

# Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation

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In his article, "The Manipulation of Commodity Futures Prices—The Unprosecutable Crime," Jerry Markham examines the history of futures market manipulation as a regulatory problem and sets forth a number of suggestions to improve the policing of this unwanted activity. He rightly observes that market "corners" and "squeezes" have occurred throughout the long and colorful history of the commodity futures markets, whether in the form of raw and defiant exercises in financial power, or as a less spectacular form of market opportunism. He also notes correctly that the seventy-year effort by the federal government to eliminate these market manipulations has been more or less unsuccessful.

Unfortunately, having provided an entertaining chronicle of the difficult and important problems associated with futures market manipulation, Mr. Markham proposes a cure that not only would worsen the disease, but also would kill the patient. The way to eliminate the price distortions and economic damage produced by market manipulations, he suggests, is to have the government intervene more actively in the marketplace. He would have the CFTC, through its arsenal of extraordinary powers, expand significantly its surveillance to detect potential manipulations, take early action to curtail the activities of large traders, in some cases to order the liquidation of positions, and otherwise assert its regulatory will in the marketplace. In other words, Mr. Markham would have the CFTC become the greatest and most powerful manipulator of all time.

## I. Defining the Problem

Of course, it is easy to be the music critic who finds fault with the melodic structure and thematic development of a composition. It is far more difficult, however, to master music theory and to understand the dozens of available instruments sufficiently to write a symphony. However, the complexity and importance of our commodity futures markets merits an effort to understand the economic theories which underlie those markets and to discern a coherent regulatory structure within which the different market instruments can play their parts in harmony.

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Perhaps the most elusive part of grappling with market manipulation is to understand the real nature of the problem. Too often, this issue is approached backwards, like obscenity. Manipulation is difficult to define, but we know it when we see it. Market power, in this comparison, is like exposed skin: different people can tolerate different amounts of it, so the point at which it becomes offensive varies with the observer. Thus, the many attempts to define manipulation have focused on different examples of trading activities which evoke varying degrees of disapproval. For example, manipulation is often presumed in cases involving an intentional domination of the futures market by the accumulation of large positions,<sup>1</sup> trading activities which are perceived as distorting futures prices,<sup>2</sup> or market actions which in hindsight are deemed to be "uneconomic."<sup>3</sup>

However, drawing a line between healthy economic behavior and that which is offensive has proved to be too subjective and imprecise to produce an effective regulatory tool. The absence of a clear statutory definition, the elusiveness of the economic concepts involved and the ad hoc nature of the enforcement process has produced a regulatory approach which lacks the clarity and predictability which would allow effective monitoring, early detection and successful prosecution. The traditional approach of a court-defined concept of manipulation calls for judgments which can only be made after painstaking investigation and highly complex economic analysis, *i.e.*, were the actions intentional, did an "artificial" price develop, and was the artificial price caused by the actions in question?

The problem with these traditional attempts to define manipulation is that they focus on punishing bad behavior, rather than defining and preventing harm to the futures market. It would be more profitable to recognize that the primary regulatory problem is to prevent damage to the proper functioning of the markets and only secondarily to punish the offenders.<sup>4</sup> In other words, the regulatory focus in dealing with manipulation should be on developing a prophylactic approach which prevents economic harm, rather than on enforcing

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1. In the case of *Volkart Brothers, Inc. v. Freeman*, 311 F.2d 52 (5th Cir. 1962), the accused manipulator had assembled a long cotton futures position covering 12,100 bales out of a total open interest of 13,400 bales. See also *Great Western Food Distributors, Inc. v. Brannan*, 201 F.2d 476 (7th Cir. 1953) (respondent had accumulated 76% of all long December 1947 egg futures contracts); *G.H. Miller & Co. v. United States*, 260 F.2d 286 (7th Cir. 1958) (respondents accumulated 100% of the December 1952 egg futures contract by the final days of the delivery month).

