

## DERIVATIVES' ROLES IN MANIPULATION

*Shaun D. Ledgerwood & Jeremy A. Verlinda*

*Dr. Ledgerwood is a Principal with The Brattle Group specializing in the analysis and proof/disproof of market manipulation claims in energy, commodity, financial, and securities markets. Dr. Verlinda is a Senior Associate with The Brattle Group specializing in the economics of antitrust claims, focusing on issues of monopolization, criminal price fixing, and merger analysis. Drs. Ledgerwood and Verlinda work from the company's offices in Washington, D.C.*

A market manipulation occurs when an economically rational actor deliberately uses false information to cause demand or supply to deviate from underlying economic fundamentals in order to benefit from that deviation. Financial derivatives often serve as the means through which such benefits are derived, as the enforcement actions brought by the Commodity Futures Trading Commission (CFTC)<sup>1</sup> and other U.S. regulators<sup>2</sup> attest. Counterparties to manipulated contracts are injured by the behavior, as are other market participants who hold directionally-equivalent financial exposures when the manipulation occurs. Conversely, market participants with exposures aligned with those of the manipulator—including positions legitimately held as speculative positions or hedges—also benefit from the behavior, perhaps piquing a regulator's

investigatory interest as to whether they too engaged in manipulative behavior.

By moving resources from its Division of Market Oversight into its Division of Enforcement, the CFTC has expressed heightened interest in pursuing major violations of its market manipulation rules.<sup>3</sup> Given this scrutiny, should derivatives traders be concerned that they might have civil liability if they hold positions that benefit from another market actor's manipulation? Is there a way to proactively distinguish legitimate trading from manipulative behavior? For traders who held derivatives positions injured by manipulative behavior, what recourse is available to address their harms? Do the antitrust laws provide an additional source for liability for or recovery from manipulative behavior? This article addresses these questions.

### Defining Market Manipulation

A manipulation consists of three elements: a *trigger*, a *nexus* and a *target*. The *trigger* begins the manipulation with an act intended to bias a market outcome to cause the manipulation to occur. This biased outcome, such as a distortion in a market price or output, is the *nexus* that links the manipulation's cause and effect. This effect alters the worth of the *target*, which then produces the manipulation's revenues. Proof of a manipulation then requires proof that the manipulator *intentionally* acted in a manner designed to

cause (trigger) a change in some market mechanism (nexus) to alter the value of one or more positions (targets) that benefit from the change.<sup>4</sup>

Manipulation triggers include *outright fraud*, such as intentionally releasing false information to the market, engaging in wash trades, or other fictitious transactions, and *uneconomic behavior*, such as trading large quantities of the underlying product at a loss to intentionally bias a price or other market outcome. Acts that do not fall into these categories generally serve a stand-alone le-

gitimate business purpose and thus are not manipulative. The manipulation's *nexus* can be any market-related linkage that can be biased by the trigger, usually the price of the underlying commodity or financial contract. The manipulation's *target* is then one or more positions that benefit from the bias created, often derivatives that are valued from the biased price. The CFTC's anti-manipulation enforcement actions can be analyzed using this framework because they follow this same logic of cause and effect.<sup>5</sup> This is shown in Table 1, below.

**Table 1: Summary of CFTC Manipulation Cases**

Case <sup>6</sup>	Alleged Triggers	Alleged Nexus(es)	Alleged Targets
<i>In re Diplacido</i>	Uneconomic physical power trades during NYMEX settlement windows	Daily settlement prices of NYMEX trading hubs	OTC derivatives tied to NYMEX settlements
Optiver US, LLC	Liquidation of physical futures just before and during the settlements of several NYMEX futures contracts	Daily settlement prices of NYMEX Crude Oil, Heating Oil and NY Harbor Gasoline futures contracts	Physical commodity TAS positions valued by the daily NYMEX futures settlement prices
Parnon Energy Inc. et al.	(1) Accumulated and held large physical WTI crude positions before and through the NYMEX settlement; (2) Dumping those positions during the "cash window"	(1) NYMEX daily and final settlements for the WTI front month contract; (2) NYMEX daily settlement for the WTI back month	Financial calendar spreads: (1) Long to the front month settlement price; and (2) Short to the back month settlement price
Donald R. Wilson and DRW Investments, LLC	Elevated bids allegedly designed to raise the 3-Month IDEX Interest Rate Swap Futures Contract settlement price	Settlements of 3-Month IDEX Interest Rate Swap Futures Contracts, set in part by uncleared bids	Futures contract positions long to the settlement prices of the 3-Month IDEX Interest Rate Swap Futures Contracts
Kraft Foods Group, Inc. & Mondelēz Global LLC	Purchases of Dec. 2011 CBOT wheat futures near the contract expiry in quantities alleged to be undeliverable/unusable	(1) Final settlement price of the Dec. 2011 CBOT wheat futures contract; (2) Lower wheat prices in the Toledo cash market	(1) Calendar swaps long to the Dec. 2011 CBOT wheat futures price; (2) Purchases of Toledo wheat at lowered prices

