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INTRODUCTION

A central focus of the Commodity Exchange Act,[1] and its predecessor legislation dating back to 1922,[2] is market manipulation. An essential goal of this legislation is the punishment and prevention of such manipulation.[3] While market manipulation is pro-

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1. 7 U.S.C. §§ 1-22 (1970 & Supp. V 1975).
2. The Grain Futures Act, ch. 369, 42 Stat. 998 (1922).
3. *See* Commodity Exchange Act § 3, 7 U.S.C. § 5 (1970) (entitled Resolution Declaring Dangerous Tendency of Dealings in Commodity Futures), which provides in pertinent part:

> Transactions in commodity involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest; such transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodity and the products and byproducts thereof in interstate commerce; the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodity and the products and byproducts thereof . . . ; such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodity and the products and byproducts thereof . . . as a means of hedging themselves against possible loss through fluctuations in price; the transactions and prices of commodity on such boards of trade are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling commodity and products and byproducts thereof . . . and such fluctuations in prices are an obstruction to and a burden upon interstate commerce in commodity and the products and byproducts thereof and render regulation imperative for the protection of such commerce and the national public interest therein.

See generally 80 CONG. REC. 6161, 6164 (1936) (remarks of Senator Pope); 62 CONG. REC. 9406, 9414 (1922). Thus, considered in light of the economic purposes of futures trading, that is, price discovery and hedging, *see General Guide,* COMM. FUT. L. REP. (CCH) ¶ 100, at 1011-12 (1976), "manipulation on commodity exchanges distorts price, causing the dissemination of false prices with the consequent economic repercussions in the marketing of cash commodities, and dissuades persons with hedging needs from utilizing futures markets." *Id.* ¶ 140, at 1039.

hibited by exchange rules,[4] neither these rules nor the statute[5] defines manipulation. Thus, the only guidelines are derived from judicial precedent in which actions associated with specific price movements have been adjudged to constitute manipulation.[6]

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4. *See, e.g.*, CHICAGO BOARD OF TRADE, Reg. 150(c) (1977); COMMODITY EXCHANGE, INC, § 210(m) (1975); INTERNATIONAL MONETARY MARKET OF THE CHICAGO MERCANTILE EXCHANGE, ch. 4, Reg. 421(h) (1973); N.Y. COCOA EXCHANGE, INC., Trade Rule 1 & Bylaw § 158 (1977); N.Y. COTTON EXCHANGE, Rule 5.08(l) (1975) ("No member of the Exchange shall engage in any practice which results in the manipulation of prices or the cornering of any commodity dealt in on the Exchange."); N.Y. MERCANTILE EXCHANGE, Rule 41.03 (1975) ("No member of the Exchange shall engage in any practice which results in the manipulation of prices or the cornering of any commodity dealt in on the Exchange.").

5. Commodity Exchange Act § 6(b), 7 U.S.C. § 9 (Supp. V 1975) (civil penalty for manipulation) provides in pertinent part:

> If the [Commodity Futures Trading] Commission has reason to believe that any person . . . is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity . . . it may serve upon such person a complaint stating its charges in that respect . . . requiring such person to show cause why an order should not be made prohibiting it from trading on or subject to the rules of any contract market, and directing that all contract markets refuse all trading privileges to such person, until further notice of the Commission, and to show cause why the registration of such person, if registered as futures commission merchant or any person associated therewith . . . , commodity trading advisor, commodity pool operator, or as floor broker hereunder, should not be suspended or revoked. . . . Upon evidence received, the Commission may prohibit such person from trading on or subject to the rules of any contract market and require all contract markets to refuse such person all trading privileges thereon for such period as may be specified in the order, and, if such person is registered as futures commission merchant . . . , commodity trading advisor, commodity pool operator, or as floor broker hereunder, may suspend for a period not to exceed six months, or revoke, the registration of such person, and may assess such person a civil penalty of not more than $100,000 for each such violation.

Commodity Exchange Act § 9(b), 7 U.S.C. § 13(b) (Supp. V 1975) (criminal penalty for manipulation) provides in pertinent part:

> It shall be a felony punishable by a fine of not more than $100,000 or imprisonment for not more than five years, or both, together with the costs of prosecution, for any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any contract market . . . .