2. In *Peto v. Howell*, 101 F.2d 353 (7th Cir. 1938), the court found that the alleged manipulation had caused the price of July 1931 corn futures to rise 25-1/2 cents during the final three days of futures trading, and that immediately after expiration of that contract, the price of corn dropped 40%. In *Cargill, Inc. v. Hardin*, 201 F.2d 476 (7th Cir. 1953), Cargill was reported to have realized prices up to \$2.28-1/4 per bushel for May wheat futures, while cash prices were reported as low as \$2.03-3/8 per bushel.

3. See *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971), *cert. denied*, 406 U.S. 932 (1972); *Perdue, Manipulation of Futures Markets: Redefining the Offense*, 56 *FORDHAM L. REV.* 345, 349-52 (1987).

4. This was the recommendation of the Federal Trade Commission seventy years ago. *FEDERAL TRADE COMMISSION, REPORT ON THE GRAIN TRADE* 242 (1921) [hereinafter *FTC Report*].

a moral code against market participants whose behavior might be found objectionable.

The reason that manipulation is a problem is that it distorts the price development function of the futures markets and disturbs the relationship between futures prices and the pricing and delivery of commodities in the cash markets. The task, therefore, is to devise a regulatory approach toward manipulation that recognizes the essential relationship of futures and cash markets and the effect of each on the pricing of commodities.

## II. The Illusory Issue of Price Artificiality

One common thread in the various attempts to define manipulation is that the actions in question produce an "artificial" price for the commodity, one that is not reflective of the so-called normal forces of supply and demand.<sup>5</sup> Unfortunately, this assertion relies upon the premise that there is a non-artificial or normal price development process for each commodity which can be discovered and measured against the "artificial" prices resulting from manipulation in the futures market.

Determining what constitutes an "artificial" price, however, can be difficult. In fact, a commodity futures market is an economic device which is itself wholly artificial, an abstraction which is divorced from the actual supply, demand, physical characteristics, or economic value of the presently existing commodity to which it relates.<sup>6</sup> The great variety of grades, types, physical locations and other attributes of a commodity are boiled down to a set of standardized specifications to which everyone interested in the commodity can relate.<sup>7</sup> The places to which the commodity could be delivered in the real channels of commerce are narrowed to a few locations which can be certificated by the exchange and as to which hedgers can compute their own transportation costs.<sup>8</sup> The contracts on which market participants make bids and offers are thus

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5. *Cargill, Inc. v. Hardin*, 452 F.2d at 1167; HIERONYMOUS, *ECONOMICS OF FUTURES TRADING* 321 (2d ed. 1977).

6. One commentator has said:

The relationship between the cash market and the futures markets is complex and subtle. There is only an indirect price relationship between the two. Cash price reflects supply and demand at a particular time and place, but futures price reflects anticipation of supply and demand across time and regardless of place.

Bianco, *The Mechanics of Futures Trading: Speculation and Manipulation*, 6 HOFSTRA L. REV. 27, 29 (1977).

7. See HIERONYMOUS, *supra* note 5, at 36.

8. BOARD OF TRADE OF THE CITY OF CHICAGO, *COMMODITY TRADING MANUAL* (1982) 61-80. There are strong countervailing considerations in setting delivery points for a futures contract. On the one hand, delivery terms should be broad enough to ensure that broad participation in the market will produce prices representative of real commercial value; on the other hand, if delivery locations are too numerous, futures markets become difficult to use because the "commodity" traded lacks precise definition. Hieronymous,

homogenized from the thousands of conditions and locations in the real world in which the commodity is actually bought and sold. Of course, the contracts also are separated from the actual, cash commodity trading in terms of time. They provide for the pricing of a hypothetical transaction some time from weeks to months to years in the future. Because futures contracts are artificial in the sense that they are stylized and divorced from the actual cash commodities to which they relate, the concept of price artificiality as a measure of manipulation is elusive and, possibly, illusory.

### III. Protecting An Economic Function

The fact should be recognized that commodity futures markets are really like an elaborate game in which the participants agree to be bound by a set of rules and to abide by the financial results of their actions within the self-contained world governed by those rules.<sup>9</sup> Much like the athletes in a football game, commodity traders enter the trading arena in their colorful uniforms, engage in certain actions which have known consequences under the rules of the game and which are designed to carry out a particular strategy. As the action progresses, the officials monitor all activities and award gains or assess penalties as the rules prescribe. At the end of the contest, the cumulative effect of the actions taken by all participants are tallied up and the players are awarded a winning or losing position by the officials.

