (2) some overt act in furtherance of that intent, is not to the contrary. A literal application of this standard would erroneously divorce a claim of attempted manipulation from a threat to market integrity because every order and executed transaction has the potential to "affect" the market price to some extent. The CFTC's decisions in *Indiana Farm Bureau*[17]and *In re Abrams*[18] corrected any misimpression arising from *Hohenberg*, holding that a claim of attempted manipulation should be dismissed where the violator lacked "the specific intent, purpose or conscious object to create an artificial or distorted price."[19] Most recently, the district court in *CFTC v. Wilson*[20] reaffirmed this standard. These authorities reinforce the continued primacy of price artificiality to proving a claim of attempted manipulation.

C. The Element of Intent

The standard of specific intent derives from the foundational element of price artificiality itself. The CFTC in *Indiana Farm Bureau* declared that, to establish the intent element of manipulation under CEA Section 9(a)(2), "it must be proven that the accused acted (or failed to act) *with the purpose or conscious object of causing or effecting* a price or price trend in the market that did not reflect the legitimate forces of supply and demand influencing futures prices in the particular market at the time of the alleged manipulative activity."[21]

The CFTC, however, permits recklessness to satisfy the element of mental intent under Rule 180.1. CEA Section 6(c)(1) does not delineate a recklessness standard, but the CFTC adopted it in reliance on judicial decisions that hold recklessness to be a permissible standard for intent under SEA Section 10(b) and SEC Rule 10b-5.[22] Recklessness under SEC Rule 10b-5 relates to whether a reasonable person and the alleged violator would have been aware that his or her conduct or representations could deceive others. One of the seminal cases defined the standard for recklessness as an act, statement or omission that represents "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[23] Another court explained that it involves "a *subjective* inquiry turning on the defendant's actual state of mind."[24] Thus, the objective component of the recklessness standard focuses on what a reasonable person would perceive, while the subjective component focuses on the actor's actual awareness of the deceptive nature of his or her conduct or representations.

The securities law standard is grounded on the Supreme Court's multiple holdings that SEC Rule 10b-5 is an antifraud rule that requires proof of deception to state a claim. The Court has declared that SEA Section 10(b) "is aptly described as a catchall provision, but what it catches must be fraud."[25] The Court has made clear that, in the absence of deception, mere unfairness or overreaching in a transaction does not violate the SEA Section 10(b) or Rule 10b-5.[26] The Court has applied the same principles to manipulation claims under Rule 10b-5, holding that they require proof of a misrepresentation or actionable omission of a material fact.[27]

The CFTC described recklessness for purposes of Rule 180.1 as an act or omission that "departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing."[28] This description quotes from a court decision applying CEA antifraud Section 4b to a claim that a futures commission merchant engaged in unauthorized trading in a customer's account.[29] Unlike trading in the market, purposeful unauthorized trading or misappropriation of assets in a customer's account always has been held to be inherently deceptive activity under CEA Section 4b.[30] Although the language the CFTC quoted from the case does not expressly refer to an actor's awareness of the deceptiveness of his or her action or communication, when the language is read in the context of the claim before the court, the court's formulation is no different than the securities law precedents defining recklessness. It simply instructs that the element of wrongful intent for an unauthorized trading case is met as long as the evidence renders it "very difficult to believe the actor was not aware" that he or she was engaging in the deceptive conduct of unauthorized trading, as opposed to acting inadvertently or negligently. The CFTC's definition of recklessness thus is no different from that established in the seminal securities law cases that the CFTC cited as authority for Rule 180.1.

The CFTC's definition of recklessness as applied to a claim of manipulation or attempted manipulation under Rule 180.1 should require proof that it is very difficult to believe the alleged violator was not aware that both he or she was misrepresenting or misleading someone as to a material fact and that the deception would create a dangerous probability of causing an artificial price. The second element relating to awareness of a market price impact is necessary to distinguish Rule 180.1's application to a manipulation or attempted manipulation claim from claims for non-manipulation frauds. In this way, the intent element for manipulation and attempted manipulation claims under Rule 180.1 continue to tie back to the necessary element of price artificiality.