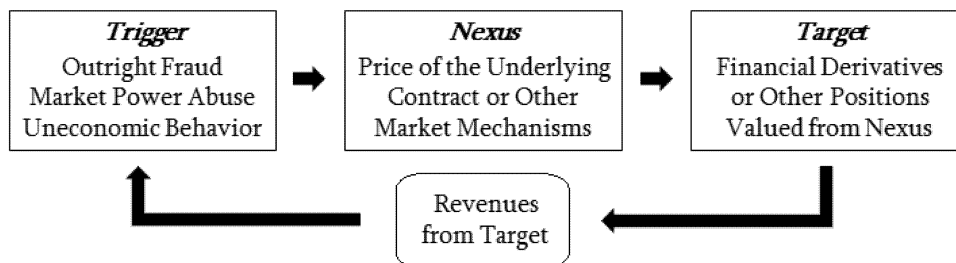
### Distinguishing Legitimate Behavior from Manipulation

A key element needed to prove a manipulation in CFTC enforcement contexts post-Dodd-Frank<sup>7</sup> requires proof of the intent of the suspected actor—either *fraudulent intent* under 17 C.F.R. Part 180.1 or *the intent to create an artificial price* under 17 C.F.R. Part 180.2.<sup>8</sup> Because no civil claim or enforcement action can survive absent such proof, holders of speculative derivatives positions that are incidentally benefitted by other’s manipulative conduct should bear no liability for the behavior under the current anti-manipulation laws. Similarly, because derivatives are passive instruments—*i.e.*, they are price-taking “targets” versus price-making “triggers”—holding speculative positions without participating in the underlying market should preclude liability under other applicable laws, including antitrust (assuming no evidence of collusion with

other market participants).<sup>9</sup> Because naked risk positions enhance market liquidity and efficiency, speculation is therefore a legitimate use of financial derivatives.

But what if the derivatives holder also seeks to participate in the underlying market? Indeed, a key purpose of financial derivatives is to provide market participants with a way to *hedge* their financial exposures to negative price movements in trading the underlying contract, particularly when such trades could negatively cause (or uneconomically “trigger”) an unfavorable movement in the price paid or received from such trades. But how can one distinguish a legitimate hedge from a speculative position “targeted” for manipulation? The logic of the framework discussed above can assist, as shown in Figure 1 below.

**Figure 1: The Logic of the Manipulation Framework**



If the derivatives holder also trades in the market for the underlying product or contract (trigger) in a manner that could alter the market price (nexus) and favorably affect the value of the derivatives (target), the question then turns to whether the revenues produced from the target are sufficiently large to *more than compensate* any losses and expenses incurred in the trigger-

ing trades. If the revenues from the derivatives exceed the losses incurred by the trades that “triggered” the chain of events, then the derivatives could be viewed as a speculative position that might have been positioned as a target for manipulation, a determination that then hinges upon the intent of the actor. Conversely, if revenues from the derivatives are less than or equal to any

losses in the triggering trades, the derivatives act as a hedge consistent with the legitimate use of such instruments.<sup>10</sup>

### Liability under the Manipulation and Antitrust Laws

In addition to providing civil and other penalties against derivatives market manipulators, the Commodity Exchange Act (CEA) allows private causes of action for violations of the CFTC's anti-manipulation rules which affect futures and derivatives contracts. Thus, derivative holders injured by manipulative activity have a basis for redress under the CEA irrespective of whether they also participated in the physical market for the underlying contract. Note, however, that such claims may be precluded if the nexus of the alleged manipulation is deemed insufficient, either for economic reasons (*e.g.*, an insufficiently-strong linkage between the trigger and target) or jurisdictional reasons (*e.g.*, extraterritoriality).<sup>11</sup>

In addition to potential liability under the anti-manipulation laws, intentional acts to manipulate the value of derivatives positions can bring even greater liability under the antitrust laws due to the trebling (tripling) of civil damages. Antitrust increasingly is used as the legal basis for bringing civil claims against manipulative acts, usually based on alleged collusion<sup>12</sup> and often when no anti-manipulation laws were in place at the time the behavior occurred. The holders of derivatives therefore should be mindful that any agreements with other market participants to trade in the underlying contract in benefit to their (otherwise speculative) positions may violate Section 1 of the Sherman Act.<sup>13</sup>

