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THE GREAT COPPER CAPER: IS MARKET MANIPULATION *REALLY* A PROBLEM IN THE WAKE OF THE SUMITOMO DEBACLE?

*Benjamin E. Kozinn**

In the financial arena, the name of the game is money—make it now, make it fast, make a lot. To some players in this financial game, the question of whether to play fairly or unfairly, legally or illegally, is not debated. Their only issue of concern is how much, how fast, and what are the chances of being caught.¹

INTRODUCTION

As the dust finally settled in the world copper markets in mid-1996, the events behind one of the “most audacious” financial scandals of all time began to emerge.² The debacle resulted from the actions of Yasuo Hamanaka (“Hamanaka”), formerly the head copper trader for the Sumitomo Corporation (“Sumitomo”), a worldwide marketer of copper metal.³ Hamanaka had engaged in approximately ten years of unauthorized commodity futures trading, allegedly beginning in 1986.⁴ In his wake, Hamanaka left at least \$2.6 billion in losses⁵ for Sumitomo and a tangled web of litigation.⁶

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1. David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the “Money Game”*, 7 St. Thomas L. Rev. 103, 103 (1994).

2. See Paula Dwyer, *Descent Into The Abyss: How the Copper-Trading Affair Engulfed Sumitomo*, Bus. Wk., July 1, 1996, at 28 (“The world has witnessed numerous spectacular financial scandals, from the Ponzi schemes of the 1920s to the rogue futures trades that capsized Barings PLC. But the Sumitomo Corp. copper-trading scandal is likely to go down in the history books as perhaps the most audacious yet.”).

3. Sumitomo Corporation, founded in 1919, is a Japanese company involved in a variety of businesses, including the marketing of copper metal. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,496 (CFTC May 11, 1998). Sumitomo, through its Copper Metals Section, or Copper Team, bought and sold physical copper and used futures for “hedging” the risks of their activity in physical copper. See *id.*; see also *infra* notes 65-69 (discussing hedging).

4. A commodity futures contract is a standardized agreement between the buyer (the long) and the seller (the short) to purchase or sell a specified quantity and quality of a commodity, at a specified price, at some point in the future on an organized

Although Hamanaka effectuated his scheme on the London Metal Exchange ("LME"), his activity caused price fluctuations that impacted the copper markets worldwide. As a result, the Commodity Futures Trading Commission ("CFTC" or "Commission")⁷ conducted an investigation in 1996 into the cause of the substantial price movements. Ultimately, the CFTC and a group of private individuals in the United States alleged that Sumitomo had "manipulated" the price of copper futures in violation of Sections 6(c),⁸ 6(d),⁹ and

exchange. See 1 Philip McBride Johnson & Thomas Lee Hazen, *Commodities Regulation* § 1.03, at 10 (2d ed. 1989) [hereinafter Johnson & Hazen, 2D]. Upon expiration of the contract the parties may either deliver or accept delivery of the physical commodity, or they may offset their position (i.e. either long or short) by purchasing an identical contract opposite to their position and making a cash payment in order to settle. See *infra* notes 61-634 and accompanying text.

5. See Cheryl Strauss Einhorn, *Sumitomo Settling: Copper-Scandal Deal to Include Fine*, *Barron's*, May 11, 1998, at 10.

6. See, e.g., *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] *Comm. Fut. L. Rep.* (CCH) at 46,501 (describing the settlement between the CFTC and Sumitomo); *In re Sumitomo Copper Litig.*, 74 F. Supp. 2d 393, 394-96 (S.D.N.Y. 1999) (describing the settlement between Sumitomo and its co-defendants in the class action brought in 1996).

7. See *infra* note 34 (discussing the history of the CFTC).

8. See Commodity Exchange Act § 6(c), 7 U.S.C. § 15 (1994). In relevant part, § 6(c) states:

If the [Commodity Futures Trading] Commission has reason to believe that any person (other than a contract market) is manipulating or attempting to manipulate . . . the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any contract market, . . . or otherwise is violating or has violated any of the provisions of this Act or of the rules, regulations, or orders of the Commission hereunder, it may serve upon such person a complaint stating its charges in that respect

Id.

The word "person" is defined in Commodity Exchange Act § 1a(16): "The term 'person' imports the plural or singular, and includes individuals, associations, partnerships, corporations, or trusts." 7 U.S.C. § 1a(16) (1994).

9. See Commodity Exchange Act § 6(d), 7 U.S.C. § 13b. The statute proclaims: If any person (other than a contract market) is manipulating the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any contract market, or otherwise is violating . . . any of the provisions of this Act or of the rules, regulations, or orders of the Commission thereunder, the Commission may, upon notice and hearing, and subject to appeal as in other cases provided for in subsection (c), make and enter an order directing that such person shall cease and desist therefrom and, if such person thereafter and after the lapse of the period allowed for appeal of such order or after the affirmance of such order, shall fail or refuse to obey or comply with such order, such person shall be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than the higher of \$100,000 or triple the monetary gain to such person, or imprisoned for not less than six months nor more than one year

Id.

It is worth noting that the Commodity Exchange Act not only proscribes manipulation of a commodity for "future delivery" (i.e. a futures contract), but also prohibits price manipulation of "any commodity, in interstate commerce" (i.e. the cash markets for a commodity). *Id.* Cash markets are the markets where a buyer or seller can purchase actual quantities of the physical commodity. See Johnson &

9(a)(2)¹⁰ of the Commodity Exchange Act (“CEA” or the “Act”).¹¹ The CFTC obtained jurisdiction over Sumitomo pursuant to § 2 of the CEA.¹² On May 11, 1998, Sumitomo submitted an “Offer of Settlement”¹³ of \$150,000,000, which the CFTC ordered.¹⁴ Subsequently, on October 5, 1999, Sumitomo and others settled the private class action suit brought against them for \$134,600,000, making the settlement the “largest class action recovery in the seventy-five plus year history of the Commodity Exchange Act.”¹⁵ The outcome of all of the litigation provides one of the most interesting studies of market manipulation in recent history, due to the fact that it raises so many questions regarding the understanding of market “manipulation.”¹⁶

This Note examines commodity futures market manipulation in light of Hamanaka’s actions and the findings of manipulation by the CFTC. Part I discusses the concept of market manipulation and describes futures markets and the elements that currently define manipulation. In addition, this part addresses the ambiguities that surround the topic of manipulation by examining various academic approaches to resolving them. Part II explains the complicated set of events that comprise the Sumitomo scandal. Part III explores the

Hazen, 2D, *supra* note 4, § 1.09, at 39. In other words, purchasing in the physical market would be, on a small scale, the equivalent of going to a farm and actually purchasing a bundle of wheat.

10. See Commodity Exchange Act § 9(a)(2), 7 U.S.C. § 13. The Act reads:

It shall be a felony punishable by a fine of not more than \$1,000,000 (or \$500,000 in the case of a person who is an individual) or imprisonment for not more than five years, or both, together with the costs of prosecution, for:

...

(2) 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, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce

Id. The concept of the “corner” articulated in § 9(a)(2) is discussed in detail *infra* notes 110-12 and accompanying text.

11. See Commodity Exchange Act §§ 6(c), 6(d), 9(a)(2), 7 U.S.C. §§ 13, 13b, 15.

12. See Commodity Exchange Act § 2(a)(1)(A)(i), 7 U.S.C. § 2; see also 17 C.F.R. § 30.9 (1999) (prohibiting fraudulent transactions by foreign entities).

13. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,501 (CFTC May 11, 1998).

14. See *id.*

15. *In re Sumitomo Copper Litig.*, 189 F.R.D. 274, 277 (S.D.N.Y. 1999). Sumitomo was required to pay \$99,000,000 of the \$134,600,000 total settlement. See *id.*

16. See Dwyer, *supra* note 2, at 28. The Sumitomo saga had yet to reach a close. As of November 12, 1999, Global Minerals & Metals Corporation has not settled with the Commission. See *In re Global Minerals & Metals Corp.*, No. 99-11, 1999 WL 1023586 (CFTC Nov. 12, 1999).

current regulatory scheme under the CEA, proposes increased monitoring of the hedging exemption under the Act, and discusses efforts of international regulators to curtail harmful global manipulative schemes. This Note adopts the view that, despite the Sumitomo scandal, manipulation, in general, is not a rampant problem in commodity futures trading. There is no need for further regulation because the current regulations are stringent enough to combat manipulation. Rather, this Note contends that utilizing the current regulatory structure, in conjunction with increased monitoring of the hedging exemption and enhanced international regulatory cooperation, will more effectively quash the efforts of rogue traders such as Hamanaka.

I. FUTURES MARKETS AND THE CONCEPT OF MARKET MANIPULATION

Before addressing the intricacies of the Sumitomo manipulation, it is necessary to examine the technical aspects of futures markets and the role they play in the world's financial communities. Consequently, this part provides a brief history of futures trading and its terminology, the function of futures markets and the evolution of the murky concept of market manipulation. Additionally, it explores the academic debate regarding manipulation in order to illustrate the complexity surrounding manipulation law and the difficulty in establishing an effective solution to the manipulation conundrum.

A. *History and Terminology of Futures Markets*

In the early part of the nineteenth century, farmers in the United States began using futures contracts to protect against detrimental price fluctuations in agricultural commodities.¹⁷ Typically, the farmers and merchants negotiated the futures contracts on an informal basis.¹⁸ Over time, however, organized exchanges evolved, presumably to handle increased demand for these types of contracts.¹⁹ The exchanges, such as the Chicago Board of Trade, offered standardized contracts on agricultural products that could be bought and sold in the future, and thus eliminated the informal nature of the prior system of futures trading.²⁰ Although the new exchanges offered many benefits to farmers and merchants, many people, particularly congressmen, opposed the exchanges because they were too speculative in nature.²¹ In fact, in 1921, a United States senator commented that the Chicago

17. See Carolyn H. Jackson, Note, *Have You Hedged Today? The Inevitable Advent of Consumer Derivatives*, 67 *Fordham L. Rev.* 3205, 3218 (1999).

18. *See id.*

19. *See id.*

20. *See id.*

21. *See id.*

Board of Trade had become such a “‘gambling hell’ that ‘Monte Carlo or the Casino at Havana are not to be compared to it.’”²² The perceived abuses on the exchanges, particularly speculation, which was the suspected cause of the collapse of commodity prices during the Great Depression, and off-exchange activity, such as the development of bucket shops,²³ led Congress to enact legislation to regulate the exchanges.²⁴

One of Congress’ principal concerns regarding the commodities markets was manipulation by traders.²⁵ Section 3 of the current version of the CEA, entitled “Necessity For Regulation,”²⁶ specifically addresses these concerns by stating that:

[T]ransactions and prices of commodities on [] boards of trade are susceptible to excessive speculation and can be *manipulated, controlled, cornered or squeezed*, to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein.²⁷

As such, the CEA proscribes manipulative activity in §§ 6(c),²⁸ 6(d),²⁹ and 9(a)(2).³⁰

22. *Id.* (quoting Christopher L. Culp Competitive Enter. Inst., *A Primer on Derivatives: Their Mechanics, Uses, Risks, and Regulation*, 3-30 (1995)); see also Timothy J. Snider, 2 *Regulation of the Commodities Futures and Options Markets* § 12.01, at 12-3 (2d ed. 1995) (“[C]ommodity futures trading was regarded by many with suspicion, particularly because the activity seemed to closely resemble another activity which was at the time patently immoral—gambling.”).

23. See Jackson, *supra* note 17, at 3218. Bucket shops (“shops”) were a means of scamming the general public. See *id.* The shops would claim to execute futures transactions for the public. See *id.* at 3218 n.130. They would take a customer’s money but never register the transaction with any exchange, essentially “bucketing” the trades. Consequently, if the value of the contract decreased, the shop would collect money from the customer. If the contract increased and the shop owed the customer money, the shop would subsequently disappear, leaving the enraged customer holding the bag. See *id.*

24. See *id.* at 3218-19 (discussing the various pieces of congressional legislation that preceded the Commodity Exchange Act that attempted to regulate exchanges).

25. See George A. Davidson, *Squeezes and Corners: A Structural Approach*, 40 *Bus. Law.* 1283, 1283 & n.1 (1985) (providing a brief history on commodity futures legislation); Richard D. Friedman, *Stalking The Squeeze: Understanding Commodities Market Manipulation*, 89 *Mich. L. Rev.* 30, 31 & n.2 (1990) (same); see also Jerry W. Markham, *Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 *Yale J. on Reg.* 281, 288-313 (1991) (providing a comprehensive history of commodity manipulation dating back to the Civil War) [hereinafter Markham, *Unprosecutable Crime*]; cf. Steve Thel, *Regulation of Manipulation Under Section 10(b): Security Prices And The Text of The Securities Exchange Act of 1934*, 1988 *Colum. Bus. L. Rev.* 359, 360 (stating that the prohibition of manipulation under the Securities Exchange Act of 1934 is to “ensur[e] that securities are in a certain sense appropriately priced.”) [hereinafter Thel, *Regulation*].

26. See Commodity Exchange Act § 3, 7 U.S.C. § 5 (1994).

27. *Id.* (emphasis added).

28. See *supra* note 8.

Problematically, however, the Act does not define the words "manipulation," "corner," or "squeeze,"³¹ despite the fact that Congress explicitly deemed such activity harmful.³² Furthermore, the legislative history fails to provide useful information for clarifying what Congress believed would constitute "manipulation."³³ Consequently, the task of interpreting manipulation has been left in the hands of the courts, administrative agencies³⁴ such as the CFTC, and academic commentators.³⁵ Accordingly, any student of commodity manipulation law will discover a body of law that is "a murky miasma of questionable analysis and unclear effect."³⁶

Several reasons may explain why the state of commodity manipulation law is in such tremendous disarray. One commentator posited that "[t]his unfortunate state of affairs is principally the result of the fact that the question of what constitutes market manipulation

29. See *supra* note 9.

30. See *supra* note 10.

31. See *In re Indiana Farm Bureau Cooperative Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,281 (CFTC Dec. 17, 1982) [hereinafter *In re Indiana Farm Bureau*].

32. See 2 Philip McBride Johnson & Thomas Lee Hazen, *Commodities Regulation* § 5.02, at 5-8 (3d ed. 2000) [hereinafter *Johnson & Hazen*, 3D]; Thomas A. Hieronymus, *Manipulation in Commodity Futures Trading: Toward a Definition*, 6 Hofstra L. Rev. 41, 41-42 (1977).