The CFTC's first application of Rule 180.1 raised questions about the Rule's scope. The CFTC's settlement order in *In re JPMorgan Chase Bank, N.A.* concerned the company's trading in credit default swaps when it had a large and concentrated market position.[31] The CFTC's order found recklessness on the basis that the company allegedly traded in a manner that posed "obvious dangers to legitimate market forces" in an effort to "defend[] the position" when other market participants sensed its vulnerability.[32] Significantly, the order did not find fraud, attempted fraud, any intent to deceive, any untoward price impact, or any intent to cause an artificial price. The CFTC's order thus seemed to apply Rule 180.1 as an anti-market disruption rule that is violated where, even in the absence of fraud and an intent to disrupt, a trader's behavior in fact poses obvious dangers to legitimate market forces. This application, which is not within the plain meaning of the language of Rule 180.1, is inconsistent with judicial interpretations of SEC Rule 10b-5, and does not provide any reliable guidance with respect to the application of Rule 180.1 to a claim of manipulation or attempted manipulation.

In contrast to the CFTC's application of Rule 180.1 in *JP Morgan*, the first judicial interpretation of Rule 180.1—*CFTC v. Kraft Foods Grp., Inc.*[33]—construed it to be an anti-fraud rule like SEC Rule 10b-5 and therefore required proof of material misrepresentations or omissions. The *Kraft* court's decision also buttresses the existing precedent that manipulation and attempted manipulation claims require a showing that the alleged wrongful conduct could cause artificial market prices and was specifically intended to cause such prices.

In *Kraft*, which remains an active case, the CFTC alleged that the defendants violated CEA Sections 6(c)(1) and 9(a)(2) as well as Rules 180.1 and 180.2 by attempting to manipulate and manipulating the prices of cash wheat and wheat futures. The CFTC alleged that the defendants needed to purchase large quantities of wheat as the raw material for their production of consumer food products and manipulated the cash market prices for wheat downward to reduce the cost of their purchases. The defendants allegedly effectuated this objective by establishing a very large position in wheat futures, which were trading at a discount relative to cash market prices, with the hope that cash market sellers would lower their prices out of fear that the defendants would acquire the wheat they needed through deliveries on the futures contracts.

The defendants moved to dismiss the Section 6(c)(1) and Rule 180.1 claims on the ground that the CFTC had not pled fraud with particularity as required by Federal Rule of Civil Procedure (FRCP) 9(b).[34] The defendants asserted that nothing in the CFTC's complaint plausibly alleged a misrepresentation or actionable nondisclosure of a material fact. The CFTC argued that FRCP 9(b) did not apply because Section 6(c)(1)'s prohibition of "any manipulative or deceptive device" is in the disjunctive and therefore it allows for an independent cause of action for manipulation that is distinct from fraud and not subject to FRCP 9(b).[35] The court disagreed with the CFTC.[36] The court held that Section 6(c)(1) and Rule 180.1 must be read together, and concluded that, in combination, the provisions are intended to reach only fraudulent conduct.[37] The court also observed that its analysis is supported by the analogous language in SEC Rule 10b-5 and longstanding precedent that Rule 10b-5 cause of actions sound in fraud.[38] Notably, the court rejected the CFTC's argument that fraud is not a necessary component of a claim under Section 6(c)(1) because fraud is not a necessary element of a claim under Section 9(a)(2), stating "[q]uite simply, Section 6(c)(1) contains explicit language requiring fraud, and Section 9(a)(2) does not."[39]

The court nonetheless found that the complaint adequately pled fraud by alleging that the defendants "through activities in the market, conveyed a false sense of demand, and the resulting prices in the market (both of cash wheat and of wheat futures) were based not solely on the actual supply and demand in the market, but rather were influenced by Kraft's false signals of demand."[40] Relying on the CFTC Final Rule 180.1 Release and CEA precedent, the court also found that Kraft satisfied the intent element of Rule 180.1, *i.e.*, intentional or reckless manipulation, "because the [c]omplaint sets out factual allegations showing that Kraft intended to 'deceive or defraud investors by controlling or artificially affecting the price of' commodities and/or futures."[41] The CFTC "specifically alleged that Kraft adopted its strategy of buying wheat futures '*in order to* depress the price of wheat in the cash market and inflate the futures price of wheat.' "[42]