Further, a recent court ruling (*Merced*) suggests that courts may be open to considering

antitrust liability when manipulative acts are triggered *unilaterally* by derivatives holders under Section 2 of the Sherman Act.<sup>14</sup> The complaint was filed by an electric utility which has claimed an antitrust injury resulting from the alleged manipulation of power prices at four locations in California.<sup>15</sup> Like most manipulations triggered by intentionally uneconomic behavior, the trades alleged to have biased prices were not necessarily of sizes sufficient to dominate the indices at issue and thus lacked the high market share claim typically used as evidence for showing "market power." However, in denying a motion to dismiss based on antitrust standing, the court instead considered that the defendant's ability to use intentionally uneconomic trades to profitably move prices in an illiquid market could provide sufficient "direct evidence" of market power.<sup>16</sup>

Figure 1 explains how the court might view derivatives in this context. Although derivatives are passive investments that do not directly contribute to price formation, such positions may be viewed to confer market power by contributing to the revenues used to make a manipulative scheme profitable overall. Put differently, for a given cost "x" expended to trigger a movement "y" in some nexus price, any revenues from a targeted derivative position of size "z" valued therefrom will make the scheme net profitable if  $x < (y * z)$ .<sup>17</sup> Assuming that the nexus is sufficiently illiquid to allow for some price movement ( $y > 0$ ), a larger derivatives position will increase the revenues from the scheme ( $y * z$ ) and thus can create an implication of "market power" by increasing the manipulator's ability to profitably move the market price.

Practitioners will be watching *Merced* closely to see how the court assesses any direct evidence

of market power and whether or not it ultimately finds a unilateral act of manipulation to be a violation of Section 2. If so, antitrust-based manipulation claims will need to address issues that are germane to other manipulation claims brought under the CEA or similar statutes, including the role of nexus-related liquidity in enabling manipulation and the relevance of intent to evaluating behavior. Courts also may be unlikely to deviate materially from the monopolization standard associated with Section 2 violations, which would require an assessment of the degree of harm to competition caused by the manipulation. If the *Merced* court determines that the derivatives manipulation described therein is incompatible with the monopolization standards associated with Section 2 violations, the precedent could be used to limit, or even preclude, future Section 2 claims against market manipulation.

#### ENDNOTES:

<sup>1</sup>See *Anthony J. DiPlacido*, Comm. Fut. L. Rep. (CCH) ¶ 30,970 (CFTC Docket No. 01-23, Nov. 5, 2008); *CFTC v. Optiver US, LLC*, No. 08-cv-6560 (S.D.N.Y. 2012); *CFTC v. Wilson et al.*, No. 1:13-cv-07884 (S.D.N.Y. 2013); *CFTC v. Parnon Energy Inc. et al.*, No. 1:11-cv-03543 (S.D.N.Y. 2014); and *CFTC v. Kraft Foods Group, Inc. and Mondelēz Global LLC*, cv No: 15-2881 (N.D. Ill. 2015).

<sup>2</sup>See *SEC v. Donald L. Koch & Koch Asset Management, LLC*, No. 14-1134 (D.C. Cir. 2015) (action brought by the U.S. Securities and Exchanges Commission against securities trader for “banging the close” in violation of 17 C.F.R. § 240.10b-5 (2011)). The Federal Energy Regulatory Commission (“FERC”) is highly active in bringing enforcement cases under its anti-manipulation rule contained in 18 C.F.R. § 1c (2010). See, for example, *Amaranth Advisors L.L.C.*, 120 FERC ¶ 61,085 (2007); *Barclays Bank PLC*, 144 FERC ¶ 61,041 (2013); *BP Am.*

*Inc.*, 144 FERC ¶ 61,100 (2013); *Constellation Energy Commodities Grp.*, 138 FERC ¶ 61,168 (2012); *Deutsche Bank Energy Trading, LLC*, 140 FERC ¶ 61,178 (2012); and *J.P. Morgan Ventures Energy Corp.*, 140 FERC ¶ 61,227 (2012).

<sup>3</sup>Statement of Acting Chairman Giancarlo before the 42nd Annual International Futures Industry Conference (Mar. 15, 2017), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20>.

<sup>4</sup>The FERC Office of Enforcement, Division of Energy Market Oversight has adopted this framework as well, but refers to the manipulation’s trigger as the “tool,” its nexus as the “target” and its target as the “benefitting position.” See *Energy Primer: A Handbook of Energy Market Basics*, pp. 118-119, available at <http://www.ferc.gov/market-oversight/guide/energy-primer.pdf>.

