

market manipulation & spoofing

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From Pit Trading to Big Data

In 1982, the CFTC issued its pivotal Indiana Farm Bureau decision, which soon became the standard of proof for market manipulation under Sections 6(c) and 9(a)(2) of the CEA: activity that intended to produce an artificial price and that produced demonstrable artificiality. For nearly three decades, manipulation enforcement actions hinged on regulators proving the mutual confluence of intent and price artificiality, which created a substantial burden of proof. This high burden of proof meant that regulators could not pursue enforcement actions in cases where intent was clear, but the manipulator failed to create demonstrable artificiality. However, the burden of proof also created a salutary effect by providing market participants with a clear, common sense threshold for wrongdoing. If a market participant traded in a manner indicative of intent to create an artificial price at a time when that participant would stand to benefit from such artificiality, and succeeded in creating artificiality, the CFTC could and would pursue an enforcement action against the participant of sufficient size to deter such behavior.

When I was on the Commission, the CFTC was generally able to meet this high burden of proof to bring manipulation cases against egregious offenders in order to deter manipulative behavior. For example, in the Enron Online case, the CFTC looked at the trading behavior of Enron and one of its traders, Hunter S. Shively, and discovered that Shively had purchased an extraordinarily large amount of Henry Hub spot natural gas contracts in a period of 15 minutes, causing an artificial price rise. This unusual trading behavior, combined with Shively's offer to cover the losses of another trader and evidence he communicated his intent to "bid-up" the market, helped us demonstrate the intent to create artificiality, and the resulting price increase demonstrated the creation of actual artificiality. Immediately after buying the natural gas contracts,

Enron began to sell its accumulated Henry Hub spot natural gas contracts. Enron profited from the price artificiality it created earlier, demonstrating Enron's motive and further evidencing its intent. The CFTC ultimately collected a \$35 million civil monetary penalty from Enron in the settlement of its enforcement action.

In 2010, the Dodd-Frank act substantially bolstered CFTC authorities and changed the CFTC's enforcement approach toward potential price manipulation. Dodd-Frank prohibited three disruptive practices: (1) violating bids or offers, which the CFTC interpreted as a per se offense; (2) disregard for the orderly execution of transactions during the closing period, e.g., "banging the close," which the CFTC interpreted as requiring a recklessness scienter standard; and (3) bidding or offering with the intent to cancel the bid or offer before execution, i.e., "spoofing," which the CFTC interpreted as having an intent scienter standard. Importantly, the CFTC interpreted none of the new disruptive trading practices as requiring the creation of actual price artificiality.

Having worked closely with CFTC enforcement staff, I don't doubt that the lower standards are intended to serve a valid purpose, namely allowing the CFTC to pursue attempted manipulators who did not succeed in causing provable price artificiality. However, the first rule you learn as an economist is TANSTAAFL: "There Ain't No Such Thing As A Free Lunch." Policy changes always involve tradeoffs, and a lower burden of proof for manipulation cases creates the risk that the CFTC will pursue enforcement actions against market participants engaging in legitimate trading strategies that, due to circumstances, may be difficult to distinguish from manipulative behavior.

The removal of the requirement to demonstrate price artificiality is particularly troublesome because, absent the creation of artificiality, there is usually uncertainty as to whether trading is actually intended

to manipulate. For example, a trader with models suggesting that a prompt month futures contract is substantially undervalued might rationally place large numbers of orders, but if such trading behavior occurs during the closing period, it may resemble banging the close. If the trader stops buying in the close, and the price falls substantially after they stop buying, artificiality may be proven, in which case it suggests manipulation may have occurred. However, if the price plateaus after the trader stops buying, this suggests that the trader may have identified and corrected a legitimate underpricing relative to actual supply and demand in the market. With only a recklessness or intent standard to meet, the CFTC might pursue an enforcement action in the latter case even though the economics suggest the trader was potentially influencing the price with his trades, but did not create an artificial price. Market participants' uncertainty regarding the precise threshold for manipulation and fear of fines may lead participants to behave with excessive caution in executing certain trading strategies, reducing price discovery and market efficiency.

The CFTC's interpretive guidance on the new Dodd-Frank disruptive practices has been followed by a parallel shift in the CFTC's approach toward its longstanding manipulation enforcement powers under Sections 6(c) and 9(a)(2) of the CEA. The CFTC in its 2013 enforcement action against DRW Investments LLC alleged that it only needed to show that DRW intended to affect the price of a product, and did not need to show that DRW intended to create an artificial price.

In commodity markets, market participants are expected to use their proprietary market knowledge to make trading decisions. An interpretation of the CFTC's manipulation authority that does not require the CFTC to demonstrate intent to create an artificial price could penalize traders using proprietary market information and models in legitimate attempts to bring

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prices in line with their expectations. In essence, the CFTC has left open the door to pursuing enforcement actions against firms for fulfilling the price discovery function of markets, which can only reduce the quality of price discovery in commodities markets.