33. See Markham, *Unprosecutable Crime*, *supra* note 25, at 311. The most commonly cited piece of legislative history, in the context of market manipulation, is the Congressional testimony of Arthur Marsh, president of the New York Cotton Exchange, during the adoption of the Commodity Exchange Act. See Jerry W. Markham, 13A *Commodities Regulation: Fraud, Manipulation & Other Claims* § 15.04, at 15-8 (1999) [hereinafter *Markham, Commodities*]. Mr. Marsh stated:

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 futures markets, is manipulation.

Id. at 15-8 through 15-9 (quoting *Hearings on Cotton Prices Before a Subcomm. of the Senate Comm. on Agriculture & Forestry*, 70th Cong., 1st Sess. 201-02 (1928)).

34. Congress created the CFTC pursuant to the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-64, 88 Stat. 1398 (1974). Prior to the CFTC's creation, however, the Commodity Exchange Authority administered the Commodity Exchange Act "under the direction of the Secretary of Agriculture and a Commodity Exchange Commission composed of the Secretaries of Agriculture and Commerce and the Attorney General." See Markham, *Unprosecutable Crime*, *supra* note 25, at 313.

35. See *In re Indiana Farm Bureau*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 27,281 ("Neither manipulation nor attempted manipulation is defined in the Commodity Exchange Act. That task has fallen to case-by-case judicial development."); Craig Pirrong, *Commodity Market Manipulation Law: A (Very) Critical Analysis and a Proposed Alternative*, 51 Wash. & Lee L. Rev. 945, 945 (1994) [hereinafter *Pirrong, Critical Analysis*].

36. Snider, *supra* note 22, § 12.01, at 12-5.

is in the first analysis an *economic one*, and accordingly, one with which our legislative and, to some extent, our judicial machinery seem particularly unqualified to grapple successfully.³⁷ In addition, the CFTC has not established a workable definition of “artificial price,”³⁸ which constitutes the heart of any manipulation case.³⁹ Finally, neither the courts nor the Commission are presented with many opportunities to decide manipulation cases.⁴⁰ Thus, in an effort to make sense of the confusion surrounding manipulation law, it is necessary to examine briefly what purpose the futures markets serve, how they operate, and how the concept of manipulation arises.

B. The Futures Markets: Function and Purpose

In the realm of commodities trading⁴¹ there are primarily two markets: cash or spot markets⁴² and futures markets.⁴³ The term “futures contract” is not defined within the Act, but § 2(a)(1)(A)(i) states that “[t]he [Commodity Futures Trading] Commission shall

37. *Id.* at 12-4 (emphasis added).

38. *Infra* notes 135-54 and accompanying text.

39. See Markham, *Unprosecutable Crime*, *supra* note 25, at 284.

40. See Snider, *supra* note 22, at 12-4, 12-5. The author argues that the reason for the paucity of cases is three-fold: 1) manipulative activity is difficult to identify as distinguished from ordinary market activity; 2) the severe sanctions imposed for a finding of manipulation tend to encourage settlement; and 3) bringing a manipulation case requires a tremendous amount of time, expense, and manpower and as such the CFTC will not bring a complaint unless it is confident that it will succeed. See *id.*; see also *supra* notes 8-9 (describing under which circumstances the CFTC may file a complaint).

Another possible explanation for the lack of manipulation cases heard by the courts and the Commission is the CFTC Division of Enforcement’s unsuccessful track record with regard to manipulation cases. See, e.g., Suzanne McGee & Stephen E. Frank, *Manipulation May Be Hard to Prove in Sumitomo Case*, Wall St. J., July 15, 1996, at C1 (noting that of the approximately twenty manipulation cases brought by the CFTC’s enforcement division, the only victories were those cases that settled without admitting or denying the allegations) [hereinafter McGee & Frank, *Hard to Prove*]. Furthermore, even Judge Milton Pollack, presiding over the class action suit against Sumitomo, noted that claims of manipulation “have been notoriously difficult to prove.” See *In re Sumitomo Copper Litig.*, 74 F. Supp. 2d 393, 395 (S.D.N.Y. 1999); see also Hieronymus, *supra* note 32, at 44 (“No manipulation case is ever simple. The forces that determine price are numerous, complex, and always uncertain.”).

41. The Act defines a commodity as virtually anything that is the subject of futures trading. See Johnson & Hazen, 2D, *supra* note 4, § 1.01, at 4. Currently, the Act defines “commodity” in section 1a, which provides a laundry list of specified items, in addition to “all other goods and articles, except onions as provided in Public Law 85-839 (7 U.S.C. § 13-1), and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.” See Commodity Exchange Act § 1a, 7 U.S.C. § 1 (1994). Futures contracts on onions were excluded in 1958 because of the perceived adverse effect that futures trading had on the cash market prices of onions. See H.R. Rep. No. 1036, 85th Cong., 1st Sess. (Aug. 8, 1957), reprinted in 1958 U.S.C.C.A.N. 4210-17.

42. See *supra* note 9 (describing the cash market for physical commodities). The words “cash” and “spot” market will be used interchangeably throughout this Note.

43. See Johnson & Hazen, 2D, *supra* note 4, § 1.20, at 85.

have exclusive jurisdiction . . . [over] transactions involving contracts of sale of a commodity for *future delivery*, traded or executed on a contract market."⁴⁴ A commodity futures contract is a standardized agreement to buy or sell a fixed quantity, quality, and grade of an identified commodity at some specific time in the future.⁴⁵ A commodity exchange⁴⁶ is a marketplace where commodity futures are traded.⁴⁷ Trading on exchanges⁴⁸ occurs in trading "pits" in an "open outcry auction."⁴⁹ Customers call their brokerage firm and submit an order.⁵⁰ The order is then transmitted to the exchange floor by telephone, and the floor broker bids (offers) the order to the other brokers in the pit.⁵¹ In an effort to limit negotiations in the pit only to price, the exchanges are required to standardize all other terms of the contracts.⁵²

44. Commodity Exchange Act § 2(a)(1)(A)(i), 7 U.S.C. § 2 (emphasis added).

45. See Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets*, 105 Harv. L. Rev. 503, 542 (1991). The purchaser of a futures contract is called a "long" and the seller of the future is called a "short". See Pirrong, *Critical Analysis*, *supra* note 35, at 948; *supra* note 4.

46. Section 5a of the Act outlines the requirements that a "contract market" must satisfy in order to function lawfully as a commodity exchange. See Commodity Exchange Act § 5a, 7 U.S.C. § 7a.

47. See Ralph T. Byrd, *No Squeezing, No Cornering: Some Rules for Commodity Exchanges*, 7 Hofstra L. Rev. 923, 924 (1979). One commentator creatively characterized commodity futures markets as:

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. 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.

Robert C. Lower, *Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation*, 8 Yale J. on Reg. 391, 394 (1991).

48. Section 5 of the CEA gives the CFTC the authority to designate an exchange a "contract market" whereby legal futures trading may take place. See Commodity Exchange Act § 5, 7 U.S.C. § 7. Generally, § 4(a) of the CEA makes it unlawful to enter into contracts for future sale or delivery of a commodity not on a Commission-designated "contract market." See Commodity Exchange Act § 4(a), 7 U.S.C. § 6(a).

49. Pirrong, *Critical Analysis*, *supra* note 35, at 948. The noise level generated by the open outcry system of trading overwhelms anyone who has witnessed the floor of a commodity exchange.

50. See *id.* In addition to simply filling customer orders, some participants on the floor of an exchange trade on their own behalf. See *id.*

51. See *id.* If a customer desires to sell a future, she completes the same steps as a purchaser, except that she simply places an order of sale. For a more detailed description of how trading is effectuated, see Edward T. McDermott, *Defining Manipulation in Commodity Futures Trading: The Futures "Squeeze"*, 74 Nw. U. L. Rev. 202, 202 n.1 (1979).

52. See Pirrong, *Critical Analysis*, *supra* note 35, at 948; Johnson & Hazen, 2D, *supra* note 4, § 1.03, at 11. The exchanges on which futures trade determine the

In addition to providing standardized contracts, exchanges also demand that market participants provide minimal financial requirements known as "initial margin."⁵³ Margin is a monetary deposit that is sufficient to purchase the legal right to an entire contract in the future.⁵⁴ In order to ensure that customers will satisfy their financial obligations on a contract, the exchange's clearing house⁵⁵ values the contracts in every customer's account at the end of each trading day.⁵⁶ Once the account value is determined, the clearing house readjusts the cash balance in the margin account, a procedure referred to as "marking to market."⁵⁷ Depending upon which direction the market moved in relation to a customer's position, a customer is either credited with gains or she must provide further margin known as variation margin.⁵⁸ If, for example, a customer entered into a long futures position for \$100 (i.e. agreed to purchase a futures contract) and subsequently, at the end of a trading day, the price of the contract dropped to \$95, the customer would receive a "margin call"⁵⁹ (i.e. a request to increase the funds in the margin account to bring the account back up to \$100).⁶⁰

Finally, once the parties enter into their respective positions, either long or short, the parties satisfy their obligations by either accepting or delivering⁶¹ the actual commodity, or by liquidating their positions

month, quantity, and grade of the commodity to be delivered on each contract. *See id.* For example, a copper contract for the month of May could set the quantity of copper (e.g. at 10 tons), the quality or grade (e.g. 80% pure) and place of delivery (e.g. at Long Beach, CA).

53. *See* George Crawford & Bidyut Sen, *Derivatives for Decision Makers* 12 (1996).

54. *See id.*

55. A clearing house is "[a]n adjunct to, or division of, a commodity exchange through which transactions executed on the floor of the exchange are settled. [The clearing house is] [a]lso charged with assuring the proper conduct of the exchange's delivery procedures and the adequate financing of the trading." *See* Commodity Futures Trading Commission, *Glossary*, at 8 (CFTC P-105 (Revised 01-97)) (on file with *Fordham Law Review*) [hereinafter, *Glossary*].

56. *See* Crawford & Sen, *supra* note 53, at 12.

57. *See id.*

58. *See* *Glossary*, *supra* note 55, at 41 (defining variation margin).

59. *See id.* at 26 (defining "margin call").

60. *See* Crawford & Sen, *supra* note 53, at 12-13.

61. If the short seeks to deliver the actual commodity, she files a "notice of intention to deliver" with the sponsoring exchange (e.g. New York Mercantile Exchange) or clearing house. *See* Johnson & Hazen, 2D, *supra* note 4, §1.17, at 74-75. The notice of intention is not directed at any one particular long. *See id.* at 75. Rather, the exchange or clearing house assigns the actual commodity to an eligible long (buyer), typically the long who has held his position for the most time. *See id.* Delivery, however, does not result in "a truckload of soybeans in your back yard." *Id.* Instead, the long is provided with a document which conveys title. *See id.* This document is most frequently referred to as a "warehouse receipt." *See id.* For a more detailed explanation of the delivery process, *see id.* § 1.17, at 73-83.

in an offsetting⁶² transaction.⁶³ This process permits the futures markets to perform several important economic functions.⁶⁴

The first function of the futures markets is that they permit "hedging."⁶⁵ As explained by one commentator, "[h]edging is a practice by which a trader with a position in the cash market purchases an offsetting futures position and thereby reduces the risks associated with price variations."⁶⁶ For example, a corn producer may fear that the price of her cash inventory will decline. If she sells the corn now she could sell it for \$1000 per ton. She will not harvest her crop, however, for three months. In order to protect against a price decline, she sells a three-month futures contract that expires during harvest season for \$1000. If at the end of the three-month period the cash price of corn is \$800 per ton, the corn producer will purchase an offsetting futures contract for \$800, closing out her hedge. The \$200

62. To "offset" means to enter into an agreement directly opposite the one in which the individual has an obligation. For example, if a short sold a September copper contract, he can offset, or liquidate, by purchasing a September contract identical to the September contract he previously sold. *See id.* § 1.04, at 12-14. In other words, offsetting eliminates the requirement of physical acceptance or delivery, and results in a net cash settlement (i.e. receipt or payment) depending on which position (i.e. the long or the short) the market favored upon expiration of the contract. In actuality, approximately 98% of physical futures contracts are settled using the offsetting process rather than through actual delivery or acceptance. *See Crawford & Sen, supra* note 53, at 11.

In addition to actual delivery or acceptance, some futures contracts are strictly "cash settled." *See Pirrong, Critical Analysis, supra* note 35, at 948 n.6. An example of a well-known cash settled contract is the Standard & Poors 500 Index contract traded on the Chicago Mercantile Exchange. *See id.* Instead of delivering or accepting delivery of the entire basket of stocks, the value of the bundle is determined on the settlement date in order to establish the settlement price. *See id.* Who pays the cash settlement and the amount of the settlement will depend upon in which direction the market moved during the delivery period. *See id.* For example, someone who purchased a September S&P 500 contract at \$98, and sold the contract at \$100, would receive a \$2 payment upon settlement.

63. *See Byrd, supra* note 47, at 924.

64. *See id.* at 925.

65. *See* Commodity Exchange Act § 3, 7 U.S.C. § 5 (1994) (stating that futures markets are "a means of hedging").

The regulations accompanying the CEA in § 4a(a) state that contract markets must submit to the CFTC "a bylaw, rule, regulation or resolution which shall limit the maximum net long and net short position which any one person may hold or control under contracts for future delivery of any commodity subject to the rules of such contract market." 17 C.F.R. § 1.61(a)(1) (1999). This language is consistent with the language of § 3 of the CEA which addresses the "Necessity For Regulation" of the commodity markets. *See supra* note 26 and accompanying text.