There is one link between this game and reality, however. The crucial element which gives a futures contract its economic purpose and distinguishes it from a game is the delivery requirement.<sup>10</sup> Under each futures contract, the parties are required to make or take delivery of the specified quantity and grade of the commodity at one of the approved delivery points established by the exchange.

Of course, the futures markets have evolved to the point where the delivery requirement has disappeared from certain of the newest contracts. A trader taking a position in stock index futures contracts, for example, is not required to make or take delivery of the basket of stocks representing the S&P 500

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*Manipulation in Commodity Futures Trading: Toward a Definition*, 6 HOFSTRA L. REV. 41, 47 (1977).

9. Professor Hieronymous explains:

Futures trading is an exciting game, the score of which is kept with money. There are important amounts of money involved so that the game is taken seriously. But a game it is. The people who participate, including the commercials—the hedgers—appear to be first interested in the game itself and second in the money.

HIERONYMOUS, *supra* note 5, at xii.

10. See Note, *The Delivery Requirement: An Illusory Bar to Regulation of Manipulation in Commodity Exchanges*, 73 YALE L.J. 171 (1963).

Index or the Major Market Index. Instead, he receives a cash settlement based on the theoretical results of his having bought or sold that basket of stocks.<sup>11</sup> However, the delivery requirement has generally been thought to be an essential element of a futures contract relating to tangible commodities which are bought and sold in particular physical channels.<sup>12</sup>

As to such tangible commodities, the delivery requirement is necessary to assure that the futures contract trades at a price which is tied directly to the price of the actual physical commodity. When a futures delivery month is still far into the future, the relationship between futures and cash market prices can be quite distant. The futures price builds in a host of expectations and predictions about what conditions will be like in the future as to weather and harvests, general economic conditions, and industrial needs, not to mention the uncertainties attached to the mere passage of time. So great are the elements of speculation with respect to a distant delivery month, that it would be impossible to determine what an "artificial" price for the appropriate futures contract would be. As the delivery month grows closer, however, the uncertainties are narrowed and clarified, the acres under cultivation are known, demand for the item can be gauged more accurately, and economic developments become more a part of reality than prediction. Thus, the futures price and the cash market price converge. If it were not so, the futures contract would not be usable by producers and handlers of the commodity as a substitute for future transactions, there would be no hedgers in the marketplace and the market would lose its primary economic purpose.<sup>13</sup>

The highly abstracted device of the futures contract is therefore an economic construct designed to serve the producers, processors and consumers of different commodities. By establishing a highly stylized set of specifications to which a large number of interested parties can relate, the futures markets offer to a wide array of participants an easy-to-use substitute for expected cash market transactions in the future, thus permitting them to lock in a financial result for a transaction which cannot happen until some time later. But unless futures prices can achieve a smooth transition from forecast to reality, they cannot serve as price insurance for a future transaction; too many variables are introduced which can destroy the relationship between the thing insured and the payoff required under the policy. It would be the same problem if, when his

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11. See, e.g., CHICAGO MERCANTILE EXCHANGE, CONSOLIDATED RULES § 4003 (1987).

12. See, Comment, *The Delivery Requirement: An Illusory Bar to Regulation of Manipulation in Commodity Exchanges*, 73 YALE L.J. 171, 173-74 (1963); Comment, *Commodities: Futures Control: Manipulation Under the Commodity Exchange Act*, 57 MINN. L. REV. 1243, 1246 n. 11 (1973).

13. H. WORKING, SELECTED WRITINGS OF HOLBROOK WORKING, BOARD OF TRADE OF THE CITY OF CHICAGO 277 (1977). Professor Working listed four conditions necessary for a futures contract to succeed: (1) that the contract terms and commissions are such as to attract appreciable merchandising use, (2) that there is a possibility of sufficient speculative use to provide a fluid market, (3) that handlers of the commodity have reason to make use of the contract as a substitute for merchandising contracts in the future, and (4) that there be adequate public recognition of the economic usefulness of the market. *Id.*

house burned down, a homeowner discovered that his insurance covered not the value of his home, but rather the value of his car.