See also Commodity Exchange Act § 6(c), 7 U.S.C. § 13b (Supp. V 1975) (misdemeanor for violation of cease and desist order issued for manipulative activity pursuant to Commodity Exchange Act § 6(b), 7 U.S.C. § 9 (Supp. V 1975)).

6. *See* cases cited note 11 *infra*. Although the decisions of the courts and the Commodity Futures Trading Commission (CFTC) in manipulation cases are a matter of public record, the decisions and actions of exchanges in such situations are not similarly available. The Commodity Exchange Act provides in pertinent part:

> (1)(A) Any exchange or the Commission if the exchange fails to act, may suspend, expel, or otherwise discipline any person who is a member of that

Judicial decisions, however, have not provided a clear set of guidelines for traders to follow when contemplating a given market situation and course of action.[7] There is a line demarcating manipulation which may not be transgressed, but its location is uncertain. It is necessary, therefore, to attempt to draw the line for the guidance of both commercial and speculating traders.

There are two approaches to such line-drawing. One is to trace court and exchange decisions;[8] the other is to look toward those actions which should or should not be tolerated because of their effect on the price-formation and risk-management functions of the market. This article adopts the latter approach.

The conclusion of this approach is somewhat extreme in its high level of tolerance of the use of market power. This conclusion

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> exchange, or deny any person access to the exchange. Any such action shall be taken solely in accordance with the rules of that exchange.
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> (B) Any suspension, expulsion, disciplinary, or access denial procedure established by an exchange rule shall provide for written notice to the Commission and to the person who is suspended, expelled, or disciplined, or denied access, within thirty days, which includes the reasons for the exchange action in the form and manner the Commission prescribes. *Otherwise the notice and reasons shall be kept confidential.*

Commodity Exchange Act § 8c, 7 U.S.C. § 12c (Supp. V 1975) (emphasis added). The CFTC has issued an interpretation of this confidentiality provision in response to inquiries from exchanges requesting such interpretation:

> Congress did not intend that the Commission must keep the disciplinary action information confidential. The confidentiality requirement is directed at the exchanges in order to give the Commission the option to exercise its review powers . . . prior to public release of any exchange disciplinary action. However, upon completion of its review, if any, of the exchange action . . . the Commission, absent a good reason presented to it, may exercise its discretion and permit the release of information regarding the exchange disciplinary action. Once it does so, any exchange is free to disseminate the information.
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> The general public and members of any exchange should be informed of disciplinary actions taken by an exchange. Notice of these disciplinary actions would preclude an otherwise unknowing general public and/or members of an exchange from dealing with a member who has been suspended, expelled, or denied access to an exchange. In addition, such publicity would serve as a deterrent against further exchange rule violations. Exchange members would be put on notice that the exchange is enforcing its rules, thereby encouraging compliance with such rules.
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> Since there is no requirement of confidentiality of exchange disciplinary actions imposed upon the Commission, and since there is a strong public interest in making such actions public, it is the Commissions's intention to disclose disciplinary actions taken by an exchange unless it is shown that in a particular case continued confidentiality is appropriate.

40 Fed. Reg. 30,155, 30,156 (1975).

7. *See* cases cited note 11 *infra*.

8. *See generally* 57 MINN. L. REV. 1243 (1973); 73 YALE L.J. 171 (1963).

stems from the notion that market price is the result of competition, and that competition is a contact sport. This article draws the line toward tolerance of the use of power and countervailing power to a greater extent than will gain immediate acceptance. It is recognized that there is a place for the thinking of people of more moderate persuasion. Nonetheless, it is hoped that the conclusion of this article will elicit greater consideration of the problem than has occurred thus far.

STANDARD DOCTRINE

While market manipulation is specifically proscribed by sections 6(b)[9] and 9(b)[10] of the Commodity Exchange Act, nowhere in this Act is the term specifically defined. Thus, the transactional definition of the term has been left to judicial and administrative construction.[11] The implications of this are twofold: First, the definition of manipulation is difficult; second, the circumstances surrounding sharp price variations are so diverse and involve so many elements of causation that each instance requires detailed examination to determine whether manipulation has occurred, and if so, who was responsible.