66. Wendy Collins Perdue, *Manipulation of Futures Markets: Redefining the Offense*, 56 Fordham L. Rev. 345, 350 (1987). The use of the word offsetting in the quoted definition is not intended to imply the same meaning as "offsetting" through the purchase or sale of a futures contract in order to eliminate the delivery or acceptance requirement. Rather, in the context of hedging, offsetting simply means to take a position opposite the one that the hedger took in the cash market. So, if the hedger seeks to sell her cash inventory, she will also sell a future in order to protect against the possibility of a price decline in the cash market.

loss on the physical sale of corn will be offset by her \$200 gain on the futures hedge. Because prices in the cash market supposedly parallel one another,⁶⁷ the purchase of the offsetting futures contract, and subsequent profit on the futures transaction, protects against a decline in the cash price of the producer's inventory.⁶⁸ In other words, the futures markets provide an insurance function for the hedger.⁶⁹

The second purpose of futures markets is to provide a means of "speculation."⁷⁰ In contrast to the hedger, the speculator⁷¹ is willing to assume either the long or short position depending upon in which direction the speculator believes that prices will move.⁷² Speculators, although highly criticized⁷³ and regulated,⁷⁴ perform an important function in that they "transfer risk from hedgers to speculators who are willing to bear it and can presumably afford it."⁷⁵ Although Congress recognized the benefit speculators offer to the market,⁷⁶ it also sought to limit detrimental speculation.⁷⁷ Section 4a(a) of the CEA, entitled "Excessive Speculation—Limits On Trading," authorizes the Commission to set limits on both the positions (i.e. the quantity of futures contracts a trader either purchases or sells) and the daily volume of trading in a particular contract.⁷⁸ The excessive

67. See *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,298-99 (CFTC Dec. 17, 1982) (Stone, Comm'r, concurring); see also *infra* note 86 and accompanying text (explaining the relationship between the cash market and futures market).

68. See *Perdue*, *supra* note 66, at 350 nn.43-44. The futures prices, however, can diverge from the cash price, leaving the hedger with what is known as "basis" risk. See Mark J. Powers & David Vogel, *Inside The Financial Futures Markets* 183 (2d ed. 1984). Basis is the difference between the price of the futures contract and the price of the commodity in the cash market. See *id.*

69. See Joseph J. Bianco, *The Mechanics of Futures Trading: Speculation and Manipulation*, 6 Hofstra L. Rev. 27, 32 (1977).

70. See *Byrd*, *supra* note 47, at 927.

71. A speculator is defined as "an individual who does not hedge, but who trades with the objective of achieving profits through the successful anticipation of price movements." See *Glossary*, *supra* note 55, at 37 (defining "speculator").

72. See *Byrd*, *supra* note 47, at 927.

73. See, e.g., Bianco, *supra* note 69, at 31 ("[T]he speculator is frequently viewed as a sinister character."). Even in the early years of futures trading, speculation in futures markets was viewed as a form of gambling which was not the intended function of the exchanges. See *supra* notes 21-24 and accompanying text.

74. See *infra* Part III.A. (outlining the CEA's current regulatory structure).

75. Bianco, *supra* note 69, at 32; see also Johnson & Hazen 2D, *supra* note 4, § 1.14, at 59 ("The role of the speculator is both necessary and proper."); *supra* note 65 and accompanying text (discussing the statutory prohibitions on excessive speculation).

76. See *Leist v. Simplot*, 638 F.2d 283, 305-07 (2d Cir. 1980) (discussing congressional recognition of the essential role of speculators).

77. See *Commodity Exchange Act* § 4a(a), 7 U.S.C. § 6a (1994).

78. See *id.* The Act states:

Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden

speculation provision, however, only applies to the group classified as "speculators." Hedgers, in contrast, are overtly exempted from the position and trading limits under § 4a(c) of the Act.⁷⁹

Finally, the futures markets serve as a vehicle for price discovery.⁸⁰ Unlike transactions in the cash market, futures transactions deal with homogenous goods and highly standardized contracts.⁸¹ Cash merchants buy and sell their inventories subject to prior and existing business relationships as well as other non-price factors.⁸² For instance, the price for a particular quantity or grade of a cash commodity may be a result of the unique requirements of a particular merchant.⁸³ Moreover, cash market transactions, unlike futures transactions, are not publicly reported.⁸⁴ Additionally, there are generally fewer cash transactions than there are futures transactions, making the cash market a less competitive forum.⁸⁵ As a result of these combined factors, the futures markets "will frequently be the best available barometer of prices for a particular commodity."⁸⁶

Although futures markets provide tremendous financial benefits, they also invite harmful activity, such as market manipulation, that detracts from the markets' advantages. Consequently, Congress mandated regulation because of individuals who engage in unscrupulous behavior in an attempt to affect the price of a specific futures contract.⁸⁷

C. The Concept of Market Manipulation

In an effort to protect the pricing function of the futures markets and to deter individuals from attempting to affect prices, Congress

on interstate commerce in such commodity.

Id.

79. See Commodity Exchange Act § 4a(c), 7 U.S.C. § 6a(c).

80. See *In re Indiana Farm Bureau Coop. Ass'n, Inc.* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,298 (CFTC Dec. 17, 1982) (Stone, Comm'r, concurring) (stating that one major function of the futures markets is that they are a price discovery mechanism).

81. See *id.*

82. See Johnson & Hazen, 3D, *supra* note 32, § 5.04, at 5-30.

83. See *id.*

84. See *id.*

85. See *id.*

86. *Id.* However, the proposition that the futures price, rather than the spot price, is the best indicator of value only holds true until just prior to the delivery period. See *id.* at 5-31. Unlike the spot market, the futures market reflects a more global demand for a commodity. See *id.* Consequently, the cash price and futures price do not tend to converge until just before the delivery period. See Bianco, *supra* note 69, at 29. The convergence between cash and futures prices is the result of the shorts moving the necessary supplies of a commodity into place in order to prepare for delivery. See Johnson & Hazen, 3D, *supra* note 32, § 5.04, at 5-31. Thus, the costs to the shorts of obtaining the deliverable supplies will generally be reflected in the price of futures. See *id.*

87. See Commodity Exchange Act § 3, 7 U.S.C. § 5.

drafted a number of statutory provisions.⁸⁸ Furthermore, pursuant to the CEA, the CFTC and its predecessors established regulations to further hinder devious behavior.⁸⁹ One of the most important regulations established to deter manipulation is § 1.38 which mandates that “[a]ll purchases and sales of any commodity for future delivery . . . be executed openly and competitively.”⁹⁰ Additionally, Parts 15-21 of the regulations accompanying the CEA, outline strict reporting requirements for players in the futures markets.⁹¹ Despite the significant statutory and regulatory prohibitions, however, the concept of “manipulation” continues to confuse and frustrate the courts, regulatory agencies, and academics alike.⁹²

The legal world has yet to agree upon a definition of manipulation.⁹³ Numerous articles and treatises attempt to define it.⁹⁴ In contrast, an unresolved academic debate questions whether manipulation is even possible.⁹⁵ If one accepts the argument that manipulation is a reality, then there are various types of activities that could be deemed manipulative, thereby adding to the confusion.⁹⁶ In an effort to

88. See *supra* notes 8, 9, 10, and 65 (detailing relevant CEA provisions). Moreover, §§ 4b and 4c prohibit specific acts and trading practices including fraud, bucketing, providing or causing to be provided false reports, wash sales, and cross-trades. See Commodity Exchange Act §§ 4b, 4c, 7 U.S.C. §§ 6b, 6c. Discussion of these proscriptions is, however, outside the scope of this Note.

The CFTC is not the only entity authorized to institute an action under the CEA. Section 22 provides for actions by private “person[s].” See CEA § 22, 7 U.S.C. § 25(a)(1); see also *supra* note 8 (defining the word “person” as used in the CEA). An example of a private suit brought pursuant to the CEA is *In re Sumitomo Copper Litig.*, 189 F.R.D. 274, 277-78 (S.D.N.Y. 1999), in which a group of U.S. investors sued Sumitomo and others for losses they sustained as a result of the Sumitomo manipulation.

89. See Snider, *supra* note 22, § 12.05, at 12-10.

90. 17 C.F.R. § 1.38 (1999).

91. See *id.* Parts 15-21.

92. See *supra* notes 32-40 and accompanying text.

93. See *supra* notes 31-36 (outlining the problems with defining manipulation).

94. See Snider *supra* note 22, § 12.01, at 12-5; Friedman, *supra* note 25, at 31-35; Hieronymus, *supra* note 32, at 41-47; Markham, *Unprosecutable Crime*, *supra* note 25, at 282-85; McDermott, *supra* note 51, at 202-05.

95. Compare Fischel & Ross, *supra* note 45, at 547 (arguing that manipulation is not really possible, but acknowledging that “[s]uccessful manipulations appear to be more likely to occur in futures markets than in other securities markets.”), with Steve Thel, *\$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219, 219-24 (1994) (challenging Fischel and Ross’ argument with regard to the securities markets and contending that manipulation is a reality) [hereinafter Thel, *\$850,000*]; see also *infra* Part I.D. (discussing various academic approaches to manipulation).

96. See Thel, *\$850,000*, *supra* note 95, at 247-79 (describing the different forms of activity that could be deemed manipulative). One form of activity that is manipulative is the dissemination of false information, such as a false crop report. See Snider, *supra* note 22, § 12.11, at 12-21. Dissemination of false information is one of the few judicially agreed upon forms of manipulation. See *Cargill v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) (“[O]ne of the most common manipulative devices [is] the floating of false rumors”); *General Foods Corp. v. Brannan*, 170 F.2d 220, 224 (7th

simplify the discussion of manipulation for the purposes of this Note, however, the term manipulation will refer specifically to "market power manipulation"⁹⁷ of futures contracts with underlying physical commodities, because market power manipulation by long traders is the most frequently charged form of manipulation under the CEA.⁹⁸

1. What is Market Power?

Generally, "market power" is the exercise of "monopoly power,"⁹⁹ a concept derived from antitrust laws.¹⁰⁰ In the realm of commodities trading, market power manipulation arises when a long controls enough of a particular futures contract, a substantial portion of the underlying cash commodity, or both, during or near the end of the delivery month.¹⁰¹ Because the long controls a significant portion of the underlying commodity, she leaves no avenue for the shorts to either offset their position or make delivery.¹⁰² Inevitably, the shorts are forced to deal solely with the long manipulator and must pay an "artificial"¹⁰³ price to fulfill their obligation, in order to avoid defaulting on their contract and having to pay draconian sanctions.¹⁰⁴

Obtaining market power over an equity security (e.g. IBM stock), in contrast, does not provide the same benefits as obtaining monopolistic power in a commodity (or commodity futures contract).¹⁰⁵ Therefore,

Cir. 1948) ("[T]he common criteria usual in manipulation . . . cases are deceit [and] trickery through the spreading of false rumors.").

97. See, e.g., Stephen Craig Pirrong, *The Economics, Law, and Public Policy of Market Power Manipulation* 6-9 (1996) (providing a comprehensive examination of and a proposed solution to the manipulation of commodity markets) [hereinafter Pirrong, *Market Power*].

Another commentator referred to "market power manipulation" cases as "*delivery impairment cases*." See Snider, *supra* note 22, § 12.11, at 12-20 (emphasis in original).

98. See Markham, *Unprosecutable Crime*, *supra* note 25, at 380-89. Professor Markham compiled an index of all of the manipulation cases brought under the CEA. Out of the 44 cases listed, 37 (84%) were market power cases. See *id.*; see also Pirrong, *Market Power*, *supra* note 97, at 6 & 16 n.18 (citing Markham for the list of manipulation cases brought pursuant to the Commodity Exchange Act).

99. See Pirrong, *Market Power*, *supra* note 97, at 18-19.

100. See Johnson & Hazen, 2D, *supra* note 4, § 5.34, at 775.

101. See Pirrong, *Critical Analysis*, *supra* note 35, at 949.

102. See *id.* at 954; see also Johnson & Hazen, 3D, *supra* note 32, § 5.03[6], at 5-29 ("[T]he proper appraisal of manipulative ability is to view both cash and futures activity in combination, rather than separately, since the ultimate issue is whether the shorts have any recourse for fulfilling their obligations except through the suspected manipulator.")

103. The concept of artificial price will be discussed *infra* notes 104-18 and accompanying text. Artificial price could be viewed as a price that is not achieved by "legitimate" forces of supply and demand. See *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,284 (CFTC Dec. 17, 1982). This definition, however, is vague and not very helpful in clarifying the ambiguities surrounding manipulation.

104. See Pirrong, *Critical Analysis*, *supra* note 35, at 954.

105. See Fischel & Ross, *supra* note 45, at 543.

the danger of manipulation in the commodity futures context is greater. In securities markets, if a monopolist attempts to sell her IBM stock at incrementally higher prices, investors will turn to alternative investments that provide similar characteristics and expected returns.¹⁰⁶ Commodity futures, on the other hand, are not capable of the same substitution when the futures contracts expire.¹⁰⁷ Those shorts that did not offset prior to expiration must either deliver the physical stocks or pay a cash settlement.¹⁰⁸ If a trader established a large long position relative to the available supply held by others, the short probably will have to pay an extravagant price to obtain either the physical commodity or to purchase the offsetting futures contracts held by the trader with the dominant long position.¹⁰⁹

The exercise of market power by an individual or group is characterized as a "corner" or "squeeze."¹¹⁰ Although the courts and certain commentators have distinguished between these terms, they are intended to, and do, result in the same outcome—the extrapolation of a high price from the shorts in order to settle their contracts with the long.¹¹¹ In order to profit from a manipulative scheme, the manipulator must be able to achieve a greater profit on settling his futures contracts than on the loss he will sustain while "burying the corpse."¹¹²

2. Defining Manipulation

Over the years, courts and various regulatory agencies have attempted to establish a definition of a manipulation. For example, there are six cases in which various courts of appeals considered the

106. *See id.*

107. *See id.*

108. *See supra* notes 61-62 and accompanying text.

109. *See Fischel & Ross, supra* note 45, at 543.

110. *See* Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: the Case of Market Manipulation*, 38 J. L. & Econ. 141, 144 (1995) [hereinafter Pirrong, *Self-Regulation*]. Professor Pirrong provides a well-articulated explanation of how the long trader is able to acquire a dominant position without the shorts being able to identify the long or her positions. *See id.* at 145-46.