The reason that undue market control or manipulation is such a problem is that it interrupts this crucial transition from the hypothetical price development of the futures contract to the hard, cold reality of the ongoing cash market. By forcing an expiring futures contract to price levels it would not reach without the intentional distortion, a market manipulator thus destroys the essential relationship between futures and cash markets, and with it the desire of hedgers to participate in the futures contract. Without hedgers, the economic justification for futures market activity—that it provide a means of price protection for the producers, processors and consumers of a commodity—disappears and futures trading becomes merely an entertainment or a form of gambling.

The key to understanding the regulatory problem posed by market manipulation is therefore to focus on the cash market and to recognize that the futures market is merely a derivative and temporary stand-in for the real thing. Futures markets cannot exist without the cash markets. Manipulation cannot be evaluated in the futures market alone.<sup>14</sup> A trader who distorts the futures price by standing for delivery, still has to “bury the corpse.”<sup>15</sup>

#### IV. The Case Against Regulatory Intervention

The difficulty in identifying potential market distortions caused by manipulation and then taking action to prevent their harmful effects is that this task requires a profound understanding of the price behavior of each commodity: its physical characteristics, its uses, its modes of transportation, its price sensitivities to various developments, the behavior of firms dealing with it, its storage life, and its fungibility. Since there are currently eleven futures markets operating in this country, conducting trading in dozens of commodities, the scope of information which must be mastered by an effective regulator is vast. Add to this the need to monitor commodity price influences on a continuous basis, and the regulatory assignment becomes virtually impossible.

Mr. Markham would address the problem of market manipulation by having the CFTC play a “much more affirmative role in the marketplace,” indicating that the agency “must be prepared to intervene actively” to assure a “fair and orderly market.” He even suggests that preventive action should be taken before market distortions occur. This interventionist approach is predicated on a more effective surveillance system which would monitor contracts throughout their existence, and which would provide a close tracking of cash markets, as

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14. Professor Hieronymous has argued in favor of the principle of allowing free operation of the futures market so long as the underlying cash price is not disturbed. Hieronymous, *supra* note 8, at 54.

15. FTC REPORT, *supra* note 4, at 244.

well. The goal of this regulatory system would be to prevent large traders from affecting prices through their trades and to order liquidation or reduction of positions when traders might be taking advantage of congested market situations.

The incredible difficulties of training and staffing such an effort by the CFTC should be apparent. The only conceivable way that the agency could even monitor thoroughly the cash markets and futures markets under its jurisdiction would be to employ hundreds, if not thousands, of employees, trained and experienced in the idiosyncracies of each separate commodity. The task would require highly developed computer systems for price modeling and tracking of a vast array of commodity information, and a decentralized enforcement staff which could monitor trading activity in the pits and track developments in each market on a minute-to-minute basis.

Such a regulatory approach, if it were even possible and affordable, would also raise the specter of government intervention and control. With the CFTC acting as a "hands-on" policeman and occasional market participant, the markets could easily become governed by political considerations having nothing to do with the economic factors affecting price. The commodity markets would be exposed to a new and more dangerous form of manipulation.<sup>16</sup> The Senators from Iowa and Nebraska would have an interest in seeking CFTC actions which reduce the profits of speculators trading corn. Representatives from Texas would favor action which leads to higher petroleum prices. The U.S. Treasury would desire higher prices for Treasury Bill futures. Given the collapse of government-controlled markets in Eastern Europe, it is hard to rationalize supporting such an interventionist approach to market regulation.

More importantly, for the CFTC to take on a more affirmative market role would be to worsen the problems brought on by market manipulation. The problem with market corners and manipulations is that they introduce factors into the market which are inappropriate to the general discernment of the proper economic price of a commodity. Such intentional distortions disturb the equilibrium between buyers and sellers which is necessary for a broadly participatory commodity market operating for the general good. For the CFTC to intervene in the market, even where it finds justification in terms of erratic market behavior, is to introduce new market actions which are extraneous to the normal production and marketing activities of hedgers and the financial activities of speculators.<sup>17</sup> However well-intentioned the regulatory actions might be, they could only disrupt the normal price discovery process. Such actions would not represent the economic viewpoint of a party with an interest in the commodity,

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16. See the discussion of market manipulation through government programs and regulatory actions in P. JOHNSON, T. HAZEN, *COMMODITIES REGULATION* § 5.35, at 78 (1989).