D. Recent Cases Illustrating the Importance of Proving an Artificial Price

Derivatives market prices are thought to reflect the collective or aggregate opinions of market participants about the present and future value of a commodity: "[M]arket participants are constantly entering and leaving a market based on their assessment of whether the relevant commodity is overpriced or underpriced. The aggregate of these participants' actions is the essence of supply and demand and each can contribute to the equilibrium pricing of a commodity."[43] The terms "supply and demand" in this description capture not only the fundamentals of known supplies and demand but also the many other factors that bear on market opinion and price formation—*e.g.*, technical trading based on historical market price behavior; triggering of exchange daily price limits; unexpected future events such as governmental embargoes, earthquakes, and wars; general market psychology of fear or optimism; hedging and individual traders' risk tolerance and financial capacity to sustain short-term adverse price movements without liquidating. Importantly, the CFTC also has acknowledged that profit motive is a vital element of price formation in healthy competitive markets: "[S]elf-interest of every market participant plays a legitimate part in the price setting process, it is not enough to prove simply that the accused intended to influence price."[44]

When does a price become "artificial" in this matrix of market opinion? A number of judicial and CFTC decisions do not equate an artificial price with one that necessarily is manipulated. They describe price artificiality as essentially any price that in hindsight was not justified by the actual supply and demand at the time, even if it was not the product of manipulation.[45] The majority opinion in *Indiana Farm Bureau* explained that an "artificial" price is a "distorted" price or "in economic language, a non-equilibrium price."[46] And the agency found that the prices at issue in *Indiana Farm Bureau* were in fact "artificial," but were not caused by the respondent.

The CFTC's majority opinion, however, somewhat inconsistently also defined an artificial price as one that is caused by factors that "are not a legitimate part of the economic pricing of the commodity." As the CFTC stated, "when a price is effected 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 them."[47] The differentiation of "legitimate" from "illegitimate" factors connotes a factor involving improper market behavior.

Applying the foregoing principles of market pricing, proving a specific intent to cause an artificial price should require proof that the trader's behavior: (1) materially distorted or presented a dangerous probability of materially distorting the market price to a level outside the price range of where legitimate forces would set it; (2) is not supported by credible economic analysis, good faith perception and opinion of current and future commodity values, inadvertence, mistake, necessity, or other legitimate reason or excuse that would be inconsistent with a specific intent to distort prices; and (3) was undertaken for the specific purpose of causing the price distortion. This analytical framework presents a significant burden of proof because, among other reasons, the typically complicated and volatile derivatives markets, which courts and the CFTC have found susceptible to naturally occurring artificial prices, inherently allow a broad range of opinion on current and future commodity market valuations.

Several recent cases illustrate the foundational importance of assessing price artificiality in claims of manipulation and attempted manipulation. Without commenting on their merits, conceptually these cases provide examples of facts and allegations in which defining price artificiality could be critical to the outcome. In *Wilson*, the district court denied both sides' competing motions for summary judgment on the intent element. The case involved an exchange-traded three-month interest rate futures contract (the Three-Month Contract) that required the long party to make fixed interest rate payments and the short party to make floating interest rate payments based on the three-month LIBOR rate.[48] The daily settlement rate was set from a hierarchy of sources, which included, among others: (1) unexecuted electronic bids and offers entered during the fifteen minute settlement period and (2) prevailing rates in over-the-counter (OTC) swap transactions. The daily settlement price could not be higher than the best electronic offer or lower than the best electronic bid. The Three-Month Contract was relatively illiquid with very low volume of trading; many days there was no trading of it during the settlement period.[49]

The CFTC alleged that during the contract's settlement period the defendants, with the intent to cause an artificially high price, placed bids at rates that were higher than those of consummated trades in the OTC swap market and that the defendants did not expect the bids to be executed. The defendants argued that the bid rates were not artificial because they reflected the correct economic valuation of the contract's rates.