111. A "corner" and a "squeeze" are both subsets of manipulation. Traditionally, a "squeeze" is thought to result from a controlling position in the futures market accompanied by a natural shortage in the cash market. *See* Snider, *supra* note 22, § 12.10, at 12-18. The "corner," in comparison, is typically understood as a result of a dominating cash market position and/or a controlling futures position. *See id.* The goal of either an "intentional" corner or squeeze, however, is exactly the same. *See id.*

112. *See* Pirrong, *Self-Regulation, supra* note 110, at 144-45; *see also* Johnson & Hazen, 2D, *supra* note 4, § 5.27, at 53 (describing the "burying the corpse" effect). The "burying the corpse" or "burying-the-body" effect, as Pirrong deems it, is one of the hallmarks of manipulation. *See* Pirrong, *Self Regulation, supra* note 110, at 144-45. Essentially, once a long acquires a substantial portion of the cash market and subsequently drives up futures prices, she must sell off the unneeded cash commodity. *See* Johnson & Hazen, 2D, *supra* note 4, at 53. The sale typically occurs at prices below which she just paid for a long futures contract. *See id.*

issue of price manipulation.¹¹³ In *Cargill, Inc. v. Hardin*,¹¹⁴ the Eighth Circuit stated that manipulation is the result of "conduct [which] has been intentionally engaged that has resulted in a price which does not reflect basic forces of supply and demand."¹¹⁵ Additionally, the Seventh Circuit defined manipulation as "an intentional exaction of a price determined by forces other than supply and demand,"¹¹⁶ or alternatively, "the creation of an artificial price by planned action whether by one man or a group of men."¹¹⁷ Furthermore, in *Volkart Bros., Inc. v. Freeman*¹¹⁸ the Fifth Circuit examined the congressional testimony of Arthur Marsh, president of the New York Cotton Exchange during the adoption of the CEA, in its effort to craft a definition of manipulation.¹¹⁹

In *In re Hohenberg Bros. Co.*,¹²⁰ the first manipulation case decided by the CFTC,¹²¹ a full Commission defined manipulation as "conduct intentionally engaged in resulting in an artificial price."¹²² Later, in *Indiana Farm Bureau*, the Commission pronounced its definitive view

113. See generally *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971) (examining price manipulation); *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52 (5th Cir. 1962) (same); *G.H. Miller & Co. v. United States*, 260 F.2d 286 (7th Cir. 1958) (same); *Great Western Food Distrib., Inc. v. Brannan*, 201 F.2d 476 (7th Cir. 1953) (same); *General Foods Corp. v. Brannan*, 170 F.2d 220 (7th Cir. 1948) (same); *Peto v. Howell*, 101 F.2d 353 (7th Cir. 1938) (same). A comprehensive discussion of these cases, and others, is available in Markham, *Unprosecutable Crime*, *supra* note 25, at 313-23. In addition, Markham, in the appendices accompanying his article, provides an all-inclusive list of manipulation cases—the charge, the date of the decision, the result, and the amount of time required to resolve the matter. See *id.* at 379.

114. 452 F.2d 1154 (8th Cir. 1971).

115. *Id.* at 1163. The court further stated that, "[w]e think the test of manipulation must largely be a practical one if the purposes of the Commodity Exchange Act are to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man." *Id.* The problem with the *Cargill* court's definition of manipulation is that it fails to identify what constitutes "basic forces of supply and demand." *Id.* Thus, the court's attempted definition, like many others, fails to provide useful guidance in the seemingly hopeless search for a workable definition of manipulation.

116. *Frey v. Commodity Futures Trading Comm'n*, 931 F.2d 1171, 1175 (7th Cir. 1991).

117. *General Foods Corp.*, 170 F.2d at 231. More recently, in *Frey*, the Seventh Circuit opined that the "'know it when you see it' test may appear most useful." 931 F.2d 1171, 1175 (7th Cir. 1991).

118. 311 F.2d 52 (5th Cir. 1962).

119. See *Volkart Bros.*, 311 F.2d at 58; *supra* note 33.

120. *In re Hohenberg Bros. Co.* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,271, at 21,472 (CFTC Feb. 18, 1977).

121. See *Snider*, *supra* note 22, § 12.09, at 12-15.

122. *In re Hohenberg Bros.*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 21,477 (citing *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971)). Specifically, the Commission stated that:

A finding of manipulation in violation of the Act requires a finding that the party engaged in conduct with the intention of affecting the market price of a commodity (as determined by the forces of supply and demand) and as a result of such conduct . . . an artificial price was created.

on market power manipulation and stated that the “[t]he acquisition of market dominance is the hallmark of the long manipulative squeeze.”¹²³ The Commission declared, however, that the intentional acquisition of a large futures and/or cash market position is not illegal in and of itself.¹²⁴ The CFTC claimed that establishing a dominant position is illegal when the sole purpose of the position(s) is to extract “artificial”¹²⁵ prices from the shorts at the expiration of a contract.¹²⁶

The ultimate outcome of the decisions in *Cargill, Volkart, Hohenberg*, and *Indiana Farm Bureau* is a four-part test most commonly used by courts when deciding manipulation cases.¹²⁷ The Seventh Circuit, in *Frey v. Commodity Futures Trading Commission*,¹²⁸ outlined the four elements necessary to prove manipulation: 1) the *ability* to influence market prices; 2) the *intent* to execute a squeeze [or corner]; 3) that *artificial price* existed at the time of the offense; and 4) that the accused *caused* the artificial price.¹²⁹ Initially, these elements appear straightforward. Substantiating these factors, however, proves to be a vexing and complex task for plaintiffs for several reasons.¹³⁰

123. *In re Indiana Farm Bureau Coop. Ass'n, Inc.* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,285 (CFTC Dec. 17, 1982).

124. *See id.* The Commission did recognize the potential for natural congestion and explained that:

[W]here a long does not intentionally create the conditions for a squeeze, and a congested futures market arises from other causes, often a “natural” corner or low deliverable supply, manipulative intent may not be inferred where a long does not exacerbate the congestion itself, but simply seeks the best price from the existing situation.

Id. This last sentence of the Commission’s explanation attracted strong criticism from Chairman Johnson in his concurring opinion. *See id.* at 27,292 (Johnson, Comm’r, concurring) (“Recognizing the duty of shorts while avoiding undue exploitation of their plight . . . should be the objective of the Act. The majority opinion does not undertake to strike such a balance.”).

125. *See infra* notes 135-54 and accompanying text (discussing price “artificiality”).

126. *See In re Indiana Farm Bureau*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 27,285. The Commission held that:

[W]here the intentional acquisition of market dominance is coupled with a subsequent “squeeze” of shorts who are forced to deal with the accused, it may be inferred that the charging of high prices was done with the purpose of causing a price and reaping a profit beyond that which the legitimate forces of supply and demand would otherwise have allowed.

Id.

127. *See infra* note 129 and accompanying text; *see also In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786, at 34,061 (CFTC July 15, 1987) (outlining the four elements that the Division of Enforcement must prove in order to establish a prima facie case of manipulation). The four elements have been modified on occasion to fit the specific facts of a case. *See In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1045 (N.D. Ill. 1995).

128. 931 F.2d 1171 (7th Cir. 1991).

129. *See id.* at 1175 (emphasis added).

130. *See generally* Markham, *Unprosecutable Crime*, *supra* note 25, at 283 (arguing that “under present law the crime of manipulation is virtually unprosecutable.”).

a. *The Element of Ability*¹³¹

First, in order to show that a long manipulator had the "ability" to influence price, the plaintiff generally must prove that the accused controlled both the "certified cash market and the futures market."¹³² In a market power manipulation case, the problem with establishing the requisite control lies in defining the relevant cash market.¹³³ In comparison, a controlling futures position is more readily identifiable in an after-the-fact, or *ex post*, examination by simply reviewing trading records to determine whether a trader actually possessed control over the outstanding futures contracts.¹³⁴ Assessing the size of the cash market, on the other hand, is more of a question of fact that would be adjudicated by a court.

b. *The Element of Artificial Price*

The second and most troubling aspect in any manipulation case is establishing the existence of an artificial price.¹³⁵ The lack of any

131. The element of "causation" is somewhat encompassed in the element of "ability." Causation has been referred to as the "power to cause" (i.e. ability). Pirrong, *Market Power*, *supra* note 97, at 160. If an accused can demonstrate, however, that despite her ability to manipulate prices, the price aberrations were not in fact caused by her actions, the accused cannot be found to have manipulated the market. See *Johnson & Hazen*, 2D, *supra* note 4, § 5.4, at 42.

132. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1164-65 (8th Cir. 1971) (concluding that Cargill had "ability" to control price because it controlled almost all of the cash market and 62% of the long futures).

133. Compare *id.* at 1165 (excluding out-of-town hard wheat stocks as part of the available deliverable supply of No. 2 soft red wheat in determining whether Cargill controlled the cash market), and *Frey*, 931 F.2d at 1177 (stating that "*Volkart* does not preclude the possibility of successful manipulation without such control [of the cash market]."), with *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52, 59-60 (5th Cir. 1962) (declaring that uncertified cotton located at "ports designated as delivery points" should be included in the available supply, and thus holding that *Volkart* did not have the requisite *ability* to control price); see also *Great Western Food Distrib., Inc. v. Brannan*, 201 F.2d 476, 480-81 (7th Cir. 1953) (proclaiming that the added costs of bringing out-of-town eggs into the market created an "economic impediment" and should therefore not be included in the available supply); *In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786, at 34,063 (CFTC July 15, 1987) (including out-of-town supplies of wheat in Kansas City as part of the "normal" supply of wheat available in the Chicago market). The adjudicative bodies that include out-of-town supplies generally believe that the short traders have an affirmative duty to ensure that necessary supplies are in place during the delivery period. See *id.* at 34,062. In contrast, those that do not include the out-of-town supplies take the position that placing stocks into storage in anticipation of delivery is economically wasteful when offset is the likely conclusion in the futures transaction. See *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,298 (CFTC Dec. 17, 1982) (Stone, Comm'r, concurring).

134. See *infra* note 320 and accompanying text (detailing reporting requirements for contract markets).

135. See *Markham, Unprosecutable Crime*, *supra* note 25, at 284.

discernable benchmark from which to judge artificial price creates the first real problem.¹³⁶ According to the Commission, a price is artificial when it “does not reflect the market or economic forces of supply and demand operating upon the price of the particular contract under scrutiny. It is, in economic language, a nonequilibrium price.”¹³⁷ Simply stated, when the aggregate forces that impact supply and demand are all legitimate, price will not be artificial.¹³⁸ Conversely, when the forces acting on supply and demand are illegitimate, the price is necessarily artificial.¹³⁹ Thus, the majority opinion concluded that the focus of the analysis should not be on the ultimate price, but rather on the forces that caused that price.¹⁴⁰

The Commission’s discussion of artificial price, although ostensibly comprehensive, leaves much to be desired.¹⁴¹ Questions regarding what constitutes a “legitimate” force on supply and demand arise in almost all cases.¹⁴² Commissioner Stone, concurring in *Indiana Farm Bureau*,¹⁴³ sharply criticized the majority’s equilibrium price approach.¹⁴⁴ The trouble with the definition, he maintained, is that “all market prices are necessarily equilibrium responses to the various forces operating on them.”¹⁴⁵

As a result of the complications surrounding artificial price analysis, efforts to prove artificial price arise in a number of different forms.¹⁴⁶ The most frequently litigated methods of showing artificial price include: 1) comparing the price changes of the suspect contract during

136. *See id.*

137. In re *Indiana Farm Bureau*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 27,288 n.2.

138. *See id.*

139. *See id.*

140. *See id.*

141. *See, e.g.*, 2 Johnson & Hazen, 3D, *supra* note 32, § 5.04[6], at 5-35 (“[E]vidence usually offered on the question [of artificiality] is the source of as many questions as answers.”).

142. *See, e.g.*, In re Soybean Futures Litig., 892 F. Supp. 1025, 1057 (N.D. Ill. 1995) (rejecting the argument that the defendant’s misconduct was “sufficient proof of price artificiality.”).

143. In re *Indiana Farm Bureau*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 27,296.

144. *See id.* at 27,300.

145. *Id.* In other words, when someone engages in “manipulative” conduct, it has an effect on the market that results in a new market price. This new market price becomes the new equilibrium price. As Stone declared, “[i]f all market forces which contribute to shaping a price are defined to be part of legitimate supply and demand, there obviously can be no such thing as an artificial price.” *Id.*

146. *See, e.g.*, *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1167-68 (8th Cir. 1971) (addressing the various approaches that the Government argued demonstrated the existence of an artificial price); *Great Western Food Distrib., Inc. v. Brannan*, 201 F.2d 476, 482-83 (7th Cir. 1953) (discussing the three methods that the Government sought to show an abnormal price in egg futures); In re *Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786, at 34,064-66 (CFTC July 15, 1987) (analyzing “Historical Market Comparisons” and “Cash Market Price Comparisons” in assessing whether price was artificial).

the suspect period with price changes of the same type of contract during the same historical period;¹⁴⁷ 2) evaluating price movement in the spread,¹⁴⁸ for example, between the May wheat future and the July wheat future, in comparison to price changes in the previous years' spreads;¹⁴⁹ 3) analyzing the historical price relationship between different Boards of Trades;¹⁵⁰ and 4) comparing the futures price to the cash price of the commodity.¹⁵¹

These four approaches, however, have also received criticism.¹⁵² In fact, the majority of the Commission in *Indiana Farm Bureau* discredited the use of historical price comparisons in determining price artificiality.¹⁵³ The issue of artificial price continues to perplex the courts and the Commission, and as a result "there is no universally accepted measure or test."¹⁵⁴ In sum, the problem with artificial price analysis lies in the fact that the concept of price "artificiality" is an attempt to provide simplistic means of explaining complicated price anomalies. For the most part, the term "artificial" generates more questions than it does answers.

c. *The Issue of Intent*

Finally, the issue of intent presents another area of confusion in manipulation cases. In one of the earliest manipulation cases, the Seventh Circuit stated that "the intent of the parties during their trading is a determinative element of a punishable corner. Unintentional corners can develop, and should not carry the pain of forfeiture of trading privileges."¹⁵⁵ The question of the type of intent a

147. See *Cargill*, 452 F.2d at 1167. Put differently, one would compare the price rise of a contract during the suspect period with price movements during the same period in preceding years.

148. A spread is the price difference between one month's futures contract in a particular commodity and a subsequent month's contract. For example, when comparing November copper futures prices with those of December, the price difference is the spread. See Glossary, *supra* note 55, at 38.

149. See *Cargill*, 452 F.2d at 1167; *In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 34,064.

150. See *Cargill*, 452 F.2d at 1167. For example, evaluating former price differentials between a May wheat future in Chicago and a May wheat future in Kansas City.

151. See *id.* at 1167-68.

152. See, e.g., *Perdue*, *supra* note 66, at 367-70 (discussing the flaws surrounding a historical price comparison).

153. See *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,286-87 (CFTC Dec. 17, 1982) ("[H]istorical price comparisons . . . are of limited probative value here because of the unique combination of circumstances which led to the price rise in the corn pit.").

154. *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1057 (N.D. Ill. 1995).

155. *Great Western Food Distrib., Inc. v. Brannan*, 201 F.2d 476, 479 (7th Cir. 1953) (citations omitted); see also *Cargill*, 452 F.2d at 1162 (discussing the fact that many squeezes do not involve intentional manipulation, but rather are the result of "various natural market forces.").

plaintiff must demonstrate, however, quickly became a problem.¹⁵⁶ For example, the accused could either have *specifically* intended to create an artificial price (specific intent), or could merely have engaged in conduct that produced an artificial price (general intent). The confusion resulted from the *Cargill* court's discussion of intent, when it explained that "[t]he aim must be [] to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect the basic forces of supply and demand."¹⁵⁷ The Commission in *In re Hohenberg Bros. Co.* added to the mess, claiming that the accused must engage in conduct that intends to affect the price of a commodity, and as a result of that conduct, an artificial price is produced.¹⁵⁸

The CFTC finally resolved the confusion regarding its position on intent in *Indiana Farm Bureau*, declaring that a plaintiff must prove specific intent to create artificial price.¹⁵⁹ The Commission stated that "in order to prove the intent element" it must be demonstrated that the accused acted "with the purpose or conscious object of causing or effecting a price trend in the market that did not reflect the legitimate forces of supply and demand."¹⁶⁰ The Commission acknowledged, however, that evidence of intent would mostly be circumstantial, and that consequently "manipulative intent must normally be shown inferentially from the conduct of the accused."¹⁶¹ Moreover, "while knowledge of relevant market conditions is probative of intent, it is not necessary to prove that the accused knew to any particular degree of certainty that his actions would create an artificial price."¹⁶² Put differently, a plaintiff must present evidence from which it is reasonably likely that one can infer that the accused consciously desired a particular result, regardless of her level of certainty about that result.¹⁶³

Despite the courts' and the Commission's varied approaches to the examination of the manipulation dilemma, "the courts and the CFTC are still struggling to define the basic elements of the claim and to differentiate between fair means and foul in futures trading."¹⁶⁴

156. See 2 Johnson & Hazen, 3D, *supra* note 32, § 5.05[2], at 5-39 n.157.

157. *Cargill*, 452 F.2d at 1163 (7th Cir. 1971).

158. *In re Hohenberg Bros. Co.* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,271, at 21,477 (CFTC Feb. 18, 1977) ("A finding of manipulation in violation of the Act requires a finding that the party engaged in conduct with the intention of affecting the market price of a commodity (as determined by the forces of supply and demand) and as a result of such conduct or course of action an artificial price was created.")

159. *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,283 (CFTC Dec. 17, 1982).

160. *Id.*

161. *Id.*

162. *Id.*

163. *See id.*

164. *In re Soy Bean Futures Litig.*, 892 F. Supp. 1025, 1043 (N.D. Ill. 1995). This

Although the concept of manipulation appears enigmatic and often times unworkable, the case law *does* provide a starting point for piecing together the manipulation puzzle.¹⁶⁵ Importantly, though, the Division of Enforcement of the CFTC has never succeeded in adjudicating a manipulation claim.¹⁶⁶

D. Academics Confront Manipulation

As a result of the ambiguity surrounding the issue of manipulation, a number of legal scholars have attempted to reconcile the mess created by the courts and the Commission by providing a variety of proposed solutions. Their approaches range from eliminating manipulation as a statutory prohibition to implementing further regulation. It is important to consider their approaches in order to comprehend the difficulties with establishing a workable solution to the manipulation conundrum. Moreover, their solutions provide a backdrop for demonstrating why, as argued in Part III, the current regulatory scheme in conjunction with increased monitoring of the hedging exemption and international regulatory cooperation, is arguably an effective solution for dealing with market power manipulation.

The question of whether or not manipulation is a reality that mandates strict regulation has generated an academic debate.¹⁶⁷ Opposing viewpoints on whether a statutory prohibition against manipulation is necessary came to a head in two law review articles.¹⁶⁸ Professor Steve Thel contends that the art of manipulation requires regulation, and that manipulative schemes have several different formulas.¹⁶⁹ In contrast, Professors Daniel Fischel and David Ross argue that manipulation is largely self-detering, and thus does not

case involved a private class action suit, not an action by the Division of Enforcement.
165. See, e.g., *id.* at 1044 (“[T]here are some common elements that run through manipulation cases.”).

166. See, e.g., *id.* at 1043 (“[M]anipulation cases generally have not fared well with either the CFTC or the courts.”); see also McGee & Frank, *Hard to Prove*, *supra* note 40 (“In the 21 years of the agency’s existence, it has yet to win a manipulation case that has been contested in front of a judge or jury.”); Pirrong, *Critical Analysis*, *supra* note 35, at 959 (stating that regulatory decisions regarding manipulation are “an embarrassment—confusing, contradictory, complex, and unsophisticated.”) (quoting McDermott, *supra* note 51, at 205).

167. See, e.g., *supra* note 95 and accompanying text (noting the debate between Professor Thel and Professors Fischel and Ross).

168. See generally Thel, *\$850,000*, *supra* note 95 (presenting an argument for why manipulation should be prohibited by statute); Fischel & Ross, *supra* note 45 (arguing that manipulation need not be prohibited). Although the debate between the professors focused primarily on the securities markets, both discussions generally add valuable insight to the concept of manipulating markets. Fischel and Ross’ piece, however, does address manipulation as it specifically pertains to futures markets. See *id.* at 504-05, 547-52.

169. See Thel, *\$850,000*, *supra* note 95, at 221-24.

demand scrutinizing regulation.¹⁷⁰

Despite the fact that Thel's arguments focus on securities markets, his arguments with regard to manipulation are applicable to almost any organized trading forum. Thel highlights two major forms of manipulation: trade-based manipulation¹⁷¹ and contract-based manipulation.¹⁷² He acknowledges the fact that trade and contract-based manipulations are not the only two forms of manipulation.¹⁷³ His arguments demonstrate how manipulation actually functions in securities markets, and they counter Fischel and Ross's contention that manipulation does not require legal prohibition.¹⁷⁴ The crux of his claim is that "[m]anipulators can sometimes control prices with trad[ing], and by doing so they can reap profits, whether by taking advantage of preexisting contracts or by inducing other market participants to trade at manipulated prices."¹⁷⁵ Consequently, he challenges Fischel and Ross and contends that based on his argument that both contract and trade-based manipulation are problematic, manipulation should continue to be proscribed by statute.

In contrast, the heart of Fischel and Ross's argument is that traders will only try to manipulate prices if they believe that they can profit.¹⁷⁶ In order to profit, according to Fischel and Ross, manipulation requires two key elements.¹⁷⁷ First, a trader "must cause the price of the relevant security to rise; and second, the manipulator must be able to sell at a price higher than the price at which the manipulator purchased (plus transaction cost incurred)."¹⁷⁸ Unless a trader causes the first element, there is no potential for profit because there are transaction costs associated with trading.¹⁷⁹ Thus, traders will not attempt to move prices because the risks accompanying a manipulative scheme outweigh an unknown potential for profit.¹⁸⁰

Fischel and Ross specifically addressed the concept of manipulation as it relates to futures markets,¹⁸¹ stating that manipulation in futures markets does not require regulation.¹⁸² First, price manipulation in the futures markets demands huge amounts of capital.¹⁸³ Fischel and

170. See Fischel & Ross, *supra* note 45, at 507 ("[W]e conclude that the concept of manipulation should be abandoned altogether.").

171. See Thel, \$850,000, *supra* note 95, at 227-47.

172. See *id.* at 247-61.

173. See *id.*

174. See *id.*

175. *Id.* at 296-97.

176. See Fischel & Ross, *supra* note 45, at 511.

177. See *id.* at 512.

178. *Id.*

179. See *id.*

180. See *id.* at 512-19.

181. See *id.* at 542-52.

182. See *id.* at 548 (claiming that "legal prohibitions are unnecessary" in the futures markets).

183. See *id.* Notably, the Sumitomo scandal illustrated this fact. See *infra* note 270

Ross contend that as a result of the tremendous financial requirements, futures manipulation of financial futures contracts¹⁸⁴ is nearly impossible.¹⁸⁵ With regard to physical commodities such as copper, however, Fischel and Ross argue that although it is possible to increase the price of the commodity by withholding supplies from the market, this act does not necessarily ensure a profitable sale of a contemporaneously acquired large futures position.¹⁸⁶ Accordingly, they explain that one of the real problems in withholding a large physical supply from the market is the "burying the corpse"¹⁸⁷ effect that results after expiration of the futures contracts.¹⁸⁸ Upon expiration, according to Fischel and Ross, an alleged manipulator may not be able to sell his physicals position at a high price because less expensive substitutes for the physical commodity may be available to those requiring them.¹⁸⁹ As such, it can become very difficult for a manipulator to profit unless the gains earned by offsetting their futures positions with the shorts exceed the losses sustained while burying the corpse.¹⁹⁰

In addition to the problems associated with trying to profit from a manipulation, Fischel and Ross assert that futures exchanges have incentives to "adopt trading rules and contract terms that reduce the costs associated with the exercise of monopoly power that may result from corners and squeezes."¹⁹¹ As noted earlier, futures are traded on organized exchanges.¹⁹² Hence, in order to stay in business, these exchanges must compete with one another as well as with other

(discussing the capital required to complete Hamanaka's plan).

184. See, e.g., *supra* text accompanying note 45 (describing financial futures contracts); see also Fischel & Ross, *supra* note 45, at 547 n.193 (discussing particular futures markets, such as the Treasury bill market, that the authors believe are extremely difficult, if not utterly impossible, to manipulate).

185. See *supra* note 184. It is important to mention that this Note does not take any position with regard to cash settled contracts. See *supra* note 62 (discussing the S&P 500 stock index future).

186. See Fischel & Ross, *supra* note 45, at 547-48.

187. See *supra* note 112 (explaining the "burying the corpse" effect as it relates to a long market power manipulation).

188. See Fischel & Ross, *supra* note 45, at 547.

189. See *id.* at 547-48.

190. See *id.* at 548. According to the professors:

[A]lthough a would-be manipulator in futures markets may be confident that his position will cause prices to be higher at expiration than would otherwise be the case (because of inelastic demand at expiration), he has no assurance that the price at expiration will yield him a profit. An unexpected increase in deliverable supplies or a reduction in demand could cause prices to be lower than anticipated. Even if such conditions do not occur at expiration, they may occur before the manipulator has been able to unwind his position after expiration.

Id.

191. *Id.* at 548-49.

192. See *supra* notes 46-47 and accompanying text.

securities markets.¹⁹³ Fischel and Ross argue that in order to maintain competitiveness, the exchanges must adopt rules (e.g. position limits) that will protect their members from harmful exercises of monopolistic power.¹⁹⁴

At the same time, Fischel and Ross also recognize that a regulatory system that completely proscribes large positions may be harmful to the hedging and price discovery functions of the futures markets.¹⁹⁵ They observe that the exercise of market power is possibly a bad enough act that it should be prohibited.¹⁹⁶ Nonetheless, they also point out that market power can result from legitimate trading as well as from trading that is merely designed to affect price.¹⁹⁷ As a result, they propose that "optimal rules might not seek to prevent all exercises of market power."¹⁹⁸ Ultimately, the crux of their argument is that manipulation is really self-detering and "because the enforcement of prohibitions is likely to be costly, actual trades should not be prohibited as manipulative regardless of the trader's intent."¹⁹⁹

Several commentators,²⁰⁰ in addition to Thel, Fischel, and Ross, have posited alternative strategies for confronting manipulation.²⁰¹ The bulk of these other proposed solutions does not address whether manipulation is really a problem, but rather, they attempt to deal with manipulation *ex post*, by providing alternate definitions of, or standards for, manipulation. In other words, the following group of commentators challenges the current definition of manipulation and attempts to craft alternative methods of how to deal with the problem effectively.

One commentator, Professor Perdue, confronts manipulation from an *ex post* viewpoint and argues that artificial price analysis²⁰² for determining a manipulated price "substitutes one unhelpful term for another."²⁰³ Instead of applying the more financial-economic approach to manipulation, Perdue establishes a "but-for" test to determine whether conduct violates the manipulation provisions²⁰⁴ of

193. See Fischel & Ross, *supra* note 45, at 549.

194. See *id.*

195. See *id.*

196. See *id.* at 544 n.182.

197. See *id.* at 546.

198. *Id.* at 549.

199. *Id.* at 553.

200. This Note will focus primarily on the commentators that addressed futures market manipulation in the 1990's. In fact, a greater number of proposed solutions were written in the 1970's. The more recent articles, however, are more applicable to current market conditions.

201. See Friedman, *supra* note 25; Lower, *supra* note 47; Markham, *Unprosecutable Crime*, *supra* note 25; Pirrong, *Critical Analysis*, *supra* note 35; Perdue, *supra* note 66.

202. See *supra* notes 135-51 and accompanying text (discussing artificial price and the problems that accompany this method of assessing manipulated prices).

203. Perdue, *supra* note 66, at 348.

204. See *supra* notes 8-10 (citing the anti-manipulation provisions).

the CEA.²⁰⁵ Essentially, she engages in an objective inquiry: but-for the price impact on the market the alleged manipulator would not have behaved the way she did.²⁰⁶

Perdue's formula establishes a more simplified and seemingly elegant approach to manipulation, and it effectively inquires into a trader's intent: Was it manipulative, and therefore punishable, or was it innocent, and therefore, by definition, not manipulative? Proving intent in manipulation cases, however, is highly problematic.²⁰⁷ Due to the fact that "proof of intent will most often be circumstantial in nature, manipulative intent must normally be shown inferentially from the conduct of the accused."²⁰⁸ Establishing inferential intent, however, for large-scale players in the physical commodity markets, is not always easy. If, for example, a trader establishes a large long futures position as a hedge for a physical transaction, and subsequently holds that position until expiration, he may not be guilty of holding out for a price impact because he originally had a valid hedge position.²⁰⁹ Thus, this example provides at least one predictable situation in which Perdue's approach would not provide an adequate solution.

Moreover, Perdue's formulation of manipulation eliminates the need to determine whether the suspect price is not the price that would have been witnessed absent the activity of the accused. If a plaintiff, however, is not required to demonstrate that a trader's conduct had a negative price impact on the market, then any suspect activity could be deemed manipulative. Congress prohibited manipulation to protect the pricing function of the futures markets, and as such, creating an anti-manipulation scheme that does not include price analysis would stray outside of the purpose of the CEA.²¹⁰

205. See Perdue, *supra* note 66, at 348. Perdue defines manipulation "as conduct that would be uneconomical or irrational, absent an effect on market price." *Id.*

206. Perdue gives an objective phrasing of her proposed standard three times. See Perdue, *supra* note 66, at 348, 393, & 401. However, she also provides two other versions using subjective phrasing: "[M]anipulation occurs when the trader's expectation of profit derives primarily from his expectation that his transactions will affect the market," *id.* at 358, and "manipulation [is] any conduct where the anticipated profitability of that conduct depends on its affecting the price of the commodity traded." *Id.* at 395-96. Her last definition is quite ambiguous. She states that a finding of manipulation should be based upon "conduct that appears uneconomic absent a manipulative intent. Proof of such conduct should be sufficient to establish a prima facie case of manipulation . . . [which would then shift] the burden . . . to the defendant to articulate a legitimate, nonmanipulative reason for the conduct." *Id.* at 400.

207. See *supra* notes 155-58 and accompanying text.

208. *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,283 (CFTC Dec. 17, 1982).

209. See Freidman, *supra* note 25, at 37-38.

210. See *supra* notes 80-86 and accompanying text.

In response to this flaw, another commentator, Professor Friedman, modified Perdue's method.²¹¹ He proposed that a judicial body ask two questions.²¹² First, the judicial body should query "what the long [trader] would have done if he simply did not take the anticipated impact into account," and second, "what the long would have done had he put out of mind the additional pressure created by a system of punitive sanctions for default."²¹³ Put differently, Professor Friedman advocates that an adjudicative body should inquire whether a person would have acted similarly "if some aspect of reality were altered or disregarded."²¹⁴ Although his approach seeks to determine the root of a market power manipulation charge, it also suffers from the same intent-based flaws present in Professor Perdue's formulation.²¹⁵ Unlike Perdue's approach, however, Professor Friedman does not discount the use of price distortions.²¹⁶ Nevertheless, his method still remains weak because of the tremendous confusion currently surrounding the concept of price artificiality.²¹⁷

Perhaps the approach offered by Professor Stephen Craig Pirrong is best suited to tackle the manipulation dilemma. Although the Commission in *Indiana Farm Bureau* rejected the use of historical prices as a means of determining price artificiality,²¹⁸ Professor Pirrong clearly believes in the use of such information.²¹⁹ He proposes "utilizing historical data and universally accepted statistical hypothesis-testing techniques."²²⁰ Although his approach may be the most accurate from an *ex post* standpoint, his proposal is unnecessary because the current statutory and regulatory requirements prevent market participants from effectuating unfavorable manipulative schemes.²²¹

Finally, Professor Jerry Markham described manipulation as the "unprosecutable crime."²²² In accordance with his position that prosecuting manipulation cases is virtually impossible,²²³ he argues both for amending manipulation law, in order to clarify the

211. See Friedman, *supra* note 25, at 38.

212. See *id.* at 58-59.

213. *Id.* at 59. The second question with regard to Professor Friedman's proposal focuses on the draconian sanctions that shorts must pay if they default on a contract. See *supra* text accompanying note 104.

214. Friedman, *supra* note 25, at 59.

215. See *supra* notes 207-10 and accompanying text.

216. See Friedman, *supra* note 25, at 54-57.

217. See *supra* notes 135-54 and accompanying text; see also Pirrong, *Critical Analysis*, *supra* note 25, at 991 (claiming that because the use of historical prices was discredited by the CFTC in *Indiana Farm Bureau*, Professor Friedman's formula will not work without "rehabilitation of the price artificiality doctrine").

218. See *supra* note 217 and accompanying text.

219. See Pirrong, *Critical Analysis*, *supra* note 35, at 995.

220. *Id.*

221. See *infra* Part III.B.1.

222. Markham, *Unprosecutable Crime*, *supra* note 25, at 281.

223. See *id.* at 357.

ambiguities, and for a more affirmative regulatory role for the CFTC. He contends that the four-part test²²⁴ that the Commission is required to prove is a “daunting, indeed impossible, task for the CFTC staff.”²²⁵ Professor Markham criticized commentators who attempt to solve the manipulation puzzle by simply searching for a more workable definition.²²⁶ His solution calls for more affirmative measures by the CFTC.²²⁷ He proposes increased daily surveillance by the CFTC over the life of a contract,²²⁸ and furthermore, he desires more careful oversight of the cash markets as well.²²⁹

II. THE SUMITOMO SCANDAL

Even in the midst of the confusion surrounding the concept of manipulation, the Commission in *In re Sumitomo Corp.*,²³⁰ articulated the aforementioned²³¹ four-part analysis and determined that Sumitomo successfully completed a long market power manipulation in violation of the CEA.²³² Part II of this Note seeks to decipher the events of Sumitomo’s manipulation, one of the most elaborate manipulation schemes in the history of commodities trading. This part will examine the Sumitomo scandal as an example of market power manipulation, particularly in the context of whether manipulation is truly a problem. Although Hamanaka’s actions adversely affected the market, the outlandish nature of the case made it an anomaly rather than evidence of an unchecked problem.

In June 1996, the headline to an article in the *Wall Street Journal Europe edition* announced, “Copper Prices Plummet in London on Tremors from Sumitomo Fiasco.”²³³ Finally, the world began to witness the fallout of Yasuo Hamanaka’s decade-long scheme to

224. See *supra* text accompanying note 129.

225. Markham, *Unprosecutable Crime*, *supra* note 25, at 357.

226. See *id.* at 358-61.

227. See *id.* at 363 (“[T]he CFTC must play a much more affirmative role in the market place. It must simplify prosecutions, and its goal must be to assure a ‘fair and orderly’ market.”).

228. See *id.* at 365.

229. See *id.* at 365-66.

230. The full title of the order reads, “Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act and Findings and Order Imposing Remedial Sanctions.” See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,496 (CFTC May 11, 1998) [hereinafter Order Imposing Remedial Sanctions]. Importantly, none of the factual findings in the CFTC’s order were adjudicated. Sumitomo stipulated to all alleged facts in the order pursuant to its settlement. See *id.* The same problem holds true for the many factual findings in the Merrill Lynch settlement. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,686, at 48,248 (CFTC May 20, 1999).

231. See *supra* note 129 and accompanying text.

232. See *supra* notes 8-10.

233. *Copper Prices Plummet in London on Tremors from Sumitomo Fiasco*, Wall St. J. Eur., June 25, 1996, at 21.

control the price of copper.²³⁴ Hamanaka, one of the most feared traders in the world's copper market,²³⁵ was appointed as the head copper trader for Sumitomo Corporation around 1986.²³⁶ Prior to 1986, however, Mr. Hamanaka purchased and sold physical copper as a trader for the Non-Ferrous Metals Department of Sumitomo.²³⁷ In the period immediately preceding and subsequent to Hamanaka's appointment as head copper trader, from approximately 1986 to 1989, the Sumitomo Copper Team²³⁸ suffered tremendous losses.²³⁹ The dramatic losses largely resulted from purchases and sales of actual copper, made by Hamanaka, in conjunction with speculative futures trading, which was an attempt by Hamanaka to recover losses from previous physical copper dealings.²⁴⁰ According to the CFTC, Hamanaka "lied to his superiors, destroyed documents, falsified trading data and forged signatures" in order to hide his losses.²⁴¹ In fact, Hamanaka employed a secret book whereby he hid the records of his unauthorized trading.²⁴² In an attempt to redeem his failed trading, Hamanaka devised a plan allowing him to control the price of copper and recapture his previous losses.²⁴³

The plot began in 1989, when Yasuo Hamanaka met with David Campbell ("Campbell"), then president of the private metals trading firm RST Resources, Inc. ("RST"), at a privileged business meeting.²⁴⁴ At that meeting, Hamanaka allegedly disclosed to Campbell his intention to "squeeze" the world copper market in an attempt to drive up the price of copper.²⁴⁵ Subsequently, from 1989 to 1992, Hamanaka conducted a significant amount of business with RST, eventually becoming the company's largest client.²⁴⁶ In 1993,

234. See Fred Vogelstein & Stephen Frank, *Sumitomo Says Unauthorized Dealings In Copper Caused \$1.8 Billion in Losses*, Wall St. J., June 14, 1996, at A3 [hereinafter Frank, *Unauthorized Dealings*].

235. See Vogelstein & Frank, *supra* note 234, at A3 (describing Hamanaka as "flamboyant . . . who until recently was the world's most powerful copper trader—and the one most feared by other traders.").

236. See Dwyer, *supra* note 2, at 29.

237. See *In re Sumitomo Corp.* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,497 (CFTC May 11, 1998).

238. See *supra* note 3.

239. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 46,497.

240. See *id.*

241. *Id.* & n.2.

242. See *id.* at 46,497.

243. See *id.* Hamanaka admitted under oath, as part of a guilty plea to fraud and forgery in a Japanese court, that he used complex accounting and trading techniques to hide his unauthorized trading. See *id.* at 46,497 n.2.

244. See Stephen E. Frank, 'The Fancy Deal': *Sumitomo's Business Fuels Rapid Growth of Global Minerals*, Wall St. J. Eur., June 24, 1996, at 1.

245. See *id.* Mr. Campbell's attorney denied that Hamanaka and Campbell ever discussed the proposed "squeeze." See *id.*; see also *supra* notes 99-112 and accompanying text (describing the elements of a long market power manipulation).

246. See Frank, *supra* note 244.

however, with \$1,000,000 dollars in hand, Campbell resigned from RST and founded Global Minerals & Metals Corp. ("Global").²⁴⁷ Afterwards, Sumitomo ceased doing business with RST and became Global's largest client.²⁴⁸

The move by Campbell to establish Global allowed Hamanaka to execute the first of many carefully timed maneuvers. First, Hamanaka and Campbell entered into a string of intricate agreements whereby Sumitomo agreed to make monthly purchases of copper from Global from 1994 to 1997.²⁴⁹ The agreements took form in "a series of supply contracts that contained unusual minimum price and price participation provisions."²⁵⁰ Ultimately, the goal of these agreements was to establish the appearance of "legitimate and genuine commercial need to obtain physical copper."²⁵¹ In order to complete this plan, Global would purchase copper warrants²⁵² from a Zambian copper producer.²⁵³ Subsequently, Global would sell the copper to Sumitomo, and finally Sumitomo would complete the circle by selling the same amount of copper back to the Zambian firm.²⁵⁴ As a result of the paper ("book")²⁵⁵ transactions, Hamanaka established a façade of legitimate business, thereby providing him with "false commercial

247. See *id.* Global is a New York-based metal trading firm. See *id.* A complaint, filed by the CFTC, alleged that Global manipulated the price of copper between October and December of 1995. See *In re Global Minerals & Metals Corp. and Merrill Lynch & Co.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,649, at 48,094-95 (May 20, 1999).

248. See Frank, *supra* note 244.

249. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,497 (CFTC May 11, 1998).

250. *Id.* The minimum price provision obligated Sumitomo to purchase the copper from Global at either the settlement price on the LME, or at a minimum price set by Sumitomo—whichever was higher. See *id.* In other words, the minimum price agreements kept cash copper prices at a minimum level set by Sumitomo. In addition, the price participation provision required Global to pay Sumitomo 30% of the difference between the market price at the time of shipment and the minimum price on futures contracts used to "hedge" the supply contracts. See *id.* These contracts allowed both parties to benefit from price appreciation of copper. See *id.*

251. *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249 n.1.

252. A warrant is a "[c]ertificate of physical deposit, which gives title to physical metal in an exchange approved warehouse." Glossary, *supra* note 55, at 42.

253. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,093. Hamanaka, through Global and other small brokers, purchased extensively in the unregulated cash market for copper. See Suzanne McGee & Stephen E. Frank, *CFTC Probes Unusual Loans to Sumitomo*, Wall St. J., July 23, 1996, at A2 [hereinafter McGee & Frank, *Unusual Loans*]. The funding to make such large purchases allegedly came from two loans, a \$400 million dollar loan from J.P. Morgan & Co., and a \$500 million dollar loan from Chase Manhattan Corp. See *id.*

254. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,093.

255. See *id.*

justification”²⁵⁶ to establish a large futures position supposedly hedging the illusory delivery obligations.²⁵⁷

The second step in Hamanaka’s scheme mandated the establishment of a massive futures position.²⁵⁸ In order to acquire the necessary futures contracts on the London Metal Exchange (“LME”),²⁵⁹ Sumitomo opened an account with Merrill Lynch (“Merrill”), and designated the “B” account, authorizing Global to trade using Sumitomo’s vast line of credit.²⁶⁰ This move provided Global, a thinly capitalized start-up company, with instant credibility and the necessary credit to purchase the large number of futures contracts needed to effectuate Hamanaka’s planned course of action.²⁶¹

Using the “B” account, Global began to establish a large long position in LME copper futures.²⁶² By September of 1995, Global acquired an open long futures position²⁶³ of 780,000 metric tons of copper.²⁶⁴ Through the use of other small brokers²⁶⁵ in combination

256. *Id.* Somewhat ironically, in a 1991 interview, Mr. Hamanaka said, “‘Because we trade so much volume, say, at a peak of several hundreds of thousands tons in absolute volume, it may look like engaging in speculation.’” See Frank, *Unauthorized Dealings*, *supra* note 234.

257. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,093.

258. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,497 (CFTC May 11, 1998).

259. The LME has been characterized as “the center for global metals trading.” McGee & Frank, *Metal Detection*, *infra* note 275; see also *Reactions to Sumitomo Loss Proliferate as Copper-Market Volatility Continues*, Wall St. J. Eur., June 24, 1996, at 23 (claiming that “90% of copper exchange business is done [on the LME]”). Furthermore, the main page of the LME website states that one of the primary focuses of the LME is to provide a hedging function to non-ferrous, metal-based industries. See *LME website* (visited Feb. 26, 2000) <<http://www.lme.co.uk/cgi-bin/main1.cgi>>.

260. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249. According to the CFTC, a Managing Director at Merrill suggested using this type of account. See *id.* The account gave Global “power of attorney over the trading in these ‘B’ accounts pursuant to documentation on which [Hamanaka] forged the signatures of his superiors.” *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 46,498. Additionally, Merrill provided trading advice to Global and Sumitomo on how to acquire both a dominant cash and futures position. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,250.

261. See Frank, *supra* note 244.

262. See *In re Global Minerals & Metals Corp.* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249. Presumably, Hamanaka ceased trading on the U.S. markets, namely the Commodities Exchange, Inc. (“Comex”), a U.S. exchange where copper futures are actively traded, as a result of the strict disclosure requirements dictated by the CFTC. See McGee & Frank, *Metal Detection*, *infra* note 275. The LME allegedly had more lax supervision, a perfect setting in which to implement Hamanaka’s plan. See *infra* note 287 and accompanying text.

263. An “open” position is one where the contracts, either purchased or sold, have not expired and the trader has not entered into offsetting transactions.

264. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249.

with the "B" account, Sumitomo possessed two million metric tons of copper in the form of futures and owned nearly one half of LME copper warrants.²⁶⁶ At this point, Hamanaka began to unwind²⁶⁷ the futures positions by taking delivery on expiring futures contracts to further his plan to control the cash supply of copper and ultimately generate large profits.²⁶⁸ He masked this scheme under the rubric of legitimate commercial need for physical copper.²⁶⁹ Merrill, through the "B" account, provided Global with the financing necessary to take delivery on the LME warrants.²⁷⁰ By November 1995, Sumitomo controlled virtually 100% of the LME warehouse receipts.²⁷¹ Moreover, throughout the fourth quarter of 1995, Sumitomo maintained a dominant and controlling LME futures position.²⁷²

The structure of Hamanaka's positions placed him in an ideal position to execute a market power manipulation.²⁷³ He not only obtained a dominant position in the cash market, but he also established a powerful long futures position.²⁷⁴ These positions would force traders who previously sold copper futures, and who innocently waited until the end of the delivery period, to run to Hamanaka to offset their positions at prices that Hamanaka could virtually dictate.

265. Allegedly, Hamanaka conducted some business through Winchester Metals Ltd., the metal trading division of Winchester Commodities Group Ltd. See Stephen E. Frank, *U.S. Grand Jury to Probe Sumitomo Trader's Moves*, Wall St. J., June 18, 1996, at C1. In addition, it was alleged that Hamanaka made purchases through Rudolff Wolff, another brokerage house in London. See *id.*

266. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249. A "[w]arrant or Warehouse Receipt for Metals" is a "[c]ertificate of physical deposit, which gives title to physical metal in an exchange approved warehouse." Glossary, *supra* note 55, at 42.

267. Generally, to "unwind" refers to the act of offsetting or taking delivery on a futures position. See Glossary, *supra* note 55, at 8 ("Closing-out"); see also *supra* notes 61-63 (explaining the process of offsetting a position).

268. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249.

269. See *supra* notes 249-57 and accompanying text.

270. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,249. In total, Merrill financed \$500 million to purchase the warrants. See *id.* Additionally, Merrill loaned \$100 million under a Commodity Inventory Purchase Obligation ("CIPO") credit line in order "to finance the acquisition of the premium grade and location copper which was selected through the purported 'sifting' of the warrants received on delivery and which was to be shipped to Sumitomo." *Id.*

271. See *In re Sumitomo Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,498 (CFTC May 11, 1998). Specifically, on November 24, 1995, Sumitomo, through its account at Merrill, controlled 8098 of 8666 (93%) LME copper warrants. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 48,250.

272. See *In re Sumitomo Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH), at 46,498.

273. See *supra* notes 97-112 and accompanying text for discussion of market power.

274. See *id.*

The LME's decision, in late 1994, to open a warehouse in Long Beach, California, would ultimately impact U.S. markets and would also prove to be devastating to Hamanaka's scheme.²⁷⁵ The warehouse allowed LME clients to store copper, and it gave North American customers easy access to the metal.²⁷⁶ The opening of the warehouse by the LME prompted an "angry response from Daniel Rappaport, the feisty chairman of the New York Mercantile Exchange,"²⁷⁷ which initially sounded like childish jealousy.²⁷⁸ During the fall of 1995, however, copper prices began to rise and cash supplies began to tighten.²⁷⁹ The constricted cash market resulted from copper continuously flowing into LME warehouses, while none ever seemed to leave. This effect was a natural consequence of Hamanaka's and Global's actions.²⁸⁰ Consequently, cash copper began to exceed the prices for copper futures.²⁸¹ This inversion of futures prices to cash prices, referred to as "backwardation" by market participants, may signal that someone is trying to control the supply of a commodity.²⁸²

Importantly, because there is a direct correlation between copper prices on the LME and those on the Commodity Exchange, Inc. ("Comex"), prices in the United States were affected.²⁸³ LME futures began to trade at a premium over Comex futures.²⁸⁴ The higher LME futures prices in turn caused copper supplies to move from Comex warehouses into the LME's Long Beach warehouse.²⁸⁵ The significant

275. See Suzanne McGee & Stephen E. Frank, *Metal Detection: Sumitomo Debacle is Tied to Lax Controls by Firm, Regulators*, Wall St. J., June 17, 1996, at A1 [hereinafter McGee & Frank, *Metal Detection*].

276. See *id.*

277. *Id.*

278. See *id.* Mr. Rappaport believed that the LME's Long Beach warehouse was an attempt to eradicate the copper business of the Comex division of the New York Mercantile Exchange. See Suzanne McGee & Stephen E. Frank, *Warehouse Effect: Sumitomo's Losses Add Fuel to Debate on Lax Supervision*, Wall St. J. Eur., June 17, 1996, at 1 [hereinafter McGee & Frank, *Warehouse Effect*].

279. See McGee & Frank, *Metal Detection*, supra note 275.

280. See *id.*

281. See Brian P. Volkman, *Defining The Role of Commodities Regulators*, 19 N.Y.L. Sch. J. Int'l & Comp. L. 215, 219 (1999).

282. See *id.* at 219-20. The opposite of backwardation is "contango," which is a "[m]arket situation in which prices in succeeding delivery months are progressively higher than in the nearest delivery month." Glossary, supra note 55, at 10. The reason for contango is that a futures position generally reflects the cost of holding the commodity. See Satyajit Das, *Swaps and Financial Derivatives* 505 (2d ed. 1994). Incorporated in holding costs are interest expenses incurred in funding the holding of a cash commodity. See *id.* In addition, there are storage costs and the possibility of "the physical loss of the commodity through wastage and deterioration of the quality." *Id.* (emphasis in original).

283. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327, at 46,498 (CFTC May 11, 1998).

284. See *id.* at 46,498-99.

285. See *id.*

movement of copper supplies to the LME warehouse, in late fall 1995, finally moved the CFTC to start an investigation.²⁸⁶

Problematically, however, the CFTC could not initially identify the controlling party due to a slow response and denial by the LME of any market irregularities.²⁸⁷ Unbeknownst to international regulators, the large build-up of LME copper was in fact the result of the significant purchases of LME copper warrants by Hamanaka and Global.²⁸⁸ Hamanaka continued to take control of the LME copper warrants and maintained dominant futures positions well into the spring of 1996.²⁸⁹ At one point, copper prices reached an outstanding \$2,800 per metric ton due to the manipulator's activities.²⁹⁰ Finally, however, in April 1996, after numerous complaints and letters by the CFTC to the LME, British regulators and the Sumitomo Corporation finally agreed to cooperate in the Commission's investigation.²⁹¹

The investigation that ensued opened up a can of worms that no one foresaw. During the investigation, a clerk at Sumitomo discovered the unauthorized accounts at Merrill and several other small brokerage houses, and subsequently reported them to his superiors.²⁹² Sumitomo quickly removed Hamanaka from his post as head copper trader on May 9, 1996.²⁹³ Hamanaka's removal occurred, however, before he could fully unwind his futures and cash positions at the high price that he had orchestrated.²⁹⁴ In the months that followed his removal, Sumitomo began to sell off the positions amassed by Hamanaka, thereby causing copper prices to plummet.²⁹⁵ On June 5, 1996, before investigators had full opportunity to uncover Hamanaka's grand scheme, Hamanaka called one of his superiors and confessed.²⁹⁶ Yasuo Hamanaka's great copper caper had ended!²⁹⁷

286. See Dwyer, *supra* note 2, at 28.

287. See McGee & Frank, *Metal Detection*, *supra* note 275. In fact, the LME historically has a reputation for lax supervision. One observer went so far as to "blast the [LME's] lackluster efforts at surveillance and enforcement as well as its lax disclosure requirements and criticize rules they say could allow *rogue traders to flourish*." *Id.* (emphasis added).

288. See *In re Global Minerals & Metals Corp.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,686, at 48,249 (CFTC May 20, 1999).

289. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 46,498.

290. See *id.*

291. See McGee & Frank, *Metal Detection*, *supra* note 275.

292. See McGee & Frank, *Warehouse Effect*, *supra* note 278.

293. See *id.*

294. See Vogelstein & Frank, *supra* note 234.

295. See, e.g., *supra* note 233 ("The benchmark three-month copper futures on the London Metal Exchange plunged to a 2 1/2-year low of \$1,785 a ton . . ."). The \$1,785 price, cited on June 25, 1996, is more than \$1000 a ton less than the price of \$2,800 reached in May 1996. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 46,498.

296. See Dwyer, *supra* note 2, at 28.

297. Ultimately, Hamanaka left Sumitomo with \$2.6 billion in losses and an additional \$200 million necessary to settle multiple lawsuits. See *supra* notes 5-6 and

Ultimately, the CFTC found that as a result of Hamanaka's activity, Sumitomo Corporation *intentionally caused artificial prices* in the copper markets.²⁹⁸

The most glaring aspects of the Sumitomo scandal are that it not only required a great deal of intricacy, but that it also demanded incredible levels of time and capital. Hamanaka, through Global, borrowed in excess of \$600 million from Merrill Lynch alone.²⁹⁹ Moreover, the plan took Hamanaka almost eight years to implement fully.³⁰⁰ Consequently, if future manipulative schemes require anywhere near the level of complexity of the Sumitomo scandal, then manipulation is arguably not the rampant problem that regulators believe. Furthermore, the current U.S. regulatory structure is arguably sufficient to prevent rogue traders like Hamanaka from effectuating harmful manipulative schemes.

III. A PRAGMATIC SOLUTION FOR PREVENTING MARKET POWER MANIPULATIONS

Although some commentators believe that increased regulation is necessary to prevent another Sumitomo-like situation,³⁰¹ the current system is arguably adequate to preclude a trader from obtaining market power because the disclosure requirements are rigorous and hinder attempted acquisitions of market dominance. In order to prevent the risk that large traders will speculate, however, more stringent monitoring of the hedging exemption is necessary to determine when hedgers truly have a legitimate commercial purpose. Furthermore, because Hamanaka took refuge on foreign exchanges, it is extremely important that international regulators continue their effort towards establishing a functional and collaborative system to share information.³⁰² When the CFTC observed abnormal supplies of copper flowing from Comex warehouses into LME warehouses, followed by outrageous price increases on U.S. exchanges, the CFTC and British regulators should have been working side-by-side to uncover the root cause of these irregularities. This kind of collaboration could potentially have stopped Hamanaka's manipulation much earlier.

accompanying text.

298. See *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 46,499-46,500.

299. See *supra* note 270 (detailing Hamanaka's borrowing from Merrill Lynch). To date, Hamanaka's other borrowings have not been made public.

300. See text accompanying *supra* notes 244-46 (describing how Hamanaka began the initial stages of his plan as early as 1989). The actual price rises did not occur until the fall of 1995, and they continued until the spring of 1996. See text accompanying *supra* note 289-90.

301. See *supra* notes 227-29 and accompanying text.

302. See *infra* Part III.C.3. (discussing the Tokyo Commodity Futures Markets Regulators' Conference).

This part begins by exploring the regulatory structure set out in the CEA, and explaining how the current system prevents the acquisition of market power by individuals whose sole objective is to adversely affect prices. It then proposes that in order to prevent the risk of speculation by large market participants who use the hedging exemption by claiming that they have legitimate business needs, it is essential that the CFTC more carefully monitor those falling under the exemption. Finally, this part outlines the proposed cooperative measures of the Tokyo Commodity Market Regulators' Futures Conference, an international regulatory discussion that confronted the issue of manipulation. It concludes that the combination of the current regulatory scheme, tougher monitoring of the hedging exemption, and continuing cooperative efforts by international regulators will protect prices on U.S. markets and stifle the efforts of traders, such as Hamanaka, who attempt to move prices by acquiring market power.

A. Current Regulatory Structure

At present, the CEA explicitly places position limits on excessive speculation.³⁰³ While recognizing the invaluable function of speculators to the hedging process, Congress also sought to curtail detrimental speculation.³⁰⁴ Ironically, however, according to the CFTC, the bulk of market power manipulation cases have been brought against parties making use of the hedging exemption.³⁰⁵

The regulations provide a system whereby the secrecy required to obtain market power is virtually eliminated, even for traders who qualify for the hedging exemption. For example, 17 C.F.R. § 15.01 (d)(1) provides that those persons³⁰⁶ holding positions in excess of the position limits of 17 C.F.R. § 150.2, "any part of which constitutes bona fide hedging positions" within the terms of 17 C.F.R. § 1.3(z) of the regulations, are required to report their positions to the CFTC.³⁰⁷ Although 17 C.F.R. § 150.2 only includes certain commodities,³⁰⁸ the CFTC could add additional commodities to the list, such as copper, in order to increase protection in markets susceptible to manipulative

303. See *supra* notes 77-79 and accompanying text.

304. See *supra* notes 21-30, 70-79 and accompanying text (discussing the excessive speculation prohibitions under the CEA).

305. See Markham, *Unprosecutable Crime*, *supra* note 25, at 370; see also Snider, *supra* note 22, § 12.05, at 12-9, 12-10 n.34 ("It is ironic to note that many manipulations are conducted by hedgers who, because of their extensive commercial activity, are in an advantageous position based on their access to market information and ability to handle the cash commodity.")

306. See *supra* note 8 (defining the word "person" as used in the CEA).

307. 17 C.F.R. § 15.01(d)(1) (1999).

308. The commodities listed under 17 C.F.R. § 150.2 are: corn, oats, soybeans, wheat, soybean oil, soybean meal, hard red spring wheat, white wheat, oats, cotton no.2, and hard winter wheat.

activity. Determining which commodities are to be added to the list of 17 C.F.R. § 150.2 could be based on the susceptibility of a particular commodity to acquisitions of market power of both the futures and cash markets.

Furthermore, despite the fact that 17 C.F.R. § 150.3³⁰⁹ permits some persons to exceed the limits of 17 C.F.R. § 150.2 if they have a bona fide hedging position,³¹⁰ 17 C.F.R. § 15.01(d)(1) deters traders from attempting to hide speculative transactions under the mask of a bona fide hedge.³¹¹ The regulations outline the elements a person must include in a report and those seeking to abuse the hedging exemption will likely be unveiled when compelled to report their positions.³¹² Importantly, the quantity of physical stocks that a person owns as well as the “quantity of a fixed price sale commitment” that a person seeks to hedge are at least two items that must be included in a Commission-mandated report. These reporting requirements would, therefore, require companies like Sumitomo to expose large futures and cash positions which are truly speculative in nature, but which the company submits are bona fide hedging transactions. If the CFTC, for example, observed the establishment of an immense copper position on a U.S. exchange, the position would send a red flag to the CFTC that the commodity in question was an area that required further investigation. The investigation would subsequently lead them to Sumitomo, a risk that Hamanaka did not want to face.

In addition to reporting requirements for persons, the regulations require that organized exchanges set position limits for the parties that trade on the exchange.³¹³ Exchange-established limits provide an added level of protection against manipulative activity. The exchange-set position limits make it even more difficult to amass the requisite level of futures contracts needed to exercise market power.

Finally, § 4g(a) of the CEA requires any person registered with the CFTC as a “futures commission merchant [(“FCM”)],³¹⁴ introducing broker,³¹⁵ floor broker,³¹⁶ or floor trader³¹⁷ to keep reports of their

309. The exemption, however, is not granted without qualification. *See id.* § 150.3. Section 150.3 permits the CFTC to “call for information” if a person claims an exemption from the speculative limits. *Id.* § 150.3 (ii)(b).

310. *See id.*

311. *See id.* § 15.01 (d)(1).

312. *See id.* § 19.01.

313. *See id.* § 150.2. Interestingly, a *Wall Street Journal* article published soon after the Sumitomo debacle was uncovered claimed that it would be easier to prosecute Sumitomo for violating position limits than manipulation. *See McGee & Frank, Hard to Prove, supra* note 40.

314. Futures commission merchants (“FCM”) are defined as “[i]ndividuals, associations, partnerships, corporations and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that accept payment from or extend credit to those whose orders are accepted.” Glossary, *supra* note 55, at 19 (emphasis added).

315. An introducing broker (“IB”) is:

activity and to "keep such books and records open to... the Commission."³¹⁸ An FCM must maintain records in a manner in which trades by customers are capable of being matched with the trades that are reported in an exchange's daily reports.³¹⁹ For example, the regulations require contract markets (e.g. NYMEX) to give detailed daily reports to the CFTC, including the open interest in a contract for that day and the number of contracts purchased and sold.³²⁰ Furthermore, the section of the regulations entitled "Special Calls" authorizes the Commission, at its request, to discover all information pertaining to accounts held by an FCM.³²¹ Specifically, the Commission, under 17 C.F.R. § 21.02, can demand the names of traders and the positions they hold through the FCM.³²² As a result, the CFTC can uncover a large position that a company like Sumitomo is attempting to conceal using its FCM (e.g. Global).³²³

The stringent regulatory structure under the CEA is precisely one of the reasons that Hamanaka ceased trading activity on U.S. exchanges.³²⁴ If Hamanaka sought to trade on U.S. exchanges, the regulatory agencies would monitor his every move and could at any time inquire into suspect trading activity by obtaining position reports from Sumitomo, Global, and the exchanges. The combination of reporting and disclosure requirements creates such a risk of being exposed that even rogue traders, who do not care whether they trade legally or illegally,³²⁵ would not attempt manipulative schemes because the chances of success are slim to none. Hamanaka's scandal flourished, however, because he was capable of establishing large speculative positions using the title of "hedger" and veiling his

[a]ny person (other than a person registered as an "associated person" of a futures commission merchant) who is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on an exchange who does not accept any money, securities, or property to margin, guarantee, or secure any trades or contracts that result therefrom.

Id. at 23.

316. A floor broker is "[a]ny person who, in any pit, ring, post or other place provided by a contract market for the meeting of persons similarly engaged, executes for another person any orders for the purchase or sale of any commodity for future delivery." *Id.* at 18.

317. A floor trader is "[a]n exchange member who executes his own trades by being personally present in the pit for futures trading." *Id.*

318. Commodity Exchange Act § 4g(a), 7 U.S.C. § 6g (1994).

319. See 17 C.F.R. § 17.00 (1999).

320. See *id.* § 16.00.

321. *Id.* § 21.00.

322. *Id.* § 21.02.

323. Although neither Global nor any of its members were ever registered with the CFTC in any capacity, see *In re Global Minerals & Metals Corp.* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. ¶ 27,649, at 48,090-91 (CFTC May 20, 1999), they would be required to register if they executed trades on U.S. exchanges. See Commodity Exchange Act § 4d, 7 U.S.C. § 6d.

324. See *supra* note 262.

325. See *supra* note 1 and accompanying text.

positions using Global as his FCM. Consequently, this Note encourages further oversight of the hedging exemption and increased steps by international regulators to share information and cooperate with investigations.

B. *Increased Monitoring of the Hedging Exemption*

One additional measure that could be adopted to prevent scandals resembling Sumitomo would be more careful monitoring of those who fall within the hedging exemption of § 4a(c) of the CEA.³²⁶ Greater monitoring would prevent a player who conducts large amounts of legitimate business on organized exchanges, such as Sumitomo, from parading as a speculator using a hedger's cloak. Although a trader may be required to report a hedged cash position, arguably the combination of surveillance and disclosure requirements would more effectively prevent rogue traders such as Yasuo Hamanaka from establishing illegitimate positions that merely seek to raise prices and extract unlawful profits.

Under the current system, the CFTC could discover a rogue trader's intentions because it would observe the amassing of an abnormally large position and could subsequently make a "special call"³²⁷ inquiring into its necessity. The ability to manipulate is dependent on secrecy,³²⁸ and the hedging exemption indirectly allows for large positions that have the potential to be harmful. Because most manipulation cases involve customers who fall under the hedging exemption,³²⁹ the CFTC must more carefully screen large traders who purport to have a bona fide hedge. By permitting the establishment of large or dominant positions, the CFTC runs the risk that the asserted hedge will actually be used for illegal speculation, which is precisely what regulators witnessed in the Sumitomo debacle. Hamanaka attempted to trade on U.S. exchanges and had the CFTC rigorously monitored his proclaimed hedges, the Sumitomo debacle would most likely have been avoided.

326. See Conference Report on the Futures Trading Practices Act of 1992, in Johnson & Hazen, 2D, *supra* note 4, at 128-30 (Supp. 1996). Additional regulation, however, may not be seen for several years. William Rainer, the new chairman of the CFTC, is less of a regulator than his predecessor Brooksley Born. See Cheryl Strauss Einhorn, *Going, Going... The CFTC's New Head Wants to Blast Heavy-Handed Regulation Out of the Park*, Barron's, Nov. 8, 1999, at 30. Rainer claimed that although he has more of an anti-regulation viewpoint with regard to cash-settled contracts, he is more cautious with regard to physical commodities. See *id.*

327. See *supra* notes 321-22 and accompanying text.

328. See *supra* text accompanying note 287 (discussing the fact that the CFTC could not discover who held the large futures positions on the LME).

329. See *supra* note 305 and accompanying text.

C. Increased International Regulatory Cooperation

If trading occurred only on U.S. exchanges, the CEA and accompanying regulations would arguably be sufficient to prevent large-scale manipulative schemes such as the one in Sumitomo. Because economics have become global, however, and as a result, a manipulator's actions can have worldwide effects, market regulators should cooperate on a more international level.³³⁰

Following the Sumitomo disaster in the fall of 1995 and spring of 1996, regulators recognized the importance of cooperation.³³¹ On October 31, 1997, seventeen commodity market regulators from sixteen countries met at the Tokyo Commodity Futures Markets Regulators' Conference to discuss proposed regulatory oversight of the world's commodity futures markets.³³² The two most relevant topics of the conference for dealing with market power manipulations were market surveillance and information sharing.³³³ The regulatory authorities at the conference endorsed standards for best practice, which they set out explicitly in the *Guidance on Components of Market Surveillance and Information Sharing*.³³⁴ With regard to market surveillance, the attendees of the conference agreed that they needed more routine collection of information about futures and cash market positions.³³⁵ In addition, they agreed to "cooperate to share information, in particular information on large exposures."³³⁶ Moreover, with respect to surveillance, the regulators concurred that they needed to establish better practices "to detect and to prevent abusive conduct."³³⁷ Additionally, the conference participants agreed

330. Section 12 authorizes the CFTC to cooperate with any foreign authority. See Commodity Exchange Act § 12(a). In addition, Title III of the Futures Trading Practice Act of 1992, "Assistance to Foreign Futures Authorities," provides increased authority for the CFTC to interact on a more international level. See Futures Trading Practices Act of 1992 §§ 301-05, Pub. L. 102-546, 106 Stat. 3590 (1992).

331. See Volkman, *supra* note 281, at 240.

332. See Tokyo Commodity Futures Markets Regulators' Conference 3 [hereinafter Tokyo Conference]. The represented authorities were: Australian Securities Commission (Australia), Comissão de Valores Mobiliários (Brazil), Canadian Grain Commission (Canada), Commission des Opérations de Bourse (France), Bundesaufsichtsamt für den Wertpapierhandel (Germany), Securities and Futures Commission (Hong Kong), Hungarian Banking and Capital Market Supervision (Hungary), Commissione Nazionale per le Società e la Borsa (Italy), Ministry of International Trade and Industry, Ministry of Agriculture, Forestry and Fisheries (Japan), Ministry of Finance and Economy (Korea), Securities Commission (Malaysia), Securities Board of the Netherlands (Netherlands), Singapore Trade Development Board (Singapore), Financial Services Board (South Africa), Financial Services Authority (United Kingdom), Commodity Futures Trading Commission (United States). See *id.* at 11.

333. See *id.* at 7.

334. See *id.*

335. See *id.* at 34.

336. *Id.* at 7.

337. *Id.* at 35.

that “[m]arket authorities should have access to information that permits them to identify concentrations of positions and the composition of the market.”³³⁸

Sumitomo was clear evidence of the fact that the LME had less stringent supervisory requirements than those of U.S. exchanges.³³⁹ For example, in 1996, the CFTC required disclosure of large positions, whereas the LME merely made it *voluntary* for brokers to report their large positions.³⁴⁰ As articulated by the chairman of the Chicago Board of Trade, large position reports arguably stifle the amount of business that large traders will conduct on an exchange.³⁴¹ On the other hand, the chairman of the NYMEX recognized that without the rigorous reporting requirements set by the CFTC, Hamanaka may have executed his attempt at manipulation directly on the U.S. exchange.³⁴²

Finally, the conference participants recommended that further work be undertaken to ensure effective information sharing among market regulators.³⁴³ The conference report stated that regulators need to share “relevant information concerning the supervision of their respective markets, both on a routine basis and as needed, and to promote communication among relevant personnel.”³⁴⁴ Moreover, the participants agreed that they should “support [] efforts to categorise and to prioritise the information which market authorities may wish to share during specific market events, such as the possibility of market manipulations.”³⁴⁵ The agreement to share information is vital in preventing further Sumitomo scandals. During the fall of 1995, when the CFTC noticed the backwardation³⁴⁶ in the copper market, the LME was reluctant to share information.³⁴⁷ Subsequent to Sumitomo, however, the CFTC and British regulators signed a Memorandum of Understanding in which they consented to cooperate with one another and to share supervisory information.³⁴⁸

In sum, the Tokyo Conference “encourages a parity of market surveillance and information sharing among the jurisdictions of its seventeen [sic] endorsing countries.”³⁴⁹ If implemented, the solutions proposed at the conference will make it much more difficult for rogue traders like Yasuo Hamanaka to effectuate manipulative schemes.

338. *Id.* at 7.

339. *See supra* Part III.A. (describing the strict regulatory scheme on United States futures markets as mandated by the CFTC).

340. *See Volkman, supra* note 281, at 237.

341. *See id.* at 238.

342. *See id.*

343. *See Tokyo Conference, supra* note 332, at 35.

344. *Id.* at 34.

345. *Id.* at 36.

346. *See supra* note 282 and accompanying text (describing backwardation).

347. *See Volkman, supra* note 281, at 239.

348. *See id.* at 239-40.

349. *Id.* at 240.

Problematically, the proposed cooperative measures will only work if the countries that endorsed the conference participants allow the regulators to establish effective systems for market surveillance and information sharing.³⁵⁰ The combination of current domestic and proposed international measures, nevertheless, are the right steps toward preventing a severe manipulation problem, and these measures provide the CFTC with multiple, simpler and quicker methods of prosecution.³⁵¹

CONCLUSION

The purpose of prohibiting the concept of manipulation, regardless of how one defines the term, is to avoid price movements that would not otherwise exist and which ultimately cause damage to other market participants. The CFTC is primarily concerned with protecting the integrity of U.S. markets. Hamanaka's trading activity in both the cash market for copper and in futures contracts on the LME caused radical price movements on U.S. exchanges. These price abnormalities were largely the result of three things. First, Hamanaka did not face the strict regulations that the CFTC imposes on U.S. exchanges. Second, Hamanaka was capable of speculating while claiming a position as a hedger because of the tremendous amounts of copper business conducted by the Sumitomo Corporation. Finally, the LME's failure to cooperate immediately with the CFTC when it alleged that there was a problem on the U.S. markets allowed Hamanaka to push prices to exorbitant levels.

One could argue that Sumitomo demonstrates the need to revamp the entire system to prevent a scandal in the physical commodity futures markets. Yasuo Hamanaka did, in fact, capture almost 93% of the physical supply of copper in addition to a dominant futures position on the LME, thereby causing prices to rise to extravagant levels.³⁵² Very few players in the futures markets, however, have enough time, capital, or creativity to implement a long market power manipulation of a physical commodity with any degree of success.³⁵³ Moreover, if the current regulatory structure is combined with more careful monitoring of those who fall under the hedging exemption, and increased cooperation among international regulatory authorities becomes a reality, futures markets are more likely to avoid detrimental situations like those witnessed in the Sumitomo scandal. Ultimately, in the futures market for physical commodities, if the LME had cooperated with the CFTC's investigation, the effect of

350. *See id.*

351. *See, e.g.,* Markham, *Unprosecutable Crime*, *supra* note 25, at 357 & n.505 (discussing the extensive time periods that typically are required to litigate charges of manipulation).

352. *See supra* notes 262-74 and accompanying text.

353. *See supra* note 270 and accompanying text.

Hamanaka's actions on world copper markets would not have been so disastrous.

Notes & Observations