17. Hieronymous, *supra* note 8, at 52-53.

and they would not constitute an expression of the supply or demand for the commodity. Even if the goal were to preserve a "fair and orderly market," unless the agency were perfectly informed on a continuous basis about each commodity, unintended price distortions would inevitably result, the predictability of the markets would be impaired and the usefulness of futures for their proper economic functions would be damaged.

Another approach which Mr. Markham suggests is an array of rules aimed at particular trading practices which he feels are detrimental to a "fair and orderly market." Sustained selling in a down market, "disruptive" trades, and trading practices that depress prices are among his regulatory targets.

First of all, anyone who has observed the futures markets first hand knows that there is very little that is orderly about futures. Pits for trading high volume contracts are densely packed and the noise is deafening. At the Chicago Board of Trade, which has the highest volume of trading of all the futures exchanges,<sup>18</sup> completed trades are noted on pieces of paper and thrown on the floor, to be picked up by runners. But in spite of this apparent chaos, millions of contracts are handled with a very low rate of error. The brilliance of this open outcry system is that it brings together all the parties who have an interest in the commodity—be they hedgers, day traders, scalpers or large position traders or speculators—to offer their opinions, and their financial involvement, to the central marketplace. The system works because contract terms are fixed and the only element left for determination in the trading pit is that of price. Trading is permitted in the most unfettered fashion possible, so as to remove as many extraneous considerations as possible from the fast-paced trading environment.

Sustained selling in a down market is a normal activity and may be perfectly appropriate in light of market conditions. Daily price limits protect the market from a "free fall" and provide a cooling off period in cases of extremely large price movements.<sup>19</sup> To prohibit traders from selling large positions when the market is falling would be to introduce a variable into the market which would run contrary to the purpose of the market to reflect the normal forces of supply and demand. Making a determination as to when to stop such activity would also require a judgment which would be difficult, if not impossible, to make in a fast moving market. And what if a falling market suddenly turns around and becomes a rising market? Would sustained selling which was unlawful at the time made suddenly be exonerated? How would a trader know when the market had declined sufficiently so that he could no longer sell? Such judgments could only be made after the fact, and since that

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18. Futures Industry Association, FIA REVIEW 5 (September/October 1990).

19. See, e.g., RULES AND REGULATIONS OF THE CHICAGO BOARD OF TRADE § 1008.01. As an example, if the trading limit for wheat is \$.20 per bushel and its previous day's settlement price was \$2.80 per bushel, trading for the day could not occur at a price greater than \$3.00 or less than \$2.60 per bushel.

is the case, the proposed rule would have little, if any, deterrent value other than perhaps to discourage legitimate and proper responses to market conditions.

Likewise, a rule against "disruptive" trades or trades which depress prices would require subjective judgments which could not be made during the course of trading and for which there would be no objective measures or formulas. Prices in an active futures market are highly volatile and every trade could probably be considered disruptive by some measure. Also, every short position taken could be said to depress prices. To determine what is too much disruption or too great a depression of prices would involve value judgments and opinions which are not susceptible to consistent and fair interpretation.

Intervention in the market, either directly by an entity that does not have continuous involvement in that market, or through trading restrictions which are based on subjective judgments with no clear standards, would disrupt the market in a far more negative way than outright manipulation. More importantly, it would introduce a "wild card" element which would greatly impair the predictability of the process. A trader who had made a perfectly correct assessment of market conditions would have no assurance of receiving the benefit of his analysis. A hedger would have the value of his price insurance eroded by distortions of the market having nothing to do with price movements resulting from prevailing conditions affecting the commodity. Such harmful intervention would soon discourage both speculators and hedgers from participating in the market and the high level of liquidity which is an essential element for market efficiency would be greatly reduced.