The court held that a jury could reasonably conclude that the defendants did not intend to create an artificial price based upon the evidence indicating that: (1) there was an economic rationale for pricing the contract higher than the OTC rates; and (2) on one occasion when a counterparty to the defendants' electronic bids had in fact appeared, the defendants had attempted to trade at rates above the OTC rates for a notional amount approximately three times larger than its open position.[50] In denying the CFTC's motion, the court held that, together, this evidence "could lead a reasonable jury to conclude that defendants believed that the Three-Month Contract had been undervalued and that the defendants' bids were legitimate sources of supply and demand."[51] In denying the defendants' motion, the court found that a reasonable jury also could find to the contrary, *i.e.*, that the defendants had the specific intent to create artificial prices based on evidence indicating that: (1) the defendants first developed a large long position and then placed electronic bids without consummating any corresponding transactions; (2) the defendants had the intent to affect the IDEX rates; and (3) the defendants' traders made statements suggesting that they did not believe their bids would be executed.[52] The court reasoned that, together, these facts "could lead a reasonable jury to conclude that defendants developed a long position in the Three-Month Contract and then undertook a bidding strategy to create artificial prices."[53]

Wilson thus raises a question about whether a tribunal may find an intent to cause an artificial price where there is a reasonable economic basis to support the challenged price and a trader has a good faith basis to believe the current market price overvalues or undervalues the commodity. A bid or executed price that is in fact within a reasonable range of an economically justifiable valuation would appear not to be an artificial price. And, if a trader has a reasonable basis to perceive that a price is within a reasonable contract valuation, it would seem that by definition the trader cannot have a specific intent to cause an artificial price. How far away a challenged bid or executed price needs to be from prevailing prices to be characterized as artificial generally is a question of fact, but given the many factors affecting market price, the range of rational derivatives market valuations typically is not limited to a tiny range. Consistent with this, bid and offer prices within reasonable proximity to others in an electronic order book or to those of executed transactions typically are not perceived as "artificial." It has not been unusual for different markets for similar or even the same products to have pricing variances (*e.g.*, pit prices versus online prices in the same future). That phenomenon generally has been perceived simply as grist for arbitrage, not evidence that one of the prices is artificial.

The concept that a trader's expectation that other market participants will not hit a bid that is relatively close to prevailing market prices is evidence that the trader's bid or offer seeks an artificial price would seem to stretch the traditional requirement for price artificiality. Market illiquidity can be attributed to many factors apart from price. It also is not unusual for an order book to include bids substantially away from the prevailing market that would not be expected to be executed absent change in market conditions. In *U.S. v. Radley*, the court rejected allegations in the context of an OTC energy market that early morning offers well below the prior day's closing transactions were evidence of intent to cause an artificial price as long as the offeror intended to perform if the offers were lifted.[54] In addition, in an illiquid market with a limited number of participants, one side of the market might avoid transacting at a new price, not because it is artificial, but out of self-interest in preserving the more advantageous existing pricing level. That could be natural market competition. This suggests that inferring intent from a belief that a bid would not be hit could undermine legitimate trading. The fact that the unexecuted bids in *Wilson* could affect the settlement price might be a distinguishing factor but it is not clear how that would related to an improper intent if a bid price cannot be independently shown to be artificial. Otherwise, in illiquid markets subject to such settlement rules, the legal risk from making a bid at a new price level might itself inhibit legitimate price formation and promote illiquidity.

Kraft suggests a different possible conundrum. How is intent to cause an artificial price to be determined when futures and cash market prices fail to converge—which market's prices are to be considered reflective of supply and demand and which artificial? The CFTC's theory of liability seems to assume that both the relatively higher cash market and lower futures market prices that existed before Kraft established its futures position were economically justified valuations. Without undertaking to address the particular facts and circumstances of *Kraft*, the issue of non-converging prices raises the following challenges for standards of liability:

- If a speculator believes cash market prices are overvalued and that futures and cash prices will converge to a level lower than the cash prices as the delivery dates of cash contracts and the expiration date of the futures converge, there generally is no legal impediment other than position limits to establishing futures positions to profit from that anticipated convergence. That incentive and trading behavior is part of the derivatives markets' price discovery function.

- Should there be a different rule for commercial companies who buy and sell in the physical market? If it assumed that a commercial buyer of the physical product cannot economically source supply by taking delivery under the futures contract, should the commercial buyer be legally constrained from establishing a futures position if that could materially lower cash prices or raise futures prices in its favor? Certainly when there is a good faith perception that the cash market is overvalued, there would be a question about whether a commercial's futures trading would support an inference of an intent to cause an artificial price since the trading could contribute to more economic valuations, not impair them.