<sup>5</sup>Whereas a manipulation charge requires this proof of a manipulation’s cause and effect, the CFTC can instead bring enforcement actions for “disruptive” trading practices such as spoofing, violating bids and offers, and disrupting an orderly settlement period. Essentially, this allows the regulator to bring a case needing only to prove the existence of a trigger. See, for example, *CFTC v. Oystacher et al.*, No. 1:15-cv-09196 (N.D. Ill. 2016) (settlement of \$2.5 million for allegedly placing fraudulent bids into the market with no intent of execution—*i.e.*, “spoofing”). Note that criminal penalties can apply to this behavior. See *United States v. Coscia*, No. 16-3017 (KFR), 2017 WL 3381433 (7th Cir. Aug. 7, 2017) (commodity trader sentenced to prison for three years for commodities fraud and “spoofing”).

<sup>6</sup>For citations to these cases, see *supra*, n. 1.

<sup>7</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>8</sup>*Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices - Prohibition on Price Manipulation*, 17 C.F.R. Part 180 (August 15, 2011). The CFTC’s fraud-based anti-manipulation rule is

codified as § 6(c)(1) in the Commodity Exchange Act (CEA), while its artificial price rule is codified as § 6(c)(3).

<sup>9</sup>Note, however, that such positions could violate other CFTC market rules, such as those governing position limits or end-user exemptions.

<sup>10</sup>This is not necessarily a “bright-line” test. For example, a derivatives position legitimately established to hedge a large physical trade may appear to be “over-hedged” if the size of that trade is smaller than was originally anticipated. The intent of the actor is therefore dispositive in such circumstances.

<sup>11</sup>See *In re: North Sea Brent Crude Oil Futures Litigation*, No. 1:13-md-02475 (S.D.N.Y. 2017) (CEA claims dismissed because the allegedly manipulated Platts Dated Brent index was extraterritorial). In considering the plaintiffs’ antitrust claims, the court also determined that the derivatives traded did not incorporate Platts Dated Brent, thus giving the plaintiffs no antitrust standing as well. *Id.*, at 22-23

<sup>12</sup>See, for example, *In re Libor-Based Financial Instruments Antitrust Litigation*, No. 1:11-md-2262-NRB (S.D.N.Y. 2012) (alleged manipulation of Libor); *In re Foreign Exch. Benchmark Rates Antitrust Litig.*, 13-cv-07789-LGS (S.D.N.Y. 2014) (alleged FOREX manipulation); *Alaska Elec. Pension Fund v. Bank of Am.*, No. 14-cv-07126 (S.D.N.Y. 2014) (alleged manipulation of ISDAfix); and *In re Zinc Antitrust Litig.*, No. 14-cv-3728 (S.D.N.Y. 2016) (order dismissing Clayton Act claims but allowing the remaining Sherman 2 to proceed against an alleged zinc warehousing manipulation).

<sup>13</sup>See *United States v. KeySpan Corp.*, 763 F. Supp. 2d 633 (S.D.N.Y. 2011) (agreement putting in place a financial swap tied to act of withholding in an electric capacity market found to violate Section 1 of the Sherman Act). See also *In re Foreign Exch. Benchmark Rates Antitrust Litig.*, 13-cv-07789-LGS (S.D.N.Y. Mar. 21, 2014) (various agreements to align financial positions with other participants’ trades to bias the 4 pm London “Fix” may violate Section 1).

<sup>14</sup>*Merced Irrigation Dist. v. Barclays Bank PLC (“Merced”)*, No. 15-cv-04878 (S.D.N.Y. 2015).

<sup>15</sup>*FERC v. Barclays Bank PLC et al.*, No. 2:13-cv-02093 (E.D. Cal. 2013).

<sup>16</sup>See *Merced Irrigation Dist. v. Barclays Bank PLC*, No. 15-cv-04878-VM (S.D.N.Y. 2016) at 34-40. Direct evidence of monopoly power, in place of proving dominance in a relevant market, is generally recognized in Section 2 case law. See, e.g., *Tops Markets, Inc. v. Quality Markets, Inc.*, 142 F.3d 90, 98 (2d Cir. 1998) (monopoly power “may be proven directly by evidence of the control of prices or the exclusion of competition, or it may be inferred from one firm’s large percentage share of the relevant market,” citing, among others, *du Pont*, where the court states that monopoly power is “the power to control prices or exclude competition.”). See also *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391(1956).

<sup>17</sup>Note that this is the same criterion used above to distinguish a hedge from a speculative derivatives position that could be a target of manipulation.