No manipulation case is ever simple. The forces that determine price are numerous, complex, and always uncertain. Prices result from the 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 this balance.

A commonly accepted definition of 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 manipulation it will be found using devices by which the prices 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 operative. . . . Any and every operation, transaction [or] device, employed to produce these abnormalities of price relationship in the futures market, is manipulation.[12]

9. 7 U.S.C. § 9 (Supp. V 1975). For text of this section, see note 5 *supra*.

10. 7 U.S.C. § 13(b) (Supp. V 1975). For text of this section, see note 5 *supra*.

11. The results of leaving the definition of manipulation to the courts have proved interesting, *see, e.g.*, Cargill, Inc. v. Hardin, 452 F.2d 1154 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972); Volkart Bros., Inc. v. Freeman, 311 F.2d 52 (5th Cir. 1962); General Foods Corp. v. Brannan, 170 F.2d 220 (7th Cir. 1948).

12. Volkart Bros., Inc. v. Freeman, 311 F.2d 52, 58 (5th Cir. 1962) (footnote

This has been shortened to a generally accepted definition: Manipulation occurs when price is intentionally distorted to a level where it would not have been if the "ordinary" forces of supply and demand had prevailed. The word "ordinary" becomes important. Price is the result of forces of supply and demand; in futures markets, this is the supply and demand for contracts. The notion underlying manipulation is that some forces are ordinary and some are manipulative. Manipulation thus implies a price distorted from that which would have prevailed in its absence. Usually, the Commodity Futures Trading Commission (CFTC) begins an investigation into possible manipulation because of a sharp variation in price, such as a major move on the last day of trading in an expiring contract.[13] In the succession of cases that have been tried under the Commodity Exchange Act and the Commodity Futures Trading Commission Act of 1974,[14] 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 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 for supplying them with contracts. The futures price and the price of

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omitted) (quoting *Hearings Before a Subcomm. of the Comm. on Agriculture and Forestry*, 70th Cong., 1st Sess. 201-02 (1927) (Senate hearings)).

13. Section 8 of the Commodity Exchange Act provides in pertinent part:

> For the efficient execution of the provisions of this [Act], and in order to provide information for the use of Congress, the Commission may make such investigations as it may deem necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to any of the provisions of this [Act]. . . . The Commission upon its own initiative or in cooperation with existing governmental agencies, shall investigate marketing conditions of commodity and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges.

Commodity Exchange Act § 8, 7 U.S.C. § 12 (Supp. V 1975). The CFTC has also adopted rules pertaining to investigations conducted by the CFTC and its staff:

> The Director of the Division of Enforcement and members of the Commission staff acting pursuant to his authority and under his direction may conduct such investigations as he deems appropriate to determine whether any persons have violated, are violating, or are about to violate provisions of the Commodity Exchange Act . . . or the rules, regulations or orders adopted by the Commission pursuant to that Act . . . . The Director shall report to the Commission the results of his investigations and recommend to the Commission such enforcement action as he deems appropriate.

17 C.F.R. § 11.2 (1977).

14. 7 U.S.C. §§ 2-22 (Supp. V 1975).

cash commodity certified for delivery is 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 thus control the deliverable supply and force the shorts to pay a high and arbitrary price.

In the short-side manipulation, the operator puts an inordinate quantity of the commodity 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 the hands of the weak and unsuspecting, who must not only redeliver but must sell long positions as well, thereby compounding the debacle.

Once a suspect price is identified, if it is a price increase, the CFTC identifies a large long, compares the size of the long position to the open interest and to the certificated deliverable supply, and brings charges. If the suspect price is a decrease, the CFTC identifies the large short, examines his position, trading, and delivery actions in relation to the open interest and to the certificated deliverable supply, and brings charges. The futures price is compared to the price reported in transactions between commercial suppliers and users; if these prices diverge, the price is considered distorted. The necessary element of intent is often treated lightly.[15] It is assumed that if an individual is powerful enough to manipulate, then he is knowledgeable enough to know what he is doing; thus, moneymaking furnishes proof of intent.