Finally, although not a case charging manipulation, the Seventh Circuit's analysis of price artificiality in *U.S. v. Coscia*[55] indicates that if a court finds that price changes are the result of fraud, it will not require traditional economic analysis to find artificiality. The decision affirmed the conviction of an algorithmic trader for spoofing in violation of CEA Sections 4c(a)(5)(C) and 9(a)(2), and commodities fraud under 18 U.S.C. § 1348(1).[56] Among other things, the court held that the algorithmic trading was programmed to use orders that were intended to be cancelled before they could be executed in order to cause price movements favoring other positions. The court called it a scheme "to pump and deflate the market—by using large orders to inflate or deflate prices, while intending to cancel the orders before they were filled."[57] The court found that the trading "created the illusion of market movement, swelling the perceived value" of the futures contract by "fostering the illusion of demand" at the higher prices and allowing the defendant to liquidate his other contracts for a gain at an "artificially deflated price."[58]

With respect to price artificiality, the opinion describes one example of violative trading causing a series of alleged "artificial" price changes of less than a third of a cent over just two-thirds of a second. As a matter of economics, it would seem impossible to establish that such a tiny, fractional price movement over less than a second could have any relationship to fundamentals of supply and demand in the cash market. Rather, it judges the integrity of futures pricing based solely on the cause of price changes within that market divorced from cash market valuations. The decision stands for the proposition that where price changes are intended and fraud is used to cause them, the element of price artificiality will be satisfied.

E. Conclusion

The CEA's primary objective is to protect the integrity of derivatives markets prices from manipulation. The starting point for any claim of manipulation or attempted manipulation should be whether a person's behavior in fact harmed or presented a dangerous probability of harming market integrity, *i.e.*, causing an artificial price within the circumstances of the particular market involved. The issue of the trader's intent becomes relevant only after those threshold issues are resolved. The better that future judicial and CFTC decisions can explain the existence or non-existence of price artificiality, the clearer the proscriptions of manipulation and attempted manipulation can become. If this occurs, complaints of vagueness might fade away.

ENDNOTES:

[1]7 U.S.C. § 5(a).

[2]*Id.* § 5(b).

[3]Remarks of Representative Purnell, Cong. Rec., 67 Cong., 1st Sess. p. 1317.

[4]7 U.S.C. § 13(a)(2).

[5]7 U.S.C. § 9(3).

[6]*E.g.*, *In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 183 (2d Cir. 2013); *Hershey v. Energy Transfer Partners*, *L.P.*, 610 F.3d 239, 247 (5th Cir. 2010); *In re Indiana Farm Bureau Coop. Ass'n*, [1982-1984 TRANSFER BINDER] CFTC No. 75-14, Comm. Fut. L. Rep. (CCH) ¶ 21,796, 1982 WL 30249, at *7 (1982) ("Indiana Farm Bureau").

[7]*Indiana Farm Bureau*, 1982 WL 30249 at *7 (citation omitted).

[8]7 U.S.C. § 9(1).

[9]The relevant part of Regulation 180.1 provides: (a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly: (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading; (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person. . . .17 C.F.R. § 180.1.

[10]*Id.* § 240.10b-5. In adopting final Rule

180.1, the CFTC observed that the Federal Energy Regulatory Commission and the Federal Trade Commission also modeled their anti-manipulation rules on SEC Rule 10b-5. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, n. 12 (July 14, 2011) ("CFTC Final Rule 180.1 Release").

[11]*Id.* at 41,401.

[12]*Id.* at n. 38, quoting *Superintendent of Ins. of N.Y. v. Bankers Life and Casualty Co.*, 404 U.S. 6, 11-13 (1971).

[13]506 U.S. 447 (1993).

[14]*Id.* at 459.

[15]*Id.*

[16][1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,271 at 21,477 (1977) ("*Hohenberg*").

[17]1982 WL 30249 at *7.

[18][1994-1996 Transfer Binder] CFTC No. 88-10, Comm. Fut. L. Rep. P 26,479, 1995 WL 455791, at *4-5 (1995).

[19]*Id.*

[20]2016 WL 7229056 at *12 (S.D.N.Y. 2016) (slip op.) (''Wilson'').

[21]1982 WL 30249 at *7 (emphasis added); *accord In re Abrams, supra* n. 18, and *Wilson, supra* n. 20.