One of Mr. Markham's criticisms of the CFTC is that the agency has been reluctant to seek injunctive relief and to declare market emergencies. He asserts that this reticence on the part of the federal regulator is one of the reasons that market manipulations have persisted. This criticism is misplaced. The CFTC has been reluctant to intervene in cases of threatened market disruption for the very reason that such intervention is harmful and should only be used as a last resort. When the agency first detects a market problem, it has insufficient information and an inadequate grasp of the many facts and circumstances bearing on the problem. Its representatives may not know the basic pattern of price movements for the particular commodity, who the major position holders are, and what conditions are affecting the cash market.<sup>20</sup> The CFTC has generally recognized that it is not in as good a position to assess the problem as is an exchange, and the agency has tried, in most market emergencies to defer to

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20. In order to declare a market emergency, the CFTC must have "reason to believe" that conditions exist which prevent a market "from accurately reflecting the forces of supply and demand for [the] commodity." 7 U.S.C. § 8a(9).

exchange action.<sup>21</sup> The CFTC has been reluctant to interfere out of an awareness of the extremely disruptive and damaging effects of incompletely informed regulatory intervention.<sup>22</sup>

## V. Some Suggested Solutions

The solutions lie not in seeking market intervention by an omnipotent (although not necessarily omniscient) regulator, but in developing properly structured contracts and well-conceived trading rules. The focus of these contract terms and trading rules must be on the essential requirement of futures trading which is the convergence of futures prices with cash prices at expiration of the futures contract. Congestion, for example, is a problem generated by the limited delivery points specified for a tangible commodity. If the limitation on permissible delivery points causes a price aberration because not enough of the commodity can be put into deliverable position, then that is an artificial problem caused by the terms of the contract. It is a problem which can be solved by establishing a safety valve procedure for satisfying the delivery obligation under the contract. The exchanges are capable of devising an appropriate formula based on economic analysis for settling up a contract in times of potential congestion. This solution could involve an alternative cash settlement of the contract based on an index derived from cash market information appropriate to the commodity and to the prevailing market conditions.<sup>23</sup> The important point is that such a mechanism should not be employed *ad hoc* at a time when price distortions are perceived. Such a safety valve should be stated clearly in the trading rules and should become applicable automatically during the delivery month, perhaps when cash and futures prices diverge by a specified amount.<sup>24</sup>

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21. Interestingly enough, the courts have held that an exchange cannot be held liable for market manipulation for taking action in a market emergency, so long as its actions are taken in good faith. *Lagorio v. Board of Trade of the City of Chicago*, 529 F.2d, 1290 (7th Cir. 1976), *cert. denied*, June 21, 1976, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,136. The CFTC, itself, has recognized that such market intervention by an exchange could constitute market manipulation if taken in bad faith, for example, if the exchange governors acted in their own private interest for personal gain. *Chicago Mercantile Exchange (CFTC May 20, 1977)* [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,436. While establishing a standard of conduct, these cases obviously recognize the proposition that emergency actions, in some circumstances, can constitute market manipulation.

22. In responding to a proposal that Congress grant power to the SEC to set margin levels on stock index futures, the Chairman of the CFTC said that the commodity exchanges are best equipped to adjust margins quickly during a crisis. She pointed out that the Chicago Board of Trade in 1987 had changed margin levels over 200 times. She queried, "Can you imagine the CFTC or SEC meeting these demands?" 22 Sec. Reg. & L. Rep. (BNA) 688 (May 4, 1990).

23. See *Bianco*, *supra* note 6, at 40 (suggesting that its regulation of each contract must take into account the peculiarities of the relevant type of commodity). It would be better if the terms of alternative cash settlement of contracts were determined by the exchanges. However, the CFTC has power to "alter or supplement" contract rules under the Commodity Exchange Act. 7 U.S.C. § 5(a)(10).