For the most part, in manipulation cases, the prosecution presents evidence confined to the activities of the defendant. Although comparisons are made with positions and actions of other large-scale operators, such comparisons are made only to establish dominance of futures and/or certificated deliverable supply. Only a limited examination of events preceding and following the climactic situation is made. Generally, the questions are simplistic: Was the position large in relation to the open interest? Was the position large in relation to technically deliverable supply? Was the price of futures different from the reported "commercial" price? Affirmative answers to these questions establish guilt. The defense in manipulation cases has also tended to be simplistic. Frequently, the defendant will argue that he acted reasonably, as a prudent

15. *See* cases cited note 11 *supra*.

merchant, processor, or speculator, as the case may be. Yet the defendant in a manipulation case is confined to his own behavior, due to the limited availability of information about the actions of other market participants. Although the specifics of the futures positions, cash positions, and trading of all large-scale traders are available to the CFTC, this information is confidential.[16]

DELIVERABLE SUPPLY

The question of deliverable supply must inevitably enter into the consideration of alleged manipulations. Subject to CFTC review, exchanges write delivery terms of contracts.[17] Delivery terms must be sufficiently restrictive so that they may be known and understood. At the same time, they must be broad enough to insure that price on delivery is representative of real commercial value. A delicate balance must be struck. If delivery locations and qualities are so numerous that delivery terms are broad, futures markets are difficult to use because that which is traded lacks precise definition. But if delivery terms are extremely narrow, markets are sub-

16. *See* Commodity Exchange Act § 8, 7 U.S.C. § 12-1 (Supp. V 1975), which provides in pertinent part:

> [T]he Commission may, in its discretion, from time to time disclose and make public the names and addresses of all traders on the boards of trade on the commodity markets with respect to whom the Commission has information, and any other information in the possession of the Commission relating to the amount of commodities purchased or sold by each such trader . . . .

The CFTC has issued a statement regarding the confidentiality of information concerning the trades and positions of individual large traders, *see* 40 Fed. Reg. 41,551 (1975). This policy statement indicates that information reported by traders and brokers on CFTC report forms which could identify positions and transactions of individual traders would only be released "when extraordinary circumstances of compelling public interest require disclosure." *Id.* at 41,552. The CFTC noted that, as of the date of publication, no such compelling interest was known. *Id.*

17. Commodity Exchange Act § 5a(12), 7 U.S.C. § 7a(12) (Supp. V 1975) provides for CFTC approval or disapproval of contract market rules:

> Each contract market shall—
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> . . . .
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> submit to the Commission for its approval all bylaws, rules, regulations, and resolutions made or issued by such contract market . . . which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements . . . . The Commission shall approve, within thirty days of their receipt unless the Commission notifies the contract market of its inability to make such determination within such period of time, such bylaws, rules, regulations, and resolutions upon a determination that such bylaws, rules, regulations, and resolutions are not in violation of the provisions of this [Act] or the regulations of the Commission . . . .

ject to manipulative distortion. Also, if delivery terms are too narrow, it becomes impossible to arbitrage between the prices of technically deliverable supply and total supply of the commodity. When there is full arbitrage a manipulator must control the whole supply of the commodity, a virtually impossible task. Thus, delivery terms are central in alleged manipulations. It is therefore necessary to define and identify deliverable supply.

Establishing delivery terms is one of the more delicate tasks facing exchanges. Exchanges attempt to set delivery terms that precisely represent commercial value, so that no advantage accrues to either the taker or the maker of delivery. Consequently, 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, trading decreases and ultimately ceases. Delivery terms that are as narrow as practicable, that is, delivery at a single or a limited number of points, seem to operate most fairly.

In the interest of keeping delivery terms as narrow as possible, it is necessary to put a *broad* construction on deliverable supply when matters of alleged manipulation are under consideration. Interpretations of deliverable supply 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 deliverable supply is technically deliverable supply *minus* the amounts of supply that are committed for processing or shipment by commercial traders, hence unavailable to the shorts for delivery. This is the most narrow interpretation of deliverable supply. The case for subtracting the committed portion of technically deliverable supply is extremely weak. Everything is available at a price. Use of the commodity can be delayed and shipping commitments shifted to other points. Reservation prices represent real commercial value, and if the futures price is lower, it falls below economic value.

The first extension of the interpretation of deliverable supply past technically deliverable supply is to include all of the commodity in deliverable position that could be, but has not been, certificated for delivery. Typically, there are substantial quantities at central markets that are not part of technically deliverable supply but that can readily be made part of deliverable supply simply by grading and making out warehouse receipts. Still further amounts can be made part of technically deliverable supply by sorting, screening, and blending.[18] The amount of total supply at the market that is eligible or that can be made eligible for delivery varies. Occasionally, the average quality at delivery points is so low that little can be added to technically deliverable supply, but such instances are rare. Traders, both commercials and speculators, pay little attention to technically deliverable supply; rather, they watch total supply at the delivery point during the delivery month.

This first extension of the interpretation of deliverable supply is entirely reasonable. Shorts should be expected to see that the available supply is certificated if they cannot otherwise fulfill their contracts. If shorts elect to bid up the futures price rather than to see that available stocks are certificated, the consequences are quite their own fault, and they should be accused of price manipulation.

The second extension of the interpretation of technically deliverable supply is to include those stocks that are in normal tributary position which can be put into delivery position without incurring abnormal 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 readily be brought in and certificated are reasonably interpreted as part of deliverable supply.

Congress recognized the need for a broad interpretation of deliverable supply. In the Commodity Exchange Act, it required a grace period of between three and ten business days following the end of trading in a given contract for delivery to be completed.[19]

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18. Sorting, screening, and blending is the process of improving the quality so that deliverable supply can be increased.

19. Commodity Exchange Act § 5a(4), 7 U.S.C. § 7a(4) (Supp. V 1975) provides in pertinent part:

Each contract market shall—

. . . .

> When so directed by order of the Commission, provide for a period, after trading in contracts of sale of any commodity for future delivery in a delivery month has ceased, during which contracts of sale of such commodity for future delivery in such month may be satisfied by the delivery of the actual cash commodity. Whenever, after due notice and opportunity for hearing, the Commission finds that provision for such a period of delivery for any one or more commodities or markets would prevent or tend to prevent "squeezes" and market congestion endangering price stability, it shall, by

There is a wide range of interpretations as to what constitutes deliverable supply when the amounts tributary to the delivery point are added to technically deliverable supply. The congressional mandate seems to extend to the amount that can be put in deliverable position within seven business days.[20] This, in itself, is narrow. Shorts, particularly commercials, do not go short merely on the last day of trading. They go into the delivery month short, and thus have a full calendar month to put stocks in deliverable 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 measurements of deliverable supply play an important role in most long-side manipulation cases. The outcome is likely to go in the direction of the interpretation. In turn, the interpretation of deliverable supply goes to the extent to which shorts are responsible for assuring that they can fulfill their commitments.

LIMITATIONS OF STANDARD DOCTRINE

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

Investigating alleged manipulation requires inquiry into the cause of the suspect price change, and, if the price is found to have been distorted, an assessment of responsibility. Adequate inquiry requires a thorough examination of all market forces that caused the price to behave as it did. The matter in question must be examined in the context of the total market and the actions of all those concerned. This examination is necessary because futures prices are formed in a crucible of competitive forces; markets are not

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> order, require such period of delivery *(which shall be not less than three nor more than ten business days)* applicable to such commodities and markets as it finds will prevent or tend to prevent such "squeezes" and market congestion . . . . (emphasis added).

The CFTC has specified that the grace period shall be seven days for certain grains: "A period of seven business days is required during which contracts for future delivery in the current delivery month of wheat, corn, oats, barley, rye, or flaxseed may be settled by delivery of the actual cash commodity after trading such contracts has ceased . . . ." 17 C.F.R. § 100.1 (1977).

20. *See* note 19 *supra* and accompanying text.

learned seminars in which men meet to discuss and arrive at a proper price. They are, in a sense, arenas in which buyers and sellers meet and compete for gains. Prices are competitively, rather than administratively, determined.

Inquiry into the cause of a price change and assessment of responsibility are difficult 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 examine the total commercial base of the commodity: existing supplies, prospective supplies, rate of use, and prospective rate of use.

The economic forces underlying prices are transmitted through the actions of market participants, that is, through people. The behavior of futures prices is the result of the position-taking activity of all futures traders. 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 develop. All of this is done in a context of uncertainty. Experienced traders are always uncertain about 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; the shorts are a force toward lower ones. These are countervailing competitive forces. The balance changes as events that affect market actions change.

The objective is to achieve fully competitive markets, and under conditions of pure or perfect competition, no single market force can have an appreciable impact on price. Such atomistic competition is a laudable goal, but it does not exist in the real world. There are large-scale operators in markets. These very large entities are the commercials who, backed by cash positions, can be powerful and disruptive forces. There are also 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 CFTC and exchange regulation[21] 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

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21. Pursuant to Commodity Exchange Act § 4a, 7 U.S.C. § 6a (Supp. V 1975), the CFTC is authorized to set limits on daily trading and positions, *see* 17 C.F.R. §§ 150.1-.12 (1977). Exchanges, in general terms, state their duty to comply with the Commodity Exchange Act, *see, e.g.*, N.Y. COTTON EXCHANGE, Rule 5.12(1)(b) (1975); N.Y. MERCANTILE EXCHANGE, Rule 41.04(b) (1975).

short three million bushels of corn is much more of a market factor than a speculator who is equally short, because the commercial is much more capable than the speculator of moving corn into deliverable position.

INHERENT CONFLICT

There is a basic conflict in the administration of markets. Markets are competitive contests among people whose judgments are backed by money, where gains and losses are at stake. Conflict inheres in competitive markets. Price formation is a process of conflict between buyers and sellers. Each uses the power at his command, however small. Every participant in the market wields some power; individually, large traders wield more power than small traders. Each has an impact on price proportional to the size of his position. The basic principle in the formation of competitive prices is the use of conflict to discover value. This principle requires people to use their bargaining power to establish price.

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

Exchanges and the CFTC are sensitive to the contests that sometimes occur near the expiration of contracts.[22] 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 assure orderly liquidation. "Orderly" is usually construed to mean 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.[23] These processes reduce the extent to which the full forces of competition are allowed to work themselves out in price formation.

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22. The author notes this sensitivity from his experience with markets and from his conversations with members of business conduct committees.

23. *See, e.g.*, COMMODITY EXCHANGE, INC., § 408 (1975); N.Y. COCOA EXCHANGE, INC., Bylaw § 3A (1977); N.Y. COFFEE EXCHANGE, INC., Bylaw § 132(b) (1977); N.Y. COTTON EXCHANGE, Bylaw § 1.38 (1977).

Any directed settlement reduces the relative strength of one side, and is thus manipulative in itself.

On the one hand, we encourage situations in which each trader has no perceptible influence on price; that is, we discourage 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 question of the degree of conflict that should be tolerated. To what extent should parents let their quarreling 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 separate points of incarceration? These are delicate questions. The very notion that parents or police will intercede in a conflict is conducive to further conflict. Perhaps the notion that parents or police will let them fight it out is most conducive to settlement. Analogously, when the CFTC and exchanges intercede, the integrity of the market is weakened, and this intercession inevitably induces further conflict.

How Much Tolerance?

How much conflict, thus how much distortion, should be tolerated in the interest of market integrity? Perhaps the game of basketball is a good example. It is a noncontact sport in which there is considerable 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." The principle, in effect, is that futures traders should be put on notice that they will be expected to honor their contract commitments to buy and sell, and that there will be no intercession unless commerce in the commodity is affected.

Under this principle, the judgment whether a price was distorted would go to the cash price of the commodity and to the flow of the commodity to and from the delivery point. A finding of long-side manipulation would be appropriate where 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 into delivery position. A finding of short-side manipulation would be appropriate where 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 where the stocks that were moved into delivery position were returned to the deliverers and had to be moved out at a loss. The principle would tolerate the free interplay of forces in futures with their accompanying gains and losses, as long as the cash price was not disturbed.

A strong case can be made for the application of this principle. First, it would greatly 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 ahead 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 the commodity, or to merchandise it to users, they would be more prudent about persisting in long positions. The way market regulation has worked out in the past is that most of the leaning has been on the longs so that shorts have been relatively confident of protection. The longs have recognized the need to be prepared to take delivery and dispose of the commodity. There have been many more allegations of long manipulation than of short manipulation. However, there may well be as many short-side power plays as long-side power plays.

The principle above would also lead to the improvement of contract delivery terms. When there is full arbitrage between the futures price and all of the total 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. Consequently, distorted futures prices would call attention to the lack of sufficient arbitrage, and thus to weaknesses in contract terms.

In addition, this principle would avoid the necessity of judging how much exploitation of an advantageous position is permissible and how much is impermissible, that is, the degree to which distortion of futures prices may be tolerated. For example, if the price of a commodity is $2.00 per bushel and a large long finds the shorts in a disadvantageous position, it is doubtful that anyone would argue that the long was manipulating if he liquidated at $2.00¼. It is probable, however, that manipulation would be alleged if the long were to force the price to $3.00 on the last day. The point is that there is a line to be drawn somewhere if futures prices are to be prohibited from seeking their own competitive level. Should it be at $2.05¼ but not at $2.05? It should be kept in mind that a trader is a competitive, profit-oriented person. Consequently, the question really being asked is: At what price is the long obligated to "take his hands out of his pockets" and sell out his position? It is the short who is bidding up the price. It is unnatural for the long to cut off his profit. Indeed, it is a heavy burden imposed on the long to require that he act against his own financial interest.

The problem in saying "this much tolerance, but no more," where a futures price is out of line with the cash price, also involves the uncertainty always present in markets. Suppose that in the above circumstance the long puts a price of $2.10¼ on his contracts because he honestly believes that he can both accept delivery and merchandise the commodity at such a price, and that this price represents real commercial value. Suppose further that when the price goes to $2.10¼ he liquidates and the cash price subsequently fails 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 to permit is a thorny question. The problem also involves the allocation of blame: Is it the long who simply stands by passively who is blameworthy? Or is it the short who has put himself in an untenable position, and who therefore must put the futures price above real commercial value? Who is more responsible for the distortion? In this case, it is the short who has acted irresponsibly toward his contractual obligations; but he, too, must be allowed to make honest mistakes.

Determining how much tolerance to allow also places a heavy burden on regulatory bodies, whether they are business conduct committees of exchanges or the CFTC. The trader must know in advance what he can and cannot do. It is insufficient to remind him that he has a responsibility to insure 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 or after the event, as in the case of actions alleging manipulation before exchanges or the CFTC, the regulator forms and enforces a judgment about what a proper price is or was; thus, in a sense, he becomes a manipulator.

CONCLUSION

The principle of judging market behavior on cash price rather than futures price goes beyond generally accepted doctrine of manipulation. The generally accepted doctrine, however, does not define manipulation. The definition changes as cases are tried and decisions rendered. No clear line has been drawn that traders can identify and follow as a guide. Each new case has required the drawing of a new line because the circumstances surrounding each case are unique.

A finding of manipulation is not a simple matter. It is more difficult as the definition of manipulation is more narrowly drawn and as it relates more to futures prices. Markets are immensely complex because the forces going into price formation are multitudinous, and because these forces are implemented by people who act in a context of uncertainty. A finding of manipulation first requires the identification of a distorted price; yet a distorted price can never be identified with precision and certainty. Second, such a finding requires the evaluation of the reasonableness of the behavior of people who act in a context of competitiveness and uncertainty. The central question in judging manipulation is whether the market participants—merchants, warehousemen, processors, speculators—acted prudently and reasonably in their various roles, and demonstrated a proper regard for the orderliness and integrity of the market.

These difficulties argue 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. 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 and the underpriced commitment are targets for the rest of the market to shoot at—and shoot it will.