I fear the CFTC effort to lower

the burden of proof in the manner it is articulating has the potential to harm the very market and market participants that the Commodity Exchange Act is designed to protect. Basic strategies of arbitrage to capitalize on a suspected mispricing across cash and futures markets would be caught

in the CFTC's interpretation of its authority. An ancient maxim warns that "the road to hell is paved with good intentions." This seems like an apt warning for the CFTC to remember as it attempts to lower the burden of proof it must overcome in manipulation cases.

ferc's latest fishing expedition

We read a story by *Argus* this week about an altogether sweeping FERC investigation into capacity allocation practices by the Colonial Pipeline system that the more we read it, the more something seemed amiss. We floated the story and the Colonial investigation to a number of insiders and market watchers. Their response was the same as ours: We can spot a politically-motivated investigation when we see one. One observer we spoke to likened this "charade" to several points raised at our market manipulation forum last week in which a federal agency finds a brand new role in "defining market manipulation." The sense here is that what may have been permissible in the past among legacy shippers, may have created some sour grapes among lesser players. Have you heard about trading pipeline history trading?

In any case, FERC directed Colonial Pipeline to dig deep and produce four years' worth of any and all documents and records relating to third-party access to its massive system of 5,500 miles worth of pipelines. Colonial has become an enormously constrained system, what with flow reversals, new refining infrastructure in the Gulf coming on line (or shutting down), repurposing of some lines for different products and so on. Colonial has seen much growth and change in the past decade. Nonetheless, FERC has asked Colonial for "all policies, practices, manuals, directives, memoranda or internal communications" going back to 2012 that address how new shippers secure access to the system. FERC believes Colonial's common administrative practices may not be permissible under the Interstate Commerce Act. The staff order also noted that the investigation would also determine whether some policies should be included in Colonial's tariffs sheet in the future. The *Argus* story noted that Colo-

nia allocates its capacity based in part on a shipper's history of moving product across its lines. "Such established, or *Regular*, shippers split 95 percent of the common carrier's capacity," and that, "*New Shippers* split the remaining 5 percent or any other unused capacity. A tiered lottery system determines their access to that space. Shipping consistently would graduate that shipper to regular shipper status ..." So clearly, this graduated process isn't fast enough for many (so, why not complain to FERC or perhaps a member of Congress?). On the other end, the more capacity that was allocated to these impatient newbies, the legacy shippers began griping about their own shrinking access to capacity. A no-win. So some smart financial traders developed an informal market for trading a company's *history* of capacity allocations. Colonial wasn't so hip on the idea of this secondary market, which it had little control over.

Almost a year ago, back in November 2015, Colonial found itself on the receiving end of a firestorm of complaints from various spec shops, a few commercial firms and some new shippers over its then newly-proposed tariff that would lower minimum shipping volumes and further, would restrict the ability for smaller players to combine and trade line space history on the oil products pipeline. A new group called the New Shipper Group filed all sorts of complaints to FERC on the matter. It seemed that the specs, in particular, loved the *history* trading market, and other derivative markets that are poised to emerge in this extremely constrained space.

There is also a story out there that a small-shipper batch of gasoline caused some serious issues in the pipeline system due to the fact it contained too much ethanol. This new tariff, some suggest, may have come in retribution for this bad batch

of gasoline, in addition to Colonial's lack of control of the secondary history market that has developed.

Back in July, this Q4 proposed tariff by Colonial was shot down by FERC. The agency said that the Colonial plan was far too weighted toward legacy shippers.

One observer we spoke to about the rejected Colonial tariff described it as "less risky (to Colonial)."

That said, the *Argus* story also noted that "shippers Tricon and Rockbriar challenged a Colonial policy not documented in its tariffs that bars for 14 months companies that sell shipping history from participating in a lottery for new space."

Another observer noted that the vast scope of the FERC order suggested that they had "no idea what they were looking for," but because of its size, "they will be guaranteed to find something wrong, (whether they) were looking for it or not. Who doesn't make a couple mistakes in four years?"

A former FERC staffer noted that this case follows a common trajectory for FERC, a massive fishing expedition into something it doesn't fully grasp. He said that in the end, Colonial will likely be (inevitably) pressed to change its current policies, pay a modest fine, "force more competition to the system, and raise its risk profile ..." He added that the pipeline company may as well "punt" now and save itself a lot of time and money. Ouch.

Given the recent 250,000-gallon gasoline spill in Alabama they're now dealing with, which will likely be investigated by FERC and 10 other federal agencies, punting on the capacity allocation investigation may be prudent, he said.

We plan on keeping close tabs on this one. New sources are always welcome...