24. There are certain difficulties with establishing a single cash market price since the cash market is decentralized and so many quality and grade distinctions often exist. However, it does seem feasible to

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One regulatory approach which would provide a positive influence on futures contract terms would be to require that each exchange have certain areas of expertise present among its business conduct committee and board representatives. For example, an agricultural economist or a financial instrument expert would be valuable parties to serve on the boards of exchanges dealing in commodities related to those areas of commerce. While most exchanges currently have "public representatives," it might be worthwhile for the CFTC to adopt minimum standards for achieving balance in exchange board representation. With the proper interests and areas of expertise represented on each board and the appropriate committees, contract terms could be evaluated to determine if any corrections are necessary to avoid problems of congestion or adequacy of deliverable supply, or other problems associated with the viability of the contract as a substitute for cash market transactions. Likewise, in the case of a market disruption or emergency, the board or committee charged with monitoring the problem should have a fair representation of the various constituencies affected by that problem. For example, the interests of producers, processors and consumers of a commodity should all be represented in this process. If representation on exchange boards and committees is balanced among the various affected parties, it would help avoid decisions which favor one group of trading participants over another.

Another situation in which manipulation can occur is where open interest in the delivery month of a contract exceeds the deliverable supply. One reason that such a high level of liquidity is generated for futures contracts is the fact that the open interest (*i.e.*, the number of contracts which have been entered into but not yet fulfilled by offset or delivery) is not limited to the supply of the commodity which is expected to be available for delivery in the delivery month of the contract. As the expiration of the contract draws near, this can present a potential problem if the holders of long positions decide to stand for delivery. This potential problem has existed since futures trading began and the exchanges have had good success in controlling it. As a contract nears expiration, the business conduct committee or other appropriate committee of the exchange monitors the open interest and negotiates or pressures the long position holders into liquidating their contracts in an orderly manner. The committee members are in a particularly good position to know the circumstances affecting the price of the commodity, as well as the behavior and motivations of the traders. In effect, this informal process duplicates, in a less scientific way, the mechanism of the CFTC proposal to require a reduction of positions to twenty-five percent of the open interest in the delivery month.<sup>25</sup>

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develop a price model which would fairly reflect the cash price of a commodity for purposes of an alternative cash settlement in the final days of a contract.

25. 43 Fed. Reg. 15438 (Apr. 13, 1978).

While this rule may not be necessary in most cases, it would be a way to provide an orderly, predictable and even mechanical way to control this problem. Such a solution would be desirable in that it would be built into the rules, it would be objective and it would be non-intrusive. This is the sort of regulation which would serve the need for convergence of futures and cash prices and which would avoid the type of subjective intervention which can produce its own harm in the marketplace.

## Conclusions

There can be no question that intentional manipulation of the futures markets has been a serious problem for as long as these markets have existed. The blatant and defiant market corners of 19th century grain traders caused great havoc and damage to the economy. Such behavior was clearly the basis for federal regulation of these markets in the first place. However, Mr. Markham would introduce a new source of disruption into the equation. By requiring the CFTC to become an affirmative participant in the marketplace at times of potential market aberrations, he would introduce a highly destructive force into the market arena which would cause far greater problems than it would solve. Also by introducing a new generation of intra-market restrictions on traders, he would further confuse and disrupt the freedom of price expression which has made the futures markets in the United States the most successful markets ever established.

In dealing with the problem of manipulation, it is important to focus on the real regulatory problem, which is to protect the economic function of the futures markets. Positioning the CFTC to become a more affirmative, activist regulator to stabilize the market would operate directly contrary to that regulatory aim. If the agency intervenes in the market to control the activities of large traders or to curtail specific types of trading activities, it becomes an intrusive influence on the market unrelated to the forces of supply and demand. It is far better to allow the exchanges to deal with threats of price distortion.

The important goal of futures market regulation should not be to prevent the use of market power, but to assure that the markets fulfill their ultimate economic purpose which is to see that the "artificial" price for each futures contract converges with the price of the commodity in the actual channels of commerce at the expiration of that contract. Positive steps toward that goal can be taken by establishing a safety-valve mechanism for settling contracts in the event of market congestion, by adopting a rule requiring an orderly disposition of contracts in the delivery month, and by seeking balance on the boards and committees of the exchanges. These measures would help assure that the futures markets fulfill their economic purpose without introducing the disruption and unpredictability which would be caused by direct market intervention.