[22]CFTC Final Rule 180.1 Release at 41,404. The Supreme Court has never decided whether recklessness is a permissible standard under SEC Rule 10b.5. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, n. 12 (1976) ("*Hochfelder*"), the Court expressly declined to reach the issue.

[23]*Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied,* 434 U.S. 875 (1977).

[24]*SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1093-94 (9th Cir. 2010) (emphasis added); *accord, e.g., Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.2d at n. 20.

[25]*Chiarella v. United States*, 445 U.S. 222, 234-35 (1980).

[26]*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

[27]*Schrieber v. Burlington Northern, Inc.*, 472 U.S. 1, 8, 12 (1985).

[28]CFTC Final Rule 180.1 Release at 41,404, *quoting Drexel Burnham Lambert Inc. v. CFTC,* 850 F.2d 742, 748 (D.C. Cir. 1988).

[29]*Drexel Burnham Lambert Inc. v. CFTC* involved whether a futures commission merchant was liable for fraud under CEA Section 4b, 7 U.S.C. § 6b, based on what the CFTC had found to be unauthorized trading arising from willful disregard of a customer's instructions that presented "obvious dangers to a client's interests in arranging a purchase or sale for the client's account." 850 F.2d at 748.

[30]*See e.g., CFTC v. Noble Wealth Data Info. Serv., Inc.*, 90 F. Supp. 2d. 676, 687 (D. Md. 2000) (defendants defrauded customers by diverting investor funds for operating expenses and personal use), *aff'd in part, vacated in part, sub nom.*, *CFTC v. Baragosh*, 278 F.3d 391 (4th Cir. 2002); *In re Slusser*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,701 (1999), *aff'd in relevant part sub nom.*, *Slusser v. CFTC*, 210 F.3d 783 (7th Cir. 2000) (defendants defrauded customers by surreptitiously retaining money in their own bank accounts that should have been traded on behalf of participants); *CFTC v. Skorupskas*, 605 F. Supp. 923, 932 (E.D. Mich. 1985) (defendant defrauded customers by misappropriating customer funds entrusted to her for trading commodity futures contracts).

[31]Order Instituting Proceedings Pursuant, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 14-01 (2013).

[32]*Id.* at 14-15.

[33]153 F. Supp. 3d 996 (N.D. Ill. 2015), *motion to certify appeal denied*, 195 F. Supp. 3d 996 (N.D. Ill. 2016) ("*Kraft*").

[34]*Id.* at 1008.

[35]*Id.*

[36]*Id.* at 1008-12.

[37]*Id.* at 1008.

[38]*Id.* at 1008-10.

[39]*Id*. at 1010.

[40]*Id.* at 1014.

[41]*Id*. at 1015, *quoting Hochfelder*, 425 U.S. at 199.

[42]*Id*. (emphasis in original).

[43]*Indiana Farm Bureau*, 1982 WL 30249 at n. 10.

[44]*Id.* at *6.

[45]*Id.* at *15-17 (Concurring Opinion of Chairman Johnson and authorities cited therein).

[46]*Id.* at n. 2.

[47]*Id.*

[48]2016 WL 7229056 at * 2.

[49]*CFTC v. Wilson*, 27 F. Supp. 3d 517, 526 (S.D.N.Y. 2014) (CFTC explained that the defendants were able to affect the settlement rate in part because of the illiquidity of the Three-Month Contract, noting that there were at least 118 days in which the defendants placed 100% of the long bids and that none of those bids were accepted.).

[50]2016 WL 7229056 at * 2.

[51]*Id.*

[52]*Id*. at *13.

[53]*Id*.

[54]*United States v. Radley*, 659 F. Supp. 2d 803, 815 (S.D. Tex. 2009), *aff'd*, 632 F.3d 177, 183 (5th Cir. 2011) (No artificial price even where bids were higher than any others because they were actually bids, and when they were accepted, defendants actually went through with the transactions.).

[55]*United States v. Coscia*, 2017 WL 3381433 (2017) (slip copy).

[56]*United States v. Coscia*, 100 F. Supp. 3d 653 (N.D. Ill. 2015) (denying motion to dismiss indictment).

[57]2017 WL 3381433 at *8.

[58]*Id.* at